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INSIDE THE SEC

Dialogue with the SEC's Director of Corporation Finance

By Michael A. Titera

At the American Bar Association Business Law Section Spring meeting in Los Angeles, California, on April 10-12, 2014, Keith Higgins, Director of the SEC Division of Corporation Finance, used the "dialogue with the director" program to deliver a speech regarding the SEC's efforts to reform the current disclosure regime. Mr. Higgins gave the customary disclaimer that he was sharing his personal views and not those of the Commissioners or other members of the SEC staff. Following his prepared remarks, Mr. Higgins answered questions on a number of topics.

SEC Review of Disclosure Regime

Mr. Higgins started by discussing the SEC staff's December 2013 report regarding Regulation S-K and the Commission's initiatives over the years to review and update the disclosure and registration requirements.[1] He described the report, which was mandated by Congress under the Jumpstart Our Business Startups (JOBS) Act, as "a springboard for further action." Mr. Higgins said "[o]ur goal is to review specific sections of Regulation S-K and S-X to determine if the requirements can be updated to reduce the costs and burdens on companies while continuing to provide material information and eliminate duplicative disclosures." In an effort to solicit the views of companies, investors, and other market participants, the SEC launched a spotlight page on *sec.gov* called "Disclosure Effectiveness," which the staff will continuously update with details about roundtables and other news.[2]

Regulation S-K

Mr. Higgins indicated that the Division will start its review of disclosure requirements by "focusing on the business and financial disclosures that flow into periodic and current reports, namely Forms 10-K, 10-Q and 8-K, and, in one way or another, make their way into transactional filings." The staff also will evaluate whether Industry Guides and form-specific disclosure requirements should be updated and perhaps codified in Regulation S-K, the SEC regulation specifying reporting requirements for various SEC filings made by public companies. In a later phase of the project, the staff will consider ways to update and modernize disclosures that form the basis for most proxy disclosure.

The staff will work to identify potentially outdated disclosure requirements, such as the

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ratio of earnings to fixed charges. The "one-size-fits-all" approach of this rule, according to Mr. Higgins, may result in disclosure that investors do not find useful and companies would not otherwise calculate. The staff also will look for rules requiring disclosure of information that investors routinely find using other sources, such as historical stock prices. In addition, the staff will identify where disclosure requirements result in redundancy or duplicative disclosures, such as rules originally created to address voids in GAAP requirements that have since closed.[3] Finally, the staff will evaluate whether the disclosure requirements might benefit from a broader principles-based approach, similar to the current rules for MD&A.

Regulation S-X

Mr. Higgins acknowledged that the application of the rules contained in Regulation S-X, the SEC regulation specifying the format and content requirements for financial statements filed with the SEC, which require the filing of separate financial statements for entities other than the registrant (such as acquired businesses, equity method investees, and guarantors), can be quite challenging and compliance can be costly. He said the staff will seek input on how investors use these separate financial statements in their decision-making, how costly it is for companies to obtain them and whether the benefits justify the challenges of presenting them.

He indicated that the staff's review of Regulation S-X also will focus on whether there are opportunities to align the reporting requirements of the Securities Act of 1933 and the Securities Exchange Act of 1934 in a way that will make it less burdensome for companies to access the markets without sacrificing investor protection. As an example of the difference between the two acts, Mr. Higgins pointed out that if there has been a change in accounting principles, Form S-3, which is a Securities Act form, requires recasted financial statements prepared in accordance with Regulation S-X before a registration statement is declared effective, but no such requirement applies to Exchange Act reports.

In addition, Mr. Higgins said the staff plans to explore ways to eliminate the overlap between the GAAP requirements in the footnotes to the financial statements and what the Commission's rules require.

How and When Information Is Disclosed

The staff's review will look for ways to harness technological advances to increase the level of efficiency with which investors can find information about a company. Mr. Higgins explained that the staff will explore whether the focus and navigability of disclosure documents can be improved by asking companies to use structured data, hyperlinks, and/or topical indexes. He encouraged the audience to use hyperlinks and topical indexes even in the absence of requirements imposed by the SEC.

Mr. Higgins said the staff will consider whether to recommend to the Commission a "company disclosure" or "core disclosure" system, where "certain information that does not change as frequently—such as the description of the business and certain other company information—would be disclosed in a 'core' document and then supplemented by periodic and current reports." He noted that despite the appeal of such a system, the staff must address a number of complex issues prior to implementation, such as the timing of required filings and the effect of the system on the liability scheme and the operation of disclosure controls and procedures, certifications and audits.

Company Efforts

Mr. Higgins encouraged companies to address the problem of disclosure overload and improve the focus and navigability of their disclosure documents even in the absence of rule changes. He provided three examples.

1. Reduce repetition. Pointing to the example of companies that include—verbatim—disclosure from their significant accounting policies footnote in their MD&A discussions of critical accounting estimates, Mr. Higgins asked drafters to think twice before repeating any disclosure. He said much of the repetition could be eliminated through cross references.

2. Focus your disclosure. Mr. Higgins identified the risk factor section as just one area where companies can make their disclosures less generic and more tailored. He also said that before including disclosure in response to staff comments issued to other registrants, a company needs to evaluate whether the disclosure actually is applicable.

3. Eliminate outdated information. Pointing out that disclosure should evolve over time, Mr. Higgins reminded the audience that "as unsettling as I am sure this can be for some, it is perfectly all right to remove disclosure when it is immaterial or outdated even if it was included in a prior filing in response to a staff comment."

The Review and Comment Process

Mr. Higgins said the staff is looking for ways it can improve its comment process to reduce unnecessary disclosure. For example, the staff recently revised its guidance to make clear that comments on critical accounting estimate disclosures for pre-IPO share-based compensation are intended to help the staff determine whether the accounting is accurate, and not for the purpose of requesting changes to disclosure in MD&A or elsewhere in the prospectus.[4] He also pointed out that just because the staff issues a comment, this does not mean that it has concluded the requested information is material. The staff comment is meant to be the beginning of a dialogue.

Q&A Session

Commission Rulemaking Priorities. At the beginning of the Q&A session, Mr. Higgins stated that finalization of the proposed pay ratio rules,[5] the Regulation A amendments (commonly referred to as "Reg A+"),[6] the crowdfunding rules,[7] and the supplemental general solicitation rules[8] are Chair White's top priorities.

Dodd-Frank Rulemaking. Mr. Higgins expects the pay ratio rule to be finalized this year and anticipates the issuance of proposed rules related to hedging policies, pay-for-performance and clawback policies this year.

Crowdfunding Proposal. Regarding the SEC's October 2013 crowdfunding proposal, Mr. Higgins indicated that the two main areas of concern for commenters are the $1 million funding limitation and the proposed audit requirements.

Reg A+ Proposal. Mr. Higgins remarked that state law preemption continues to be the most controversial aspect of the proposal. He noted that while the proposing release took the position that "it would be appropriate to preempt blue sky requirements with respect to all offerees in a Regulation A offering,"[9] the release also solicited comment on whether the coordinated review program proposed by the North American Securities Administrators Association (NASAA) would be a preferable method of regulation.[10] Mr. Higgins indicated that 48 of the 53 jurisdictions represented by NASAA support the proposed coordinated review program and that NASAA believes the program will work smoothly and would allow the designated lead examiners either to clear an offering or to comment on any deficiencies in the application within 21 business days after filing.[11]

13D Time Periods. The time periods required for filing Schedules 13D and subsequent amendments also were discussed in light of recent news stories about activist investors "tipping" other activist investors during the 10-day period before filing a Schedule 13D. The Dodd-Frank Act permits, but does not require, the SEC to change these time periods.[12] Mr. Higgins does not expect rulemaking in this area in the near term given the amount of mandatory rulemaking currently on the SEC's plate.

Regulation of Proxy Advisory Firms. Mr. Higgins explained that while the Division has not made specific recommendations to the Commission regarding the regulation of proxy advisory firms, the Division is sharing with the Commission guidance that clarifies the parameters of the existing regulations relevant to proxy advisory services. He also mentioned the December 2013 SEC roundtable regarding proxy advisory services, stating that the staff guidance and roundtable are initial steps in the process of determining whether rulemaking in this area would be helpful.[13]

Electronic Communications via Social Media. Mr. Higgins stated the Division's position that companies can satisfy the legend requirements of Rule 134 of the Securities Act of 1933 by including a hyperlink to the legend in circumstances where an electronic communication is made using a platform that limits the number of characters such that inclusion of the legend would be impossible. This position was first announced by Michele Anderson, Chief of the Division's Office of Mergers and Acquisitions, at the Corporate Law Institute at Tulane in March 2014 and, subsequent to Mr. Higgin's speech, was formalized in a Compliance & Disclosure Interpretation on April 21, 2014.[14]

Notes

1. *See* "Report on Review of Disclosure Requirements in Regulation S-K" (Dec. 2013), available at *http://www.sec.gov/news/studies/2013/reg-sk-disclosure-requirements-review.pdf*.

2. Available at *http://www.sec.gov/spotlight/disclosure-effectiveness.shtml*.

3. As an example, Mr. Higgins said one commenter indicated that the requirement to disclose certain off-balance sheet arrangements resulted from a void in GAAP at the time. *See* letter from Ernst & Young LLP available at *http://www.sec.gov/comments/jobs-title-i/reviewreg-sk/reviewreg-sk-3.pdf*.

4. *See* Division of Corporation Finance, Financial Reporting Manual, available at *http://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.pdf*, at Section 9520.2.

5. *See* SEC Release No. 33-9452, "Pay Ratio Disclosure," September 18, 2013, available at *http://www.sec.gov/rules/proposed/2013/33-9452.pdf*.

6. *See* SEC Release No. 33-9470, "Proposed Rule Amendments for Small and Additional Issues Exemptions Under Section 3(b) of the Securities Act," December 18, 2013, available at *http://www.sec.gov/rules/proposed/2013/33-9497.pdf.*

7. *See* SEC Release No. 33-9470, "Crowdfunding," October 23, 2013, available at *http://www.sec.gov/rules/proposed/2013/33-9470.pdf.*

8. *See* SEC Release No. 33-9416, "Amendments to Regulation D, Form D and Rule 156 under the Securities Act," July 10, 2013, available at *http://www.sec.gov/rules/proposed/2013/33-9416.pdf*.

9. SEC Release No. 33-9470, "Proposed Rule Amendments for Small and Additional Issues Exemptions Under Section 3(b) of the Securities Act," December 18, 2013, at 182, available at *http://www.sec.gov/rules/proposed/2013/33-9497.pdf.*

10. *See id.* at 184. *See generally* NASAA Release, dated October 30, 2013, Notice of Request for Public Comment: Proposed Coordinated Review Program for Section 3(b)(2) Offerings, available at *http://www.nasaa.org/27427/notice-request-public-comment-proposed-coordinated-review-program-section-3b2-offerings/*.

11. NASAA's coordinated review program was discussed in greater detail by Commissioner Luis Aguilar at the Annual NASAA/SEC 19(d) Conference three days prior to Mr. Higgin's speech. Commissioner Aguilar's speech is available here *http://www.sec.gov/News/Speech/Detail/Speech/1370541436767#.U1mQJvldXSg*.

12. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929R(a)(1)(A), 124 Stat. 1376, 1866 (July 21, 2010).

13. A webcast of the Proxy Advisory Services Roundtable, which was held on December 5, 2013, is available at *http://www.sec.gov/news/otherwebcasts/2013/proxy-advisory-services-roundtable-120513.shtml*.

14. SEC Division of Corporation Finance, Compliance & Disclosure Interpretations, Securities Act Rules (Interpretation #110.01) (April 21, 2014), available at *http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm#110-01*. Also note that Interpretation #110.02 addresses situations where an issuer distributes an electronic communication in compliance with Rule 134 or Rule 433 and the communication is subsequently re-transmitted by a third party (*e.g.*, "re-tweeted"). In such situations "[i]f the third party is neither an offering participant nor acting on behalf of the issuer or an offering participant and the issuer has no involvement in the third party's re-transmission beyond having initially prepared and distributed the communication in compliance with either Rule 134 or Rule 433, the re-transmission would not be attributable to the issuer."

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