Alerts

GT Insights for Public Companies
10.03.16

Experience: Corporate & Securities

View Media

SEC Enforcement and Litigation

SEC Brings Action Against General Counsel For Failure to Disclose and Accrue a Loss Contingency

The SEC recently brought an enforcement action against a company and its general counsel for failure to timely disclose, or record an accrual for, a loss contingency relating to an ongoing government investigation. Under GAAP, a public company must disclose a loss contingency when a material loss is reasonably possible. Furthermore, if the likelihood of material loss becomes probable, and if the loss is reasonably estimable, the company must then accrue for that loss.

In the action, the SEC alleges that the general counsel oversaw the company's response to the government investigation but failed to disclose material facts about the investigation to the company's chief executive officer, chief financial officer, Audit Committee and independent auditors. Those material facts included that:

- the company had sent the government agency an analysis estimating the amount at issue in the investigation,
- the company agreed to submit a settlement offer to the agency by a specific date, and
- prior to submitting the settlement offer, the company's estimate of the amount at issue had grown significantly.

The SEC alleged that, because the general counsel failed to disclose key facts regarding the investigation, the company had submitted multiple materially false and misleading filings to the SEC that did not disclose any information about the government investigation or any material weakness in the company's internal controls.

The SEC is seeking a judgment against the company and the general counsel providing for permanent injunctive relief and ordering them to pay disgorgement, interest and penalties.

https://www.sec.gov/litigation/litreleases/2016/lr23639.htm

Public Company Accounting

Too Close For Audit Comfort: SEC Announces First Enforcement Actions for Auditor Independence Failures due to Close Personal Relationships

On Sept. 19, 2016, the SEC announced that a national accounting firm, without admitting or denying the findings, agreed to pay $9.3 million to settle first-of-its-kind charges that two of its former audit partners had "close personal relationships" with public company clients in violation of auditor independence rules. In addition to violating Rule 2-02(b)(1) of Regulation S-X, the SEC found that the accounting firm caused the public companies involved to violate Section 13(a) of the Exchange Act and Rule 13a-1 thereunder.

The SEC alleged that the audit partner maintained an "inappropriate close personal relationship" with the chief financial officer of a public company client when, among other things, the partner and the chief financial officer overnighted at each other's homes and traveled together with their families on overnight trips that had no apparent business purpose. The partner also spent excessive amounts on frequent entertainment of the chief financial officer and his family. The SEC also alleged that certain accounting firm partners became aware of the excessive entertainment spending but took no action to confirm that the partner was complying with his independence obligations.

In a separate case, the SEC alleged that a different audit partner was romantically involved with the chief accounting officer of another public company client, while serving on the company's audit engagement team. Additionally, the SEC charged the coordinating partner on the engagement team, alleging that he was "aware of facts suggesting a possible romantic relationship" but failed to investigate or raise concerns.

"These are the first SEC enforcement actions for auditor independence failures due to close personal relationships between auditors and client personnel," said Andrew J. Ceresney, Director of the SEC's Division of Enforcement. The accounting firm "did not do enough to detect or prevent these partners from getting too close to their clients and compromising their roles as independent auditors."

In addition to the accounting firm, the three former audit partners and the chief accounting officer involved in the alleged violations each consented to the SEC's order, without admitting or denying the findings, and agreed to pay penalties. Each was suspended from practice before the SEC.

https://www.sec.gov/news/pressrelease/2016-187.html

SEC Regulation

SEC Provides Guidance on "Brokerage Windows" in 401(k) Plans

Current 401(k) plans often allow participants to purchase and sell securities, including issuer securities, on the open market through "brokerage windows". On Sept. 22, 2016, the SEC issued a CDI stating that the registration of these issuer securities will depend on the degree and type of participation of the issuer and its affiliates in the program. In the CDI, the SEC applied the same analysis used in Release 33-4790, which relates to the registration of open market employee stock purchase plans.

The new CDI provides that issuers will not be required to register issuer securities purchased or sold by plan participants with employee contributions in a self-directed "brokerage window" if the issuer and the 401(k) plan:

- do no more than:
  - describe the self-directed "brokerage window" as part of the investment alternatives under the 401(k) plan,
  - make payroll deductions,
  - pay administrative expenses not in any way tied to particular investments selected by employees, and
- take no action to draw employees' attention to the possibility of investing in employer securities through the "brokerage window."

https://www.sec.gov/divisions/corpfin/guidance/sasinterp.htm#139.33

SEC Extends Comment Period on Disclosure Update and Simplification Proposed Rules

On Sept. 23, 2016, the SEC extended the comment period on its proposed rules on Disclosure Update and Simplification (Release No. 33-10110; 34-78310) to allow additional time for "interested persons to analyze the issues and prepare their comments." The comment period will now end on Nov. 2, 2016.

In July 2016, the SEC proposed amendments to Reg. S-X, Reg. S-K, Reg. M-A, Reg. AB, Reg. C and various Securities Act forms as part of the SEC's ongoing Disclosure Effectiveness Initiative mandated by Congress under the JOBS Act of 2012. The proposed amendments are intended to modify or eliminate existing disclosure requirements that have become redundant, duplicative, overlapping, outdated or superseded, and include amendments such as removing the requirement in Item 201(a)(1) of Reg. S-K to provide the high and low sale prices for each quarter for the last 2 fiscal years and eliminating the disclosure of existing equity compensation plan information under Item 201(d) of Reg. S-K.

The SEC has also solicited comments on disclosure requirements that overlap with, but require information incremental to, the requirements of U.S. GAAP.

While most comments received to date addressed discrete issues or requested an extension of the comment period, the Council of Institutional Investors, or CII, submitted preliminary comments and expressed concern at the detailed, technical nature of the comments and the ability of investors to ascertain during the comment period whether the proposed changes will significantly impact the mix of information available to investors. The CII also questioned the use of resources by the SEC to finalize these rules when other projects remain incomplete (such as finalizing rules to implement remaining Dodd-Frank proposals).

https://www.sec.gov/rules/proposed/2016/33-10110.pdf

Corporate Governance

ISS Releases Results of 2017 Policy Survey

On Sept. 29, 2016, Institutional Shareholder Services, or ISS, released the results of its policy survey for the 2017 proxy season discussed in the last bi-weekly update. The following is a brief summary of the results:

- **Board Refreshment and Tenure**. Survey respondents were asked whether certain factors might have an impact on a board's refreshment and nominating process. A majority of investor respondents viewed the absence of recently-appointed independent directors unfavorably and lengthy average tenure as problematic, while only one-quarter of non-investor respondents viewed the absence of recently-appointed independent directors unfavorably. 68% of investor respondents considered a high proportion of directors with long tenure to be cause for concern, as compared to 31% of non-investor respondents.
- **Overboarding of Executive Chairs**. Survey respondents were asked whether non-CEO executive chairs should be subject to the same public company overboarding standard as non-executive directors (no more more than 5 boards) or the more restrictive CEO standard (no more than 3 boards). In response, 64% of investor respondents preferred the more restrictive CEO standard, while 36% preferred the non-executive director standard. Non-investor respondents went the other way, with 38% favoring the stricter standard and 62% favoring the less restrictive standard.
- **IPO Dual Class Structures**. Survey respondents were asked whether ISS should recommend voting against directors that, in connection with an IPO or in post-bankruptcy, approved multiple classes of stock that have different voting rights. For investor respondents, 57% supported ISS recommending against such directors and 19% opposed an against recommendation, while 24% opposed an against recommendation provided that the different voting rights were subject to a sunset provision. By comparison, of the non-investor respondents, 46% opposed the against recommendation regarding such directors, 24% supported such against recommendation and 31% opposed an against recommendation provided that the different voting rights were subject to a sunset provision.
- **Metrics to Evaluate Executive Compensation**. Survey respondents were asked whether ISS should consider other metrics in addition to total shareholder return to analyze the relationship between CEO pay and company performance. In response, 79% of investor and 68% of non-investor respondents supported the concept, 3% of investor and 11% of non-investor respondents opposed it, and 19% of investor and 21% non-investor respondents were neutral. Supportive and neutral investor respondents favored return on investment metrics (such as ROIC) and return metrics (such as ROA and ROE), while supportive and neutral non-investor respondents leaned toward earnings metrics (such as EPS or EBITDA).
- **Say-on-Frequency**. Survey respondents were asked whether "say-on-pay" votes should

be held every one, two, or three years, and whether certain factors should play a part in this frequency analysis. Of investor respondents, 66% favored annual say-on-pay votes, 11% favored a vote every two years and 7% preferred a vote every three years. 17% of investor respondents supported the company-specific recommendations, citing financial performance and the presence or absence of recent pay practices as important to the analysis. Non-investor respondents favored annual say-on-pay votes at 42%, with 7% and 19% favoring votes every two years and three years, respectively. 31% of non-investor respondents believed that vote frequency depends on factors specific to each company.

- **Cross-border Executive Pay**. Survey respondents were asked how ISS should evaluate situations where companies incorporated in one country but listed in another country face multiple say-on-pay votes due to the applicable legal requirements of different jurisdictions. Currently, ISS will evaluate each proposal under the policy of the country whose laws or listing rules require the proposal to be voted on, but will generally align its recommendations based on the policy perspective of the country in which the company is listed. In response, 65% of investor and 59% of non-investor respondents agreed that vote recommendations should be aligned so as to not produce inconsistent evaluations, while 27% of investor and 28% of non-investor respondents found opposing vote recommendations acceptable if each reflects the policy of the affected country.

ISS will issue draft policies for public comment in mid-November, with final policies being implemented on Feb. 1, 2017.

https://www.issgovernance.com/file/policy/2016-2017-iss-policy-survey-results-report.pdf

---

SEC Chair, Mary Jo White, on the Importance of Board Diversity and Possible Change in Board Diversity Disclosure

Throughout the year, Mary Jo White, Chair of the SEC, has spoken on the issue of greater diversity on company boards and more informative board diversity disclosures.

In her Sept. 25, 2016 article for *American Banker* entitled "*Board Diversity Is the Right Thing to Do,"* Chair White reinforced her position that companies are better served by increased diversity on company boards. In the article, Chair White cited several studies that have shown that diversity on boards is linked to better financial results for companies, and stated, based on her personal experience, that board diversity contributes to high-quality decision-making. Proactively embracing diversity, according to Chair White, is not just an easy business decision to make for companies, but also the right thing to do.

Chair White further added that the SEC Staff is currently preparing a recommendation to amend the current diversity disclosure rule to require more specificity, including information on the race, gender and ethnicity of board members and nominees.

http://www.americanbanker.com/bankthink/board-diversity-is-the-right-thing-to-do-sec-chair-mary-jo-white-1091580-1.html

SUBSCRIBE