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SEC Regulation

SEC Expands "Smaller Reporting Company" Eligibility

On June 28, 2018, the SEC adopted amendments to the definition of "smaller reporting company" that are "intended to reduce compliance costs for these registrants and promote capital formation, while maintaining appropriate investor protections." Specifically, a company can now claim to be a "smaller reporting company" if the company (1) has a "public float" of less than $250 million (an increase from $75 million), calculated as of the last day of its most recently completed second fiscal quarter; or (2) has less than $100 million in annual revenue (an increase from $50 million) and either has no public float or a public float of less than $700 million.

Smaller reporting companies may provide scaled disclosures under SEC rules, including producing two, instead of three years of audited financial statements and omitting certain disclosures relating to executive compensation and CEO pay ratio. The amendments provide a way for companies to phase in and out of smaller reporting company status upon falling below one or both of the thresholds described above. Specifically, a company exits smaller reporting company status because it either has public float greater than $250 million or public float and revenues greater than $700 million and $100 million, respectively. Once the company loses smaller reporting company status, it can re-enter smaller reporting company status if its public float falls below $200 million or if its public float and revenues fall below the $560 million and $80 million thresholds, respectively.

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The amendments did not change the current thresholds contained in the definitions of "accelerated filer" and "large accelerated filer" under the Exchange Act. Accordingly, companies with $75 million or more of public float that qualify as smaller reporting companies under the new rules will remain subject to the requirements that apply to accelerated filers. As an accelerated filer, even a smaller reporting company will be required to provide to auditor's attention management's assessment of internal control per financial reporting required by Section 404(b) of the Sarbanes-Oxley Act. However, during the meeting at which the new rules were adopted, Chairman Jay Clayton directed the SEC staff to recommend possible additional changes to the "accelerated filer" definition that, if adopted, would reduce the number of companies that qualify as accelerated filers.

The final rule will become effective 60 days after official publication in the Federal Register.

The cover pages for SEC filings including the cover page to the Forms 10-K and 10-Q have been revised to reject the changes to the definition of smaller reporting person.

SEC Proposes Amendments to Whistleblower Rules

On June 28, 2018, the Securities and Exchange Commission announced proposed amendments to the rules governing its whistleblower program which are open to public comment for 60 days. Current rules require that the Commission pay out 10 percent to 30 percent of the money collected to a whistleblower if the whistleblower's information is original and leads to successful enforcement actions by the Commission resulting in monetary sanctions over $1 million. The Commission credited the original information provided by whistleblowers as having led to enforcement actions in which the Commission has ordered over $1.4 billion in remedies, including more than $740 million in disgorgement of ill-gotten gains and interest.

The Commission has proposed amendments to the whistleblower rules to:

- provide the Commission with additional tools in making whistleblower awards to ensure that meritorious whistleblowers are appropriately rewarded for their efforts as follows:
  - The Commission will have discretion to make award payments to whistleblowers based on money collected as a result of deferred prosecution agreements and non-prosecution agreements, as well as settlement agreements entered into by the Commission outside of the context of a judicial or administrative proceeding.
  - The Commission will have discretion to adjust a whistleblower's award upward when the potential award would yield a payout of less than $2 million to the whistleblower.
  - The Commission will have discretion to reduce the award percentage (subject to the 10 percent statutory minimum) with respect to actions that yield collected monetary sanctions of at least $100 million. However, in no event would the award be adjusted below $30 million.
  - To eliminate potential double recovery, the proposed amendment would clarify that a law-enforcement or separate regulatory action does not qualify as a "related action" if the Commission determines there is a separate whistleblower award scheme that more appropriately applies to the enforcement action.
  - The Commission is soliciting public comment on whether it should establish a discretionary award mechanism for enforcement actions that result in total monetary sanctions of less than $1 million or are based on publicly available information, or where the monetary sanctions collected are de minimis.
- increase efficiencies in the whistleblower claims review process as follows:
  - The Commission proposes to clarify its ability to bar individuals from submitting whistleblower award applications if they have submitted false information to the Commission and have made repeated frivolous award claims in Commission actions. The

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proposed rule will also permanently bar individuals who abuse the process and submit three frivolous award applications.
    - The proposed rule will provide a summary disposition procedure for certain types of likely denials, including untimely award applications.

- clarify the requirements for anti-retaliation protection under the whistleblower statute as follows:
    - In February 2018, the Supreme Court held that whistleblower protection extends only to employees that have reported a possible securities law violation to the Commission. The proposed rule would also clarify that whistleblower protection extends to any employee reporting information about possible securities laws violations to the Commission "in writing," regardless of whether the employee submitted a whistleblower tip to the SEC Whistleblower Office using Form TCR.

In addition to its proposed rule amendments, the Commission proposed interpretive guidance that, to qualify as "independent analysis," a whistleblower's submission must provide evaluation, assessment, or insight beyond what would be reasonably apparent to the Commission from publicly available information.

"Whistleblowers have made significant contributions to the SEC's enforcement efforts, and the value of our whistleblower program is clear," said SEC Chairman Jay Clayton. "The proposed rules are intended to help strengthen the whistleblower program by bolstering the Commission's ability to more appropriately and expeditiously reward those who provide critical information that leads to successful enforcement actions. I look forward to public feedback and encourage everyone with an interest to give us their ideas on the proposed rules."

SEC Adopts Inline XBRL for Tagged Financial Data

The SEC voted on June 28th to adopt amendments to eXtensible Business Reporting Language (XBRL) requirements for operating companies and funds. The amendments, which will go into effect in phases, require the use of Inline XBRL for financial statement information and risk/return summaries. The SEC began mandating the use of XBRL disclosure technology in 2009, requiring companies to provide their financial statements to the Commission and on their corporate websites in interactive data format. The interactive data, under the 2009 rule, must be provided as an exhibit to periodic and current reports and registration statements. The June 2018 amendments aim to improve the quality and accessibility of XBRL data while also decreasing, over time, the cost of preparing disclosure information for submission to the SEC.

Inline XBRL involves embedding XBRL data directly into the filing, ensuring that the disclosure documents are both human-readable and computer-readable. This will allow investors to view the XBRL data together with the text of the documents. Accordingly, Inline XBRL technology is expected to reduce the likelihood of inconsistencies between HTML and XBRL filings. Additionally, for fund investors, risk/return summary XBRL data will become available more quickly given the elimination of the 15 business-day filing period.

Although the amendments modify the existing XBRL requirements, they do not change the categories of filers or the scope of disclosures that are subject to XBRL requirements. The amendments also eliminate the requirement for operating companies and funds to post XBRL data on their websites upon the effective date of the amendment.

Operating companies that are currently required to submit financial statement information in XBRL will be required, on a phased basis, to transition to Inline XBRL:

- large accelerated filers that use U.S. GAAP will be required to comply beginning with fiscal periods ending on or after June 15, 2019;

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- accelerated filers that use U.S. GAAP will be required to comply beginning with fiscal periods ending on or after June 15, 2020; and
- all other filers will be required to comply beginning with fiscal periods ending on or after June 15, 2021.

Filers will be required to comply beginning with their first Form 10-Q filed for a fiscal period ending on or after the applicable compliance date.

Funds that are also currently required to submit risk/return summary information in XBRL will similarly be required to transition to Inline XBRL:

- large fund groups (net assets of $1 billion or more as of the end of their most recent fiscal year) will be required to comply two years after the effective date of the amendments; and
- all other funds will be required to comply three years after the effective date of the amendments.

The cover pages for SEC filings including the cover page to the Forms 10-K and 10-Q have been revised to reject the changes relating to Inline XBRL data.

SEC Division of Corporation Finance Director Speaks on Cybersecurity

At the PCAOB Standing Advisory Group meeting held from June 5-6, 2018, SEC Division of Corporation Finance Director Bill Hinman spoke about cybersecurity disclosure issues on the heels of the SEC's Feb. 21, 2018 interpretive guidance on the subject. See this GT Insights Article for a brief discussion of that guidance. Director Hinman noted that in designing effective disclosure controls, companies should ensure that the right procedures are in place so that cyber incidents are escalated to the appropriate members of the disclosure team, such as the general counsel, and not just IT personnel. That way, he noted, the appropriate disclosure team can assess the materiality of the incident and potential disclosure requirements. He also pointed to the existing requirement to disclose the board's oversight of risk management areas, noting that the staff would be reviewing companies' disclosures in this area this year and, would expect to see appropriate disclosure if a company has material cybersecurity risk.

Director Hinman also noted that a company should consider a prophylactic policy that would prohibit insiders and individuals with knowledge of a cyber incident from trading in the company's securities if such an incident occurs, or at a minimum, while the company determines whether the event is material. Recognizing that companies might find it difficult to assess the materiality of a cyber incident, particularly if the company experiences frequent incidents, Director Hinman stated that companies should at least consider closing the trading window if it finds there is a reasonable chance an incident may be material.

SEC Comments on Revenue Recognition Disclosure

The new revenue recognition rules went into effect for most companies when they filed their first quarter Form 10-Qs in 2018. Accordingly, the SEC issued revenue recognition comments to companies related to their Forms 10-Qs and Forms S-1.

Of the published comment letters, the Staff asked companies to:

- detail how the adoption of revenue recognition impacted: accounting for grant awards;

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- clarify the nature of the following: variable consideration included in contracts, when payments are due from customers on contracts, payment terms and any related financing component in customer contracts;
- disclose considerations which further explain how the adoption of revenue recognition did not result in significant changes to the timing or nature of revenue recognition; and
- disclose whether the company actually adopted revenue recognition.

First Universal Proxy Card Used in U.S. Company Proxy Contest

In September 2016, the SEC issued proposed rules that would require parties engaged in a proxy contest to use a single proxy card allowing shareholders to vote among the company nominees and dissident shareholder nominees in whatever combination they prefer. No final rules have been issued, and until now, no U.S. public company had voluntarily adopted a universal proxy card. In May 2018, a U.S.-based public company which was engaged in a high-profile proxy contest with an activist shareholder adopted a universal proxy card, according to a press release and the form of proxy card attached to its proxy statement filed with the SEC. The company increased its board size from five to seven and recommended that its shareholders vote in favor of each of its five incumbent directors and two of the activist shareholder's independent director nominees, using the company's universal proxy card which lists both the company's and the shareholder's nominees. In a June 2018 company filing, the company complained that the activist shareholder was attempting to manipulate the outcome of the election by encouraging shareholders in private meetings to vote for some of the shareholder's nominees on the company's proxy card and others on the shareholder's proxy card, effectively giving the shareholder control of the board. In its defense, the company noted that it had support of both ISS and Glass Lewis that the activist shareholder obtain only a minority representation on the board. The voting results from the annual meeting were not favorable to company and, according to its June 2018 filing, the company announced a settlement agreement it reached with the activist shareholder pursuant to which the board would be comprised of five of the shareholder's nominees and three of the company's nominees.

SEC Enforcement

Sharp Decline in SEC Enforcement Actions Against Public Companies in First Half of FY 2018

The number of SEC enforcement actions against public companies and their subsidiaries continued to decline through the first half of the 2018 fiscal year. According to a report released in May by the NYU Pollack Center for Law & Business and Cornerstone Research, the rules and SEC enforcement actions for the first half of FY 2018 is the lowest semiannual total since the first half of FY 2013 with the SEC filing only 15 enforcement actions. This represents a 67 percent decrease from the 45 filed in the first half in FY 2017. This decline in enforcement actions reflects a continuation in the recent trend of significantly lowered SEC enforcement activity, given that the SEC filed only 17 actions in the second half of FY 2017.

The SEC targeted a narrow range of industries in these 15 actions. Ten of the 15 public company enforcement actions involved companies in the finance, insurance, and real estate industries. Five of these actions were against companies in industries involving commercial banks, a notable concentration following the SEC's announced focus on the "main street investor." The most common actions against defendants were issuer reporting disclosures (in 27 percent of cases) and advisor/investment companies

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(also 27 percent). There were also two enforcement actions with FCPA allegations, which is fewer than the first half of the FY 2010-2017 semiannual average of nearly 5.6 actions.

Both the total and average monetary settlements declined in the first half of FY 2018. Total monetary settlements declined to $65 million. The average settlement was only $4.3 million, significantly lower than the next-lowest semiannual average of $13.3 million in the second half of FY 2015. The largest settlement was $14 million, imposed on three subsidiary defendants.

Litigation

Supreme Court Rules Staff-Picked ALJs Unconstitutionally Appointed

On June 21, the Supreme Court ruled that administrative law judges ("ALJs") at federal agencies are "Officers of the United States" who must be appointed by the president, courts, or department heads pursuant to the Constitution's Appointments Clause. The Court held that SEC proceedings led by ALJs violate the Appointments Clause because the ALJs are appointed by staff employees. The Supreme Court's decision suggests that only those who challenged the constitutionality of the ALJ in their proceeding in a timely manner will be entitled to relief. Thus, the decision does not affect settled actions (which are not brought before ALJs) or decided cases where the litigant failed to challenge the constitutionality of the ALJ in a timely manner.

The Delaware Court of Chancery Provides Guidance on When Claims Involving Misconduct by a Controlling Stockholder Survive a Merger

In a recent opinion that provides guidance on the difference between direct and derivative claims, the Delaware Court of Chancery held that when a controlling stockholder uses its voting power to approve a transaction while extracting special benefits for itself in advance of a merger transaction, the resulting claims: (a) belong directly to the minority stockholders; and, accordingly (b) survive closing of the merger.

The case involved the sale of a company that was subject to a significant fine by the federal government. The company's asset pool included an indemnification right for the amount of that fine, but the indemnitor was an entity owned by the company's controlling stockholder. A special committee of the board believed that it would be unable to adequately monetize the indemnification right in a sale of the company, and was therefore considering placing that asset into a litigation trust for the benefit of the stockholders. When the company's controlling stockholder learned of that proposal, however, he caused the company to transfer the indemnification asset to one of his affiliates for a "manifestly unfair" amount.

After the company was sold, more than $600 million of the sale consideration was diverted to pay the government fine, but the company received only a small fraction of that amount from the controller in exchange for releasing the indemnification claim. The company's stockholders brought a direct claim against the controller (and others) for breach of fiduciary duties in connection with that payment.

The controller moved to dismiss, arguing that the claim was derivative because a claim that the controller did not pay enough for the release caused injury to the company – not the stockholders. The Court disagreed, rejecting that argument and holding that: (a) the claim was direct because the transfer of the of the indemnification asset to the controller prior to the sale of the company was "sufficiently intertwined" with the sale to state a claim that the sale itself was rendered unfair; and (b) the claim therefore survived the resulting merger.

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