

Good Corporate Hygiene: Still a Focus? Getting Back to the Basics

Part 2 of 2 of the Good Corporate Hygiene Series

October 21, 2021

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Earnings Announcements

Earnings Releases

- Key compliance considerations for the earnings release and call:
 - Section 10(b) and Rule 10b-5, which prohibit material misstatements or omissions
 - Compliance with SEC non-GAAP measure rules
 - Compliance with SEC guidance concerning key performance indicators (KPIs)
 - Regulation FD
 - Compliance with Item 2.02 of Form 8-K
 - Protecting forward-looking statements

Earnings Release Content

- Striking the right balance between providing too much detail versus providing sufficient information that is useful for analysts and investors, while avoiding misstatements or omissions
- Leveraging the company's supplemental data, such as monthly operating information
- Considering the usefulness of non-GAAP measures and KPIs
- Relationship between the information provided in the earnings release and information that is covered on the earnings call
- Competitive considerations: what are your peers doing?
- Consistency with other communications made by company representatives

The SEC's Historic Views

- In the course of reviewing periodic filings, the SEC Staff has been increasingly focused on information communicated in earnings releases and earnings calls
- Consistency of disclosure in filings versus those made elsewhere
 - Disclosure must be consistent across the various means for communications
 - Companies' use of social media is a particular area of concern for the Staff
- Non-GAAP financial measures and operating metrics or KPIs

COVID-19 and Earnings Releases

- Companies should address the impact of COVID-19 in earnings releases to the extent material and be prepared to answer related questions on their earnings calls
- Even after a year and a half, it may still be difficult for companies to assess or predict with precision the broad and changing effects of COVID-19
- The actual impact of the continuing pandemic may depend on many factors beyond a company's control and knowledge, which may make it more challenging to be comfortable with the disclosures being made

Non-GAAP Financial Measures

Non-GAAP Financial Measure Basics

- A non-GAAP financial measure is a numerical measure of historical or future performance, financial position, or cash flows that either:
 - Excludes (or adjusts) amounts included in the most comparable GAAP measure; or
 - Includes (or adjusts) amounts excluded from the most comparable GAAP measure
- Item 10 of Regulation S-K
 - Applies only to non-GAAP financial measures in SEC-filed documents
 - Requires reconciliation to most comparable GAAP measure, which must receive equal or greater prominence
- Regulation G
 - Applies to all public disclosures that contain non-GAAP financial measures, including press releases, investor presentations, and conference calls
 - Requires prominence for, and reconciliation to, most comparable GAAP measure
 - For oral public disclosure, an issuer may post the reconciliation simultaneously to its website and announce the location to investors

Examples of Inherently Misleading Non-GAAP Measures

- **Question 100.01** – A performance measure that excludes normal, recurring, cash operating expenses
- **Question 100.02** – A non-GAAP measure that adjusts a particular charge or gain in the current period when other, similar charges or gains were not also adjusted in prior periods
- **Question 100.03** – A non-GAAP measure that is adjusted only for nonrecurring charges when there were nonrecurring gains that occurred during the same period
- **Question 100.04** – A non-GAAP revenue measure that backs out the effect of GAAP revenue recognition and measurement principles

Equal or Greater Prominence

- **Question 102.10** – Examples of non-GAAP presentations that fail to give “equal or greater prominence” to the comparable GAAP measure include:
 - Omitting comparable GAAP measures from an earnings release headline or caption that includes non-GAAP measures
 - Presenting a non-GAAP measure using a style of presentation (e.g., bold, larger font) that emphasizes the non-GAAP measure over the comparable GAAP measure
 - A non-GAAP measure that precedes the most directly comparable GAAP measure (including in an earnings release headline or caption)
 - Describing a non-GAAP measure as, for example, “record performance” or “exceptional” without a prominent characterization of the comparable GAAP measure
 - Providing tabular disclosure of non-GAAP financial measures without including the comparable GAAP measures in the same or a prior table

Frequent Non-GAAP Staff Comments

- Reasons for non-GAAP measures
 - Additional details about usefulness and uses of non-GAAP measures
 - No boilerplate
- Non-GAAP financial measure titles
 - Titles may not accurately reflect amounts reported
 - Confusingly similar (or the same as) GAAP measures or common accepted non-GAAP measures (e.g., free cash flow, EBIT, EBITDA)
- Reconciliation to most directly comparable GAAP measure
 - Reconciling to wrong GAAP measure
- Characterization of adjustments
 - Whether characterization of adjustments as “nonrecurring,” “unusual” or “infrequent” is consistent with Item 10(e)(1)(ii)(B)

Frequent Non-GAAP Staff Comments *(cont'd)*

- How is an adjustment calculated?
- Why is an adjustment appropriate?
- Explain nature of a COVID-19 adjustment
- Individually tailored recognition and measurement methods may run afoul of C&DI 100.04
- SEC may require a revised presentation to omit an adjustment

COVID-19 Non-GAAP Financial Measures

- Issuers may want to present non-GAAP financial results measures to explain the consequences of the COVID-19 pandemic
- SEC has addressed in Disclosure Guidance: Topic No. 9 that companies should use non-GAAP financial measures for the purpose of sharing how management and the board of directors are analyzing the current and potential impact of COVID-19 and not for the purpose of presenting a more favorable view of the company
- Consider whether previous COVID-19 financial measures remain appropriate

Key Performance Indicators

SEC Guidance on KPIs

- The SEC issued guidance relating to the use of KPIs in MD&A
- The guidance is similar in principle to the guidance that the SEC and SEC Staff have provided regarding the use of non-GAAP measures
- An issuer that uses KPIs in the MD&A should consider whether additional disclosures are needed in order to make sure that the use of metrics is not misleading
 - Defining the metric
 - Explaining how the metric is calculated
 - Disclosing any assumptions or estimates underlying the metric
 - Explaining any changes to the KPI, when it was made, why it was made, etc.
 - Explaining how the management uses the metric

SEC Guidance on KPIs *(cont'd)*

- If KPIs are disclosed in earnings releases or investor presentations, the presumption is that they should be included in MD&A
- Companies also should consider
 - Whether they use metrics that are well understood or whether their metrics are highly customized,
 - What the metrics seek to measure or illustrate, and
 - Whether they have a documented process for calculating the metric
- Certifying officers and the audit committee would want to consider whether there are appropriate controls in place relating to the metric
- In light of the pandemic, an issuer may want to present an adjusted performance metric, which will require additional vetting by management and the audit committee, as well as discussions with counsel

Staff KPI Comments

- Earnings call presentation and slide deck contain KPIs not presented and discussed in filed report
 - Discuss how the KPIs are derived, how the company uses them, and why they changed period-over-period
 - Represent the KPIs will be included in future filings or explain to staff where these disclosures are made or explain why such disclosure is not warranted
- Reconcile disclosures that indicate there are multiple KPIs and disclosure of a sole KPI

Regulation FD

Regulation FD – Background

- Regulation FD (for “Fair Disclosure”) was adopted to address the problem of selective disclosure of material information by companies, in which “a privileged few gain an informational edge – and the ability to use that edge to profit – from their superior access to corporate insiders, rather than from their skill, acumen, or diligence”
- The **primary goal** of Regulation FD is to allow all investors to have equal access to a company’s material disclosures at the same time
- Regulation FD fundamentally reshaped the ways in which public companies conducted conference calls, group investor meetings and “one-on-one” meetings with analysts and investors

Basic Rule

- **What does Regulation FD actually require?**
 - ***Whenever***
 - A public company, or any person acting on its behalf
 - Discloses material non-public information (“MNPI”) to certain enumerated persons
 - ***then***
 - The company must disclose that information, either
 - Simultaneously (in the case of intentional disclosures), or
 - Promptly (in the case of unintentional disclosures)
 - Using a reasonable method of broad public disclosure

Scope of Regulation FD

- What is “non-public information”?
 - Information is considered “non-public” until it has been disseminated in a manner making it available to investors generally
 - For information to be made public, “it must be disseminated in a manner calculated to reach the securities marketplace in general through **recognized channels of distribution**, and public investors must be afforded a **reasonable waiting period** to react to the information”
- Regulation FD does not call for specific subject matter; instead, if a company provides MNPI to someone, the company generally must provide that information to everyone

Scope of Regulation FD *(cont'd)*

- **“Simultaneous” Public Disclosure for Intentional Selective Disclosures**
 - Selective disclosure is “intentional” when the individual making the disclosure knows, or is reckless in not knowing, that the information they are communicating is both material and non-public
 - Thus, even unplanned, off-the-cuff remarks that include information that the speaker knows to be, or is reckless in not knowing is, material and non-public to select analysts is an intentional selective disclosure
 - Absent advance preparation to enable simultaneous public disclosure, it is very difficult for a company to avoid a violation of Regulation FD for unplanned intentional selective disclosures

Scope of Regulation FD *(cont'd)*

- **“Prompt” Public Disclosure for Unintentional Selective Disclosures**
 - Selective disclosure is “unintentional” when the individual making the disclosure did not know, and was not reckless in not knowing, that the information they were communicating was both material and non-public
 - Regulation FD defines “promptly” as “as soon as reasonably practicable” but in no event after the later of:
 - 24 hours, or
 - The start of the next day’s trading on the NYSE, in both cases after a senior company official learns of the disclosure

Form 8-K Considerations

Item 2.02 of Form 8-K

- Item 2.02 of Form 8-K generally requires disclosure of MNPI regarding the results of operations or financial condition for a completed quarterly or annual fiscal period
 - Earnings releases are furnished under Item 2.02
- There is a conditional exemption for further Form 8-K filings in the case of disclosure of MNPI that is disclosed orally, telephonically, by webcast, by broadcast, or by similar means

Item 2.02 Conditions for Earnings Call Exemption

- The information is provided as part of a presentation that is complementary to, and initially occurs within 48 hours after, an earnings release previously furnished in an Item 2.02 of Form 8-K
- The presentation is broadly accessible to the public by dial-in conference call, by webcast, by broadcast, or by similar means
- The financial and other statistical information is provided on the company's website, together with any information that would be required under Regulation FD, and
- The presentation was announced by a widely-disseminated press release, with instructions as to when and how to access the presentation and the location on the company's website where the information would be available

Advance Notice of Earnings Call

- C&DI 102.01 specifies that adequate advance notice under Regulation FD must include the date, time, subject matter, and call-in information for the conference call with consideration given to specified non-exclusive factors
- Reasonable period of time ahead of the conference call
 - For example, for a quarterly earnings announcement that the issuer makes on a regular basis, notice of several days would be reasonable
- If a transcript or replay of the conference call will be available afterwards, the SEC Staff encouraged companies to indicate in the notice how, and for how long, such a record will be available

Additional Form 8-K If Conditions Not Met

- C&DI 106.02 indicates that if the earnings release cannot be furnished on a Form 8-K before the earnings are released, the company must furnish the material, previously non-public, financial and other statistical information required to be furnished on Item 2.02 of Form 8-K as an exhibit to a Form 8-K and satisfy the other requirements of Item 2.02 of Form 8-K
 - A transcript of the portion of the conference call or slides or a similar presentation including such information will satisfy this requirement
 - In each case, all material, previously undisclosed, financial and other statistical information, including that provided in connection with any questions and answers, must be provided

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Forward-Looking Statements Safe Harbor

Forward-Looking Statements

- The Private Securities Litigation Reform Act of 1995 (“PSLRA”) includes a safe harbor for forward-looking statements
- Important to understand the parameters of the safe harbor, which would apply in an action brought under the Securities Act or Exchange Act based on an untrue statement of a material fact or omission of a material fact necessary to make the statement not misleading, for the issuer and certain other persons for forward-looking statements **IF**
 - The statement is identified as forward-looking and is accompanied by meaningful cautionary statements identifying the facts that could cause results to differ materially from those in the forward-looking statement, or
 - The statement is immaterial

Forward-Looking Statements *(cont'd)*

- What is a forward-looking statement?
 - It will depend on the context and the facts and circumstances, but would include projections of future performance, plans for future operations, assumptions regarding the projections and plans
 - Language that suggests that the statement is forward-looking—like “we expect,” “we believe,” “we intend,” etc.
- Is that statement accompanied by meaningful cautionary language?
 - Helpful to identify the particular risks associated with the statement
 - “Substantive” statements that are tailored to the projections, estimates, opinions
 - Not boilerplate
 - To the extent that the language warns against something that already has happened, the warning would be inadequate
 - Was there actual knowledge that the statement was misleading or that the risks described already had manifested?

Forward-Looking Statements *(cont'd)*

- In preparing for earnings releases and SEC filings, companies should consider:
 - Updating their forward-looking statements disclosure
 - Ensuring that their risk factors are updated
 - Not referencing an occurrence in a risk factor as a hypothetical if the event has actually come to pass
 - Eliminating boilerplate disclaimers and disclosures regarding trends since these are unlikely to reflect current events
 - Reviewing carefully with counsel all forward-looking and trend disclosure in order to vet the cautionary language

Best Practices for Earnings Announcements

Best Practices

Design procedures to satisfactorily affect *broad, non-exclusionary distribution of information to the public*

- **SEC expressly approved the following procedures:**
 - “First, issue a press release, distributed through regular channels, containing the material information
 - Second, provide adequate notice, by a press release and/or website posting, of a scheduled conference call to discuss the material information, giving investors both the time and date of the conference call, and instructions on how to access the call
 - Third, hold the conference call in an open manner, permitting investors to listen in either by telephonic means or through Internet web casting”
- **Providing Earnings Guidance**
 - SEC has paid particular attention to the practice of providing guidance (and subsequent confirmation of guidance) to analysts
 - Companies take on a “high degree of risk under Regulation FD” when engaging in private discussions with analysts seeking guidance or affirmation of prior guidance

Best Practices *(cont'd)*

Dealing with Analysts

- ***No earnings guidance without simultaneous public disclosure.*** Do not give earnings guidance (or other material guidance) to analysts one-on-one, unless the same guidance is announced simultaneously to the public
- ***Affirmation of prior guidance without simultaneous public disclosure has serious risks***
 - Reiterating guidance may have the same effect as providing guidance originally – provides MNPI to analyst
 - SEC will interpret broadly language that may be deemed to confirm guidance
- Many companies elect not to discuss guidance outside of methods that fall within the definition of “public disclosure” and observe strict “no comment” policies regarding confirmation of guidance
- Many companies also impose “quiet periods” until earnings are released

Division of Enforcement EPS Initiative

SEC Division of Enforcement EPS Initiative

- SEC Division of Enforcement has touted its EPS Initiative as one of its accomplishments as an example of its investment in efforts to identify potential misconduct
- The EPS Initiative uses risk-based data analytics to uncover accounting and disclosure violations caused by earnings management practices to mask unexpectedly weak performance
- Investigations in this area have given rise to enforcement proceedings and well-publicized settlements involving both companies and executives
- The Division of Enforcement leverages internal data analysis tools to identify violations, including evidence of earnings management and other accounting or disclosure improprieties

EPS Initiative Fact Patterns

- Unsupported, manual accounting adjustments that were not compliant with GAAP, boosting income to consistently report earnings that met or exceeded consensus estimates
- Public filings including a valuation allowance that was at odds with the valuation methodology described in the same filings and a belated reversal of the valuation allowance, increasing its EPS when it otherwise would have fallen short of consensus estimates
- Failure to record loss contingencies related to litigation settlements as required by GAAP despite mounting evidence that such liability was probable and reasonably estimable, while misleading investors by reporting inflated net income and consistent EPS growth

Penalties for EPS Violations

- Cease and desist orders
- Civil penalties for **companies**:
 - \$5 million
 - \$6 million
 - \$1.5 million
- Civil penalties for **officers**:
 - \$70,000
 - \$50,000
 - \$45,000
 - \$10,000
- Adverse publicity and reputational harm

Materiality and When an Issuer Has a Duty to Disclose

Materiality

- Information is material if there is substantial likelihood that a reasonable investor would consider it important in making an investment decision
- “Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by a reasonable investor as having significantly altered the ‘total mix’ of the information available”
- The concept of whether a fact is material or not is a mixed question of law and fact, and the SEC has noted that the issuer is in the best position to know what is likely to be material to investors
- Materiality is often judged with the benefit of hindsight, and the SEC has often looked to trading volume and price movements as evidence of materiality
- Material information need not be disclosed currently unless there is a specific event or circumstance that affirmatively triggers a disclosure duty

When is an Update Required?

- A complete failure to speak (an omission) is a violation of Rule 10b-5 **only if there is a duty to speak**
 - “A corporation is not required to disclose a fact merely because a reasonable investor would very much like to know that fact. Rather, an omission is actionable under the securities laws, only when the corporation is subject to a duty to disclose the omitted facts.” *In re Time Warner, 1993*
- **No obligation under the securities laws to make a disclosure immediately or by a certain date, unless**
 - A specific SEC rule requires that disclosure be made by a certain date
 - A “half-truth” is uttered and disclosure of the additional information is necessary in order to make the statement not misleading
 - Disclosure is required by a duty to update a prior affirmative statement that is no longer accurate
 - Disclosure is required by a duty to correct a statement that was untrue when made

Duty to Disclose – The Court’s View

- *Richman v. Goldman Sachs Group, Inc., et al.*, 10 Civ 3461 (June 21, 2012, United States District Court for the Southern District of New York)
- Under the federal securities laws, there is no general obligation for issuers to disclose material information; rather, issuers are required to do so only where the federal securities laws specifically impose such a duty
- “[W]hen a corporation chooses to speak—even where it lacks a duty to speak—it has a ‘duty to be both accurate and complete’”
- “[A] corporation is not required to disclose a fact merely because a reasonable investor would very much like to know that fact”

Duty to Disclose – CorpFin’s View

- “We also understand that materiality is not an easily applied litmus test. If there [are] any gray areas — and as disclosure lawyers I would suspect that you more frequently see shades of gray, rather than black and white — the company is likely to include the disclosure in its filing. And why wouldn’t you? Why would you take the risk of omitting disclosure that might be material? But are too many items in the obviously immaterial category being included?”

“Disclosure Effectiveness: Remarks Before the American Bar Association Business Law Section Spring Meeting” – Keith F. Higgins, Director, Division of Corporation Finance, April 11, 2014

Timing of Disclosures

- Companies regularly should consider:
 - The pattern of disclosures that they have established
 - Whether, at the time it is releasing “good” news, the company has “bad” news – or the so-called “bad news doctrine”
 - Timing disclosures in proximity to offerings
 - The effect of the timing of disclosures on other matters, such as the company’s blackout periods/trading windows, as well as other planned actions, such as any proposed redemption or repurchases of securities

Related Person Transactions

SEC Related Person Transactions— Transaction Disclosure Requirements

- Item 404(a) of Regulation S-K—Disclosure of transactions with related persons
 - Threshold value —exceeding \$120,000
 - Company is a participant and any related person has a direct or indirect material interest
 - Related person includes directors and nominees, executive officers, immediate family members and 5+% shareholders
 - Special rules for indebtedness, employment arrangements and compensation
 - Carve outs for interests based on outside directorships and/or less than 10% equity interests
 - Carve outs for certain specific types of transactions

SEC Related Person Transactions— Approval Policy Disclosure Requirements

- Item 404(b) of Regulation S-K—Disclosure of approval policy
- Describe policies and procedures for the review, approval, or ratification of related person transactions required to be disclosed
 - Types of transactions covered
 - Standards to be applied
 - Persons or groups of persons on board or otherwise responsible for applying policies and procedures
 - Whether policies and procedures are in writing
- Identify reportable transactions that did not require approval or where policies and procedures were not followed

Recent NYSE Change

- NYSE amended Section 314 of its Listed Company Manual to require that the audit committee or another independent body of the board of directors conduct a reasonable *prior* review and oversight of all related party transactions
- For the purposes of the amended NYSE rule, the term "related party transaction" expressly refers to transactions required to be disclosed pursuant to Item 404 of Regulation S-K, or, in the case of foreign private issuers, to transactions required to be disclosed pursuant to Form 20-F, Item 7.B
 - Initially NYSE rule required the oversight of related party transactions without applying the transaction value threshold of Item 404 of Regulation S-K or the materiality threshold of Item 7.B of Form 20-F, but it reversed that position

Due Diligence Procedures

- Questions on annual D&O questionnaires
- Internal searches of payments
- Tracking family members and entities
- Self-reporting of transactions
- Regular board committee agenda items
- Code of conduct provisions
- Ongoing training and education
- Updating related person policies

Updating Governance Documents

Governance Documents

- Certificate of Incorporation
- By-laws
- Board committee charters
 - Committees required by stock exchanges
 - Additional committees desired by board
- Governance guidelines
- Code of conduct/ethics

Review and Update of Governance Documents

- Certificate of Incorporation—less frequently since board and shareholder approval required
- By-laws—generally as needed for a corporate matter
- Committee charters—typically specify annual/regular evaluation by board or committee
- Governance guidelines—frequently included in the same review cycle as committee charters
- Website posting requirements
- Maintain and follow a corporate calendar for review and update (even if no changes are recommended)

Considerations for Updating Governance Document

- Change in SEC regulations
- Change in listing standards
- Investor and/or proxy advisory firm input
- Stakeholder input
- Board or committee initiated practices
- Evolving market/peer practices

Risk Assessments and Disclosures

Risk Factors

- SEC Increased Attention to Risk Factor Disclosures
 - Recent Rulemaking
 - Market Trends
 - Staff Comments
 - Enforcement Focus
 - Guidance

Amendments to Regulation S-K Item 105

- Summary required if the Risk Factors section exceeds 15 pages
 - 2 pages or less
 - In the “forepart” of the annual report or prospectus
- Standard changed from “most significant” to “material” risks
- Organize logically under relevant headings
 - Subcaption describing the risk still required
- Generic risk factors are discouraged and, if presented, must be placed at the end, under the caption “General Risk Factors”



Risk Factor Topic Trends

- COVID-19
- Brexit
- LIBOR cessation
- Cybersecurity
- China-based issuers

SEC Staff Comments: COVID-19

- At the beginning of the pandemic, many companies addressed their risk factor disclosures by including a generic pandemic-related risk. As time has passed, the expectation is that an issuer will update specific, tailored risks

Sample SEC comment

We note your disclosure that the extent to which your operations may be impacted by the COVID-19 pandemic will depend largely on future developments, which are highly uncertain and cannot be accurately predicted, including new information that may emerge concerning the severity of the outbreak and actions by government authorities to contain the outbreak or treat its impact. Please amend your risk-factor disclosure to provide more detailed risks related to the COVID-19 pandemic, tailored to your specific facts and circumstances. For guidance, see CF Disclosure Guidance: Topic No. 9 (25 March 2020)

- Review existing risk factors, and consider whether these should be revised to address events that already have come to pass, and to address new risks that have been identified as the pandemic has become more prolonged and its effects more wide-reaching
- Consider the impact of COVID-19 as it relates to all risks

SEC Staff Comments: Climate Change

- Division of Corporation Finance Sample Letter

Sample SEC Comment

Disclose the material effects of transition risks related to climate change that may affect your business, financial condition, and results of operations, such as policy and regulatory changes that could impose operational and compliance burdens, market trends that may alter business opportunities, credit risks, or technological changes.

- Re-read the 2010 Commission Guidance Regarding Disclosure Related to Climate Change and consider whether revised or enhanced disclosure is required
- Evaluate disclosure controls and procedures with respect to climate change

SEC Enforcement

- Climate and ESG Task Force
 - “The initial focus will be to identify any material gaps or misstatements in issuers’ disclosure of climate risks under existing rules.”
- Cyber Unit
 - “The Cyber Unit will focus the Enforcement Division’s substantial cyber-related expertise on targeting cyber-related misconduct...”

SEC Enforcement *(cont.)*

- Pearson plc, a London-based educational publishing and services company, learned of a cyber breach in March 2019.
- The company's July 2019 semi-annual report on Form 6-K filed with the SEC contained the same risk factor disclosure as the prior report, describing a hypothetical risk of a data breach:
 - "Risk of a data privacy incident or other failure to comply with data privacy regulations and standards and/or a weakness in information security, including a failure to prevent or detect a malicious attack on our systems, could result in a major data privacy or confidentiality breach causing damage to the customer experience and our reputational damage, a breach of regulations and financial loss."
- SEC found the company made misleading statements and omissions about the data breach.

SEC Guidance

- 2010 Commission Guidance Regarding Disclosure Related to Climate Change
 - specific risks faced as a result of climate change legislation or regulation
 - business trends: legal, technological, political and scientific developments regarding climate change
 - indirect risk from climate change impact on a registrant’s reputation
- 2018 Commission Statement and Guidance on Public Company Cybersecurity Disclosures
 - provides a list of issues to consider when drafting cybersecurity risk factor disclosure
 - “In meeting their disclosure obligations, companies may need to disclose previous or ongoing cybersecurity incidents or other past events in order to place discussions of these risks in the appropriate context.”

Disclosure Controls and Procedures and Internal Controls Over Financial Reporting



Disclosure Controls and Procedures

- Applicable Rules
- SEC Guidance
- Practice Tips
- Enforcement Focus

Disclosure Controls and Procedures: Rules

- Exchange Act Rules 13a-15 and 15d-15 require a company's principal executive officer and principal financial officer to make certifications regarding the maintenance and effectiveness of disclosure controls and procedures. The rules define "disclosure controls and procedures" as controls and procedures designed to ensure that information required to be disclosed by the company in its Exchange Act reports is (1) "recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms," and (2) "accumulated and communicated to the company's management ... as appropriate to allow timely decisions regarding required disclosure."

Disclosure Controls and Procedures: SEC Guidance

- “When KPIs and metrics are material to an investment or voting decision, the company should consider whether it has effective controls and procedures in place to process information related to the disclosure of such items to ensure consistency as well as accuracy.”
 - Commission Guidance on Management’s Discussion and Analysis of Financial Condition and Results of Operation, Release Nos. 33-10751; 34-88094; FR-87 (Feb. 25, 2020).
- A company’s disclosure controls and procedures should not be limited to disclosure specifically required, but should also ensure timely collection and evaluation of “information potentially subject to [required] disclosure,” “information that is relevant to an assessment of the need to disclose developments and risks that pertain to the [company’s] businesses,” and “information that must be evaluated in the context of the disclosure requirement of Exchange Act Rule 12b-20.”
 - Certification of Disclosure in Companies’ Quarterly and Annual Reports, Release No. 33-8124 (Aug. 28, 2002).

Disclosure Controls and Procedures: Practice Tips

- Policy
 - Even if the policy is drafted comprehensively to focus on process, substance should be given consideration, as well.
 - Remember that DCP apply to metrics, KPI, and non-GAAP
- Establish a disclosure committee with a clearly defined role
- Build out a timetable to filing and stick to it
- Be prepared for situations where something may be considered material in hindsight

Disclosure Controls and Procedures: SEC Enforcement

- Pearson settlement also found the company had inadequate disclosure controls and procedures.
- SEC order emphasizes that although protecting customer data was critical to Pearson's business, and that Pearson had identified the risk for unauthorized access to this data as significant, Pearson failed to "maintain disclosure controls and procedures designed to analyze or assess such incidents for potential disclosure in the company's filings."



Internal Controls Over Financial Reporting

- Applicable Rules
- Enforcement Focus

Internal Controls over Financial Reporting

- Sarbanes-Oxley Act of 2002 Section 404
- 404(a) Rules Required -- The Commission shall prescribe rules requiring each annual report required by section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)) to contain an internal control report, which shall —
 - (1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and
 - (2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.
- 404(b) Internal Control Evaluation and Reporting -- With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. Any such attestation shall not be the subject of a separate engagement.

Internal Controls over Financial Reporting *(cont.)*

- Andeavor LLC entered into a Rule 10b5-1 plan to repurchase shares while the CEO had plans to discuss a potential merger with another company
- SEC found trading while in possession of MNPI, but no charges of insider trading
- SEC order found that the company failed “to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurance that stock buyback transactions were executed in accordance with management’s authorization.”
 - “abbreviated and informal process”

Human Capital

Human Capital

- Current Regulation S-K Disclosure Requirement
 - Principles-based
 - Qualified by materiality
- Disclosure Trends
 - Workers' health and safety, diversity and inclusion, recruitment, training, number of employees
- Expected Rulemaking
 - Prescriptive
 - Turnover rates, part-time vs. full-time employees

Shareholder Engagement



Shareholder Engagement

- ESG Surveys and Reporting
- Proxy Disclosure of Shareholder Communications
- Shareholder Proposals
- Regulation FD

Additional Resources

Read:

- [SEC Approves Nasdaq Board Diversity Rule](#)
- [The US Moving Toward Adopting New Climate Disclosures](#) (Harvard Law School Forum on Corporate Governance)
- [SEC Acting Chair Directs Staff to Enhance Focus on Climate-Related Disclosure](#)
- [SEC Division of Corporation Finance Publishes Disclosure Considerations for China-based Issuers](#)
- [SEC Amends Shareholder Proposal Rule](#)

Watch:

-  [MB Microtalk: Regulation FD](#)



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