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ALERT MEMORANDUM

SEC Sanctions ADT Over Non-GAAP Financial Measures in Earnings Releases

January 9, 2019

On December 26, 2018, the SEC announced settled charges against ADT Inc. after finding that ADT, in two earnings releases, gave undue emphasis to non-GAAP adjusted EBITDA figures because they identified the relevant GAAP measures only later and much less prominently.[1] Without admitting or denying the SEC's factual or legal claims, ADT agreed to an administrative settlement finding violations of Section 13(a) of the Securities Exchange Act of 1934 and Rule 13a-11 thereunder, relating to the requirements of Item 10(e) of Regulation S-K that an issuer present "with equal or greater prominence . . . the most directly comparable financial . . . measures" calculated under GAAP when it includes non-GAAP financial measures in filings and certain other reports to the Commission.

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[1] *See* https://www.sec.gov/litigation/admin/2018/34-84956.pdf.

This is just the second enforcement action concerning non-GAAP disclosures that the SEC has brought against an issuer in the two-and-a-half years since the issuance of Staff guidance on non-GAAP disclosure requirements,[2] and it is the first during SEC Chair Jay Clayton's tenure. It also is the first action related to non-GAAP disclosures finding a violation of only Section 13(a) of the Exchange Act without an accompanying finding that the disclosure in question constituted a material misstatement or omission.

The SEC's Division of Corporation Finance often allows issuers an opportunity to correct what SEC Staff may view as deficient disclosure.[3] The legal violations here appear easily established by the conduct set forth in the Commission's findings, which might explain why this matter resolved as an enforcement case. In any event, what is crystal clear after this settlement is that recent Staff commentary suggesting Staff satisfaction with compliance in this area[4] does not mean that the SEC will shy away from using the enforcement mechanism in appropriate cases.

Background

In 2003, the SEC adopted new rules and amendments to prior regulations focused on the use of non-GAAP financial measures. The SEC expressed concern that non-GAAP measures could mislead investors by obscuring GAAP results, which can more readily be compared with results from other reporting periods or other companies. In 2016, Chair Mary Jo White publicly questioned the extensive use of non-GAAP measures, saying that they had "become the key message to investors, crowding out and effectively supplanting" GAAP measures.[5] Around this same time, SEC Staff released new guidance on non-GAAP disclosures, in the form of revised Compliance and Disclosure Interpretations ("C&DIs"). The C&DIs clarified several situations that would violate Item 10(e)'s "equal or greater prominence" requirement, including presenting a non-GAAP measure in larger font than the comparable GAAP measure, listing a non-GAAP measure before the comparable GAAP measure, or describing a non-GAAP measure without "an equally prominent descriptive characterization" of the comparable GAAP measure.[6]

The Commission's enforcement activity since the May 2016 C&DIs, however, has been limited. In that timeframe, the SEC had, prior to the ADT action, initiated only one enforcement action against an issuer and one against two senior members of management (but not against the issuer) for violations of non-GAAP disclosure requirements. Both of those actions — a complaint filed in federal district court in September 2016 against the senior management personnel (which ultimately settled)[7] and a settled action in January

[2] A third action was brought by the SEC in federal district court in September 2016 against two former accounting executives at American Realty Capital Properties (now known as VEREIT Inc.), but not against the company itself, alleging that use of non-GAAP financial measures not only violated Section 13(a) of the Exchange Act but also Section 10(b) as well.

[3] In the first nine months of 2018, the SEC issued 382 comment letters concerning non-GAAP disclosures. *See* Audit Analytics, *A Look at Top SEC Comment Letter Issues in 2018* (Dec. 4, 2018), https://www.auditanalytics.com/blog/a-look-at-top-sec-comment-letter-issues-in-2018/.

[4] *See* Steve Burkholder, *Effort to Curb Non-GAAP Reporting a Success: SEC Accountants*, Bloomberg Law (May 4, 2017), https://news.bloomberglaw.com/securities-law/effort-to-curb-non-gaap-reporting-a-success-sec-accountants (quoting Mark Kronforst, then-Chief Accountant in the Division of Corporation Finance: "I think [the SEC's crackdown on non-GAAP disclosures] was a success.").

[5] Mary Jo White, *Focusing the Lens of Disclosure to Set the Path Forward on Board Diversity, Non-GAAP, and Sustainability* (June 27, 2016), *available at* https://www.sec.gov/news/speech/chair-white-icgn-speech.html#_ftnref39.

[6] *See* Non-GAAP Financial Measures: Questions and Answers of General Applicability (last updated Apr. 4, 2018), *available at* https://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm.

[7] *See* Final Judgment as to Defendant Brian S. Block, *SEC v. Block & McAlister*, No. 16-cv-7003-LGS (S.D.N.Y. Feb. 8,

2017, approved at the very end of Chair White's tenure[8]—are distinguishable from the ADT action because each involved allegations that the violations of the SEC's non-GAAP disclosure requirements also were material misstatements or omissions.

The ADT Case

In this action, the SEC found that on two occasions ADT announced non-GAAP financial measures without giving "equal or greater prominence" to the "most directly comparable" GAAP measures. Specifically:

- In the headline of its FY 2017 earnings release, ADT announced that adjusted EBITDA—a non-GAAP financial measure—was up 8%, without also mentioning net income or loss (the comparable GAAP measure) in the same headline.
- In its Q1 2018 earnings release, ADT presented adjusted EBITDA figures in the headline and noted that adjusted EBITDA was up 7% as well. It also discussed adjusted EBITDA, adjusted net income, and adjusted net income per share—all non-GAAP measures—in a bulleted list of "HIGHLIGHTS." Only later in the release did ADT report its net loss under GAAP. ADT's net loss increased by approximately 11%, in contrast to the 7% increase in adjusted EBITDA announced in the headline.

In both releases, ADT included the "comparable GAAP financial measure."[9] However, the Commission found that ADT did not afford "equal or greater prominence" to the GAAP figures because it placed them later in the releases and did not reference them in the headlines.

In addition to entering a cease-and-desist order, the Commission levied a $100,000 civil penalty against ADT.

Takeaways

It remains to be seen whether this action reflects a renewed enforcement focus on non-GAAP financial measure reporting, but the law in this area is clear. An issuer that announces non-GAAP financial measures should ensure equal or greater prominence for GAAP measures. Moreover, the SEC under Chair Clayton has now shown that in appropriate circumstances it will use an enforcement remedy to vindicate the equal or greater prominence requirement. Issuers should therefore consider carefully anything that could be construed as downplaying GAAP measures—for example, by placing GAAP measures after non-GAAP measures in the same announcement while at the same time including the non-GAAP measure rather than the corresponding GAAP measure in the headline or in the highlights, especially when the non-GAAP measure reflects a positive change when the most closely comparable GAAP measure does not.

This action is most directly relevant to earnings releases of U.S. issuers, which must be furnished to the

2018), *available at* https://www.sec.gov/files/Judg17-cv-07003Block.pdf; Final Judgment as to Defendant Lisa Pavelka McAlister, *SEC v. Block & McAlister*, No. 16-cv-7003-LGS (S.D.N.Y. Jan 11, 2018), *available at* https://www.sec.gov/files/Judg16-cv-07003McAlister.pdf; *see also* Press Release, SEC, Executives Charged With Inflating Performance of Real Estate Investment Trust (Sept. 8, 2016), https://www.sec.gov/news/pressrelease/2016-180.html.

[8] *See* MDC Partners Inc., Securities Act Release No. 10283, Exchange Act Release No. 79823, Accounting and Auditing Enforcement Release No. 3849, Administrative Proceedings File No. 3-17795 (Jan. 18, 2017), *available at* https://www.sec.gov/litigation/admin/2017/33-10283.pdf (instituting cease-and-desist proceedings and levying a $1.5 million civil penalty against MDC Partners, Inc. in part for noncompliance with Item 10(e) of Regulation S-K and including a Securities Act Section 17(a)(2) violation).

[9] *See* Press Release, ADT Inc., ADT Reports First Quarter 2018 Results (May 9, 2018), https://investor.adt.com/press-releases/press-release-details/2018/ADT-Reports-First-Quarter-2018-Results/default.aspx; Press Release, ADT Inc., ADT Reports Fourth Quarter and Full Year 2017 Results (Mar. 15, 2018), https://investor.adt.com/press-releases/press-release-details/2018/ADT-Reports-Fourth-Quarter-and-Full-Year-2017-Results/default.aspx.

Commission pursuant to Form 8-K. Foreign private issuers are not subject to the 8-K requirement, so their earnings releases are not subject to the "equal or greater prominence" requirement under Item 10(e) of Regulation S-K unless the earnings release is incorporated in an SEC filing (other than on Form 6-K). They should, however, take note too, because they must comply with Item 10(e) in some circumstances—for example, in an annual report on Form 20-F or in disclosures that are incorporated by reference into a registration statement.[10]

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[10] The less demanding disclosure requirements for non-GAAP measures under Regulation G, which do not include the "equal or greater prominence" requirement, have an exemption that is typically available for an earnings release of a foreign private issuer listed outside the United States that does not report under U.S. GAAP. However, many foreign private issuers seek to comply with these requirements even when they are not required to do so.

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