U.S. Regulation of the International Securities and Derivatives Markets, § 4.01, INTRODUCTION

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 4.01 (11th and 12th Editions 2014-2017)
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p. 4-7

This chapter describes the circumstances requiring the registration of securities in the United States under the Securities Act and the Exchange Act, disclosure requirements applicable to foreign issuers that have registered their securities under the Securities Act or the Exchange Act and considerations for such public companies communicating with their investors and financial analysts in the United States. The Securities Act provides a statutory framework for the disclosures an issuer must make to conduct a public offering in the United States, while the Exchange Act provides a framework for the disclosures an issuer must make in connection with both (i) an initial registration of securities that are listed on a national (U.S.) securities exchange or of equity securities that are otherwise publicly held, [1] and (ii) periodic reports following initial registration. After discussing registration and the disclosure regime for a public company, the final section of this chapter summarizes the process for subsequently delisting and deregistering securities in the United States.

Both acts provide that the SEC specify the detailed disclosure requirements through its rules. In fact, the disclosure requirements set out in those rules under the Securities Act and the Exchange Act are currently largely identical. [2]

p. 4-7

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p. 4-8

Foreign issuers file Form 20-F, which contains detailed disclosure requirements for foreign companies, with the SEC both for an initial registration of a class of securities under the Exchange Act and for annual reports filed under the Exchange Act. Form 20-F is also the source of disclosure requirements for registration statements filed by foreign issuers under the Securities Act to register public offerings of securities. Following an issuer's initial registration, an issuer can generally conduct a public offering of securities with a Securities Act registration statement that "incorporates by reference" the required information from previously filed Exchange Act reports. [3] This feature of the integrated disclosure regime reduces the size of the prospectus in a registration statement under the Securities Act and the time necessary for its preparation.

Footnotes

1 Section 12(b) of the Exchange Act requires registration of securities listed on a national (U.S.) securities exchange. Under § 12(g) of the Exchange Act, foreign issuers must register a class of equity securities if the issuer has total assets exceeding $10,000,000 and that class of securities is held of record by (i) 2,000 or more worldwide holders (or, for an issuer that is not a bank, a bank holding company or a savings and loan holding company, 500 or more worldwide holders who are not "accredited investors") and (ii) 300 or more U.S. holders. *See* Rule 12g3-2(a) under the Exchange Act (exempting from registration foreign issuers with fewer than 300 U.S. holders, based on the exemptive authority granted to the SEC under § 12(g)(3) of the Exchange Act); *see also* Rule 12g5-1 under the Exchange Act (defining securities "held of record" for purposes of § 12(g) of the Exchange Act); Rule 501(a) under the Securities Act (defining "accredited investors" as used in Regulation D).

2 Originally, the disclosure required under the Securities Act was not the same as the disclosure required under the Exchange Act, and the two regimes were administered separately. Beginning in the early 1980s,

however, the SEC developed the view that the information necessary for investors purchasing in a distribution should be the same as the information necessary for investors to make informed secondary market trading decisions (which was the primary rationale for imposing periodic reporting in the Exchange Act). This recognition led to two important developments. First, the accounting and disclosure requirements for a public offering were made substantially identical to the accounting and disclosure requirements for registration of a class of securities under the Exchange Act or for periodic reporting thereunder. *See* SEC Release No. 33-6437 (Nov.19, 1982). In 2008, the SEC eliminated one lingering inconsistency in the accounting requirements for financial statements, as described in § 4.05[3]. Second, an integrated disclosure system was developed, an important consequence of which was shelf registration and later automatic shelf registration.

Although registration and periodic reporting under the Exchange Act now require disclosures similar to those required under the Securities Act, some differences remain. For example, the requirements in § 404 of the Sarbanes-Oxley Act— *i.e.*, to maintain internal control over financial reporting and for management to provide an annual assessment of the effectiveness of internal control over financial reporting—are only required in annual reports. *See* § 5.03[5]. Certain other disclosure requirements under the Sarbanes-Oxley Act—the auditor attestation requirement, disclosures on audit committee financial experts, codes of ethics, etc.—also are only required in annual reports. *See* § 5.03[5] for discussion of these requirements.

Another example is the conflict minerals and mine safety disclosures required under the Dodd-Frank Act, which are only required in periodic reports. *See* § 4.08.

3 §§ 13(a) and 15(d) of the Exchange Act. *See* § 3.02[1][b] for a discussion of the Securities Act registration statement forms.

U.S. Regulation of the International Securities and Derivatives Markets, § 4.02, EVENTS REQUIRING REGISTRATION, AND THE RESULTING PUBLIC DISCLOSURE OBLIGATIONS

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 4.02 (11th and 12th Editions 2014-2017)
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[1] Public Offering in the United States

Any foreign issuer conducting a public offering in the United States must register the securities being offered under the Securities Act, unless an exemption from registration is available. If the securities will also be listed on an exchange or, in the case of equity securities, if the issuer meets certain size and shareholder levels, the issuer must also register those securities under the Exchange Act pursuant to §§ 12(b) and 12(g) thereof. If the securities are registered under § 12 of the Exchange Act or offered pursuant to a registration statement that became effective under the Securities Act, the issuer generally becomes subject to periodic and supplementary reporting obligations under the Exchange Act.

[2] Securities Act Registration Statements and Resulting 15(d) Registration

Although securities sold in a public offering in the United States would need to be registered under the Securities Act, they would not necessarily need to be registered under the Exchange Act. For example, if an issuer (whether U.S.

p. 4-9

or foreign) publicly offers debt securities in the United States without a U.S. listing, or a foreign issuer publicly offers equity securities in the United States without a listing or quotation on the OTC Bulletin Board and after the offering there are fewer than 300 U.S. holders, no Exchange Act registration is necessary. [4] However, as a result of having a registration statement (for debt or equity securities) declared effective under the Securities Act, § 15(d) of the Exchange Act requires an issuer to file with the SEC the same periodic reports under the Exchange Act for the fiscal year in which the Securities Act registration statement became effective (assuming securities were sold thereunder) and for any subsequent year in which there are 300 or more U.S. holders of record [5] of the class of securities as it would have had to file if the class had been registered under the Exchange Act. [6] If the securities are held of record by less than 300 persons on a worldwide basis or less than 300 persons resident in the United States

p. 4-9
p. 4-10

(for debt or equity securities), or if the trading volume in the United States is 5% or less of its worldwide trading volume during a recent 12-month period (for equity securities), then a foreign private issuer may terminate its Exchange Act periodic reporting obligations by filing a certification on Form 15F with the SEC and satisfying all the other conditions under Rule 12h-6, which include a one-year reporting history and the filing of at least one annual report. [7]

[3] Exchange Act Registration

[a] Requirements

[i] *Listed Securities*

Any issuer (either U.S. or foreign) that has a class of securities listed on a U.S. securities exchange must register that class under the Exchange Act. [8] This requirement applies whether or not there has been a public offering of the securities in the United States. Thus, a foreign issuer wishing to diversify its shareholder base by listing a class of its outstanding securities on the NYSE or Nasdaq must register that class of securities under the Exchange Act.

The registration requirement for securities listed on an exchange applies to both debt and equity. Thus, U.S.-listed bonds issued by a foreign government, as well as U.S.-listed shares or debt securities issued by a foreign company, are all required to be registered. Listing ADRs on an exchange requires registration of the underlying ordinary shares or other underlying securities. Since Exchange Act registration is necessary before the securities begin trading, registration is coordinated with the approval of listing by the pertinent exchange and, in the case of a U.S. public offering, with the registration process under the Securities Act.

A registration statement filed under the Exchange Act in connection with a listing becomes effective 30 days after the SEC receives the exchange's certification of its approval, but the SEC staff can and generally will accelerate the effective date if there are no unusual disclosure issues. [9] There is no material difference between the disclosure about the company and its affairs required in an

p. 4-10

p. 4-11

Exchange Act registration statement for debt securities and that required for equity securities.

[ii] *A Class of Widely Held Equity Securities*

Registration under the Exchange Act may also be required, regardless of whether the issuer seeks an exchange listing, if the issuer meets certain size and shareholder levels. If a U.S. company other than a bank, a bank holding company or a savings and loan holding company has $10 million or more in assets on the last day of its most recent fiscal year, it must register any class of equity securities if it is held of record by either 2,000 or more persons or by 500 or more persons that are not accredited investors. [10] An issuer that is required to register a widely held class of unlisted equity securities must file an Exchange Act registration statement within 120 days after the end of the fiscal year in which it exceeded the thresholds for the number of shareholders and total assets. The registration statement becomes effective 60 days after filing unless the SEC accelerates the effective date. [11]

The rules for foreign private issuers are somewhat different. As a general rule, a foreign issuer meeting the minimum asset requirement must register any class of equity securities if it is held of record by 2,000 or more persons worldwide, including 300 or more persons resident in the United States. [12] However, the securities are exempt from registration if the issuer is eligible for an exemption pursuant to Rule 12g3-2(b) under the Exchange Act. [13]

[iii] *Succession*

Subject to certain exceptions, under Rule 12g-3 under the Exchange Act, if a class of securities of an issuer that is not already registered pursuant to § 12 of

p. 4-11

p. 4-12

the Exchange Act is issued, in connection with a succession [14] by merger, consolidation, exchange of securities, acquisition of assets or otherwise, to the holders of any class of securities of another issuer that is so registered, then the class of securities of the successor issuer will be deemed to be registered under the Exchange Act. [15] Such securities will not be deemed to be registered, however, if, upon consummation of the succession (i) the class of securities issued by the successor issuer is exempt from Exchange Act registration requirements other than by Rule 12g3-2, (ii) all securities of such class are held of record by fewer than 300 persons worldwide or (iii) the successor issuer is a Canadian corporation meeting certain additional requirements.

Unless one of the exceptions applies, the successor issuer must file with the SEC an annual report on behalf of the acquired company, covering the acquired company's last full fiscal year before the succession occurred, containing information that would have been required if filed by the acquired company, unless that annual report has already been filed. The filing must take place, in the case of a foreign issuer, within four months of the end of the fiscal year for which it is required. [16] In addition, the successor issuer will be required to file with the SEC annual reports in respect of its own business "for each fiscal year beginning on or after the date as of which the succession occurred." [17] In the interim, before filing its first annual report on Form 20-F, the issuer's shares can

p. 4-12

p. 4-13

be listed and traded on a national securities exchange or traded on the OTC Bulletin Board. A previously non-reporting acquiror may avail itself of the successor provisions to start a trading market for its securities in the United States even if there is a lapse of time before it must file its first annual report.

Rule 12h-6(d) under the Exchange Act, adopted in 2007, enabled a non-Exchange Act reporting foreign private issuer that acquires a reporting foreign private issuer in a transaction exempt under the Securities Act, for example, under Rule 802 [18] or § 3(a)(10) of the Securities Act, to qualify immediately for termination of its Exchange Act reporting obligations under Rule 12h-6, without having to file an Exchange Act annual report, as long as the successor issuer meets the Rule's foreign listing, dormancy and quantitative benchmark conditions, and the acquired company's reporting history fulfills Rule 12h-6's prior reporting condition. [19] However, if a previously non-Exchange Act reporting foreign private issuer acquires an Exchange Act reporting company by consummating an exchange offer, merger or other business combination registered under the Securities Act, most likely through use of a Form F-4 registration statement, the acquiror would have to fulfill Rule 12h-6's prior reporting condition without reference to the acquired company's reporting history. [20]

[iv] *Rule 12g3-2(b) Exemption*

As discussed in § 3.04, a foreign issuer that has sponsored an American Depositary Receipt ("ADR") program with respect to its outstanding shares but has not obtained a U.S. exchange listing can qualify for an exemption under Rule 12g3-2(b). [21] Since in such a case the issuer has taken steps to promote trading of its securities in the United States, it seems reasonable to require the issuer either to register the securities or to have an exemption. But what many foreign issuers fail to realize is that, as discussed in § 4.02[3][a][ii], the registration provisions of the Exchange Act apply by their terms whether or not a foreign issuer has taken any action to cause or increase the trading of its securities in the United States. Thus, if there are 300 or more holders of record in the United States of any class of equity securities that is issued by any foreign issuer and held of

p. 4-13

p. 4-14

record worldwide by at least 2,000 persons, and the issuer otherwise meets the asset test described above, it technically must either register that class or be eligible for the exemption provided by Rule 12g3-2(b). [22] If required to register, it must file an Exchange Act registration statement within 120 days after the end of the fiscal year in which it exceeded the thresholds for assets and numbers of shareholders described above. [23]

Under Rule 12g3-2(b), as amended in 2008, a foreign company is automatically exempt from the registration requirement of § 12(g) if:

- it has no active Exchange Act reporting obligations under § 13(a) or § 15(d) (this means essentially that the foreign issuer has not listed or publicly offered securities in the United States);
- it maintains a listing of its shares [24] on one or more non-U.S. exchanges that are its "primary trading market"; [25] and
- it publishes on its website, [26] in English, the material information [27] that it makes public in its home

country, files with the principal exchange(s) in its

p. 4-14

p. 4-15

primary trading market or distributes to its securityholders. [28] To be eligible for the exemption initially, the foreign company must have already electronically published on its website in English all of the relevant documents [29] that it has published, filed or distributed since the beginning of its most recent fiscal year. Thereafter, the English documents must be published promptly [30] after publication or distribution in the home market.

Information electronically published by a foreign issuer on its website pursuant to Rule 12g3-2(b) is not considered to be filed with the SEC for the purposes of § 18 of the Exchange Act and is not otherwise subject to the liabilities imposed by that section. [31] Furthermore, obtaining an exemption and publishing information on a website pursuant to Rule 12g3-2(b) does not cause a foreign company to become an issuer subject to the Sarbanes-Oxley Act.

The SEC's rules only allow a depositary bank to establish an unrestricted ADR facility for a foreign issuer if either the issuer of the underlying shares is a reporting company under the Exchange Act, or the shares are exempt from registration under Rule 12g3-2(b). [32] The 2008 amendments to Rule 12g3-2(b) eliminated requirements for issuers to apply for the exemption and to submit documents to the SEC. This extended the exemption to vast numbers of foreign companies, increasing the number of foreign companies whose shares would be eligible for ADR facilities. While this made it easier for foreign companies to establish "sponsored" ADR facilities pursuant to an agreement between a foreign company and a depositary bank, it also made it easier for banks to establish "unsponsored" ADR facilities without such an agreement, because foreign companies' consent or cooperation is no longer necessary to allow banks to establish

p. 4-15

p. 4-16

unsponsored ADR facilities. Such depositary banks can simply establish an unsponsored ADR facility based on their reasonable, good faith belief, after exercising reasonable diligence, that a foreign company complies with Rule 12g3-2(b). [33] Many new unsponsored ADR facilities have been set up since the effectiveness of the amendments.

Foreign companies also may seek to ensure that they benefit from the Rule 12g3-2(b) exemption to avoid the information-furnishing requirements of Rule 144A under the Securities Act. [34]

The exemption under Rule 12g3-2(b) is available to a foreign company until it either (i) fails to make required publications, (ii) fails to maintain a listing of its shares on its primary trading market or (iii) registers a class of securities under § 12 or otherwise incurs reporting obligations under § 15(d) of the Exchange Act. [35] The SEC has not provided any cure period for foreign companies that fail to make required publications in order to maintain their eligibility for the exemption. Difficulties with the SEC arose in the past where a foreign issuer that exceeded the registration threshold allowed the exemption to lapse and then sought to requalify for the exemption. However, in the release accompanying the final rule amendments, the SEC indicated that a foreign company must either re-establish compliance "in a reasonably prompt manner" or else register under the Exchange Act. [36] A foreign issuer seeking to ensure that it can avail itself of the exemption should therefore develop internal procedures to ensure ongoing publication on its website of required documentation.

[b] Classes of Issuers

[i] *Foreign Private Issuers*

Registration under the Exchange Act of a class of securities of a foreign issuer is made on Form 20-F. [37] Selected financial data for the past five years

p. 4-16

p. 4-17

must be provided, including audited financial statements for the three most recent financial years, [38] together with a complete business description, an MD&A, [39] risk factors and a description of the terms of the class of securities being registered. [40]

[ii] *Foreign Government Issuers*

Foreign government issuers and certain other issuers eligible to register public debt offerings on Schedule B to the Securities Act must register securities that are listed on a U.S. exchange and file annual reports on Forms 18 and 18-K, respectively, under the Exchange Act. The requirements of these forms are comparable to the requirements of Schedule B and call for disclosure appropriate for such issuers. [41] Some large government issuers voluntarily register and file periodic reports in order to provide updated information that is incorporated by

p. 4-17

p. 4-18

reference in their Securities Act shelf registration statements in order to facilitate rapid access to the market. [42]

[c] Periodic Reporting

[i] *Annual Reports on Form 20-F*

All foreign private issuers with a class of securities registered under the Exchange Act or subject to Exchange Act reporting requirements under § 15(d) [43] are required to file annual reports on Form 20-F within four months after the end of a fiscal year. [44]

In accordance with § 408 of the Sarbanes-Oxley Act, the SEC conducts regular and systematic reviews of annual reports on Form 20-F of every foreign issuer at least once every three years, although it provides no indication of when a review is underway or when comments might be forthcoming. The scope of the review covers all of the disclosure in the filing, including financial statements, and is often followed by a comment letter requiring the issuer's responses and, as necessary, revisions to the disclosure in the Form 20-F. However, SEC reviews do not necessarily cover the entire document. The SEC typically requests that the company respond to the comments within 10 business days, although companies requiring more time to respond have often been able to obtain extensions. In most cases, the SEC requests that companies make changes to their disclosure in

p. 4-18

p. 4-19

subsequent fiscal years, although if the SEC considers that an issue merits more immediate attention, it can request that the current year Form 20-F be amended.

Foreign issuers that have filed annual reports on Form 20-F are not necessarily required to accept the SEC's comments or recommendations, although the SEC has the discretion to seek enforcement action against the company or its management. In addition, if a foreign issuer with unresolved comments on its Form 20-F seeks to register a securities offering on a registration statement that is not automatically effective, the SEC could refuse to declare the registration statement effective until the company resolves the SEC's comments. Item 4A of Form 20-F requires a company that is an accelerated filer, a large accelerated filer or a well-known seasoned issuer to disclose in its annual report any material SEC comments that were received 180 days or more before the end of the fiscal year to which the annual report relates and remain unresolved. [45]

While all foreign private issuers filing annual reports can expect regular reviews, under § 408 of the Sarbanes-Oxley Act, the frequency of the SEC's review may be increased for: (i) issuers that have issued material restatements of financial statements, (ii) issuers that experience significant volatility in their stock price as compared with other issuers, (iii) issuers with the largest market capitalization, (iv) emerging companies with disparities in price to earnings ratios and (v) issuers whose operations significantly affect any material sector of the economy. [46] Recent experience and SEC guidance suggest that the Form 20-F annual reports of large foreign issuers will continue to be subject to review on a more frequent basis than the three-year minimum.

[ii] *Interim Reports*

SEC rules require U.S. issuers to file quarterly reports on Form 10-Q as well as annual reports on Form 10-K. [47] Foreign issuers are only required by the SEC to file annual reports on Form 20-F. However, if foreign issuers make interim reports available for legal reasons (*e.g.*, if required by another country having jurisdiction over a foreign issuer) or as a matter of practice, these reports would be filed on Form 6-K as discussed below. [48] Both the NYSE and Nasdaq

p. 4-19

p. 4-20

require at least semi-annual financial reporting as a condition of listing, including by foreign issuers, and any such reports would then be filed with the SEC. [49]

[iii] *Current Reports on Form 6-K*

Form 6-K requires that a foreign private issuer promptly provide to the SEC and to each U.S. stock exchange on which its securities are listed material information about the issuer or its subsidiaries that the issuer (i) made public in its country of domicile or incorporation pursuant to the law of that country, (ii) filed with any foreign stock exchange on which its securities are listed and that was made public by such exchange or (iii) distributed to its securityholders. [50] This information would include periodic financial reports in the home jurisdiction or to foreign exchanges and could also concern changes in management or control, acquisitions or dispositions of a material amount of assets, changes in the company's certifying accountants, financial condition or results of operations, material legal proceedings, changes in the constituent documents governing the terms of any class of securities registered with the SEC, material increases or decreases in the outstanding amount of the company's securities or indebtedness, the results of the submission of matters to a vote of the company's securityholders or any other information that the company deems of material importance. [51]

With respect to acquisitions or dispositions of material amounts of assets, foreign companies are generally subject to less rigorous reporting requirements

p. 4-20

p. 4-21

than U.S. companies subject to the Exchange Act's periodic reporting requirements. U.S. companies must file on Form 8-K detailed information about any material acquisition or disposition of assets, including historical and/or *pro forma* financial statements presented in accordance with U.S. GAAP. [52] In contrast, a foreign company is not required to file additional information with the SEC, but if the information is material and is otherwise made public, it must then be filed "promptly" on Form 6-K. Such information may be much more limited in scope. [53]

When information is made public by press release, distributed directly to securityholders or contains annual audited or interim consolidated financial information, a full English translation is required if the information is not already in English. [54] In most other cases, including generally with respect to reports required to be furnished and made public under the laws of a foreign issuer's home country or the rules of any foreign stock exchange, English summaries meeting the requirements of Rule 403(c)(3)(ii) under the Securities Act and Rule 12b-12(d)(3)(ii) under the Exchange Act may be used. [55]

p. 4-21

p. 4-22

The obligation to file current reports is not procedurally burdensome because Form 6-K consists simply of cover and signature pages, signed by a duly authorized officer, to which the relevant information is attached. [56] Copies of the original documents are not required, and the documents included in a report on Form 6-K are not considered to be filed for the purposes of § 18 of the Exchange Act or otherwise subject to the liabilities imposed by that Section. [57] However, disclosures in the documents are subject to Rule 10b-5 under the Exchange Act and general antifraud provisions, and the SEC may also bring an administrative proceeding if the Form 6-K contains materially misleading information. [58]

[iv] *Notification Requirements*

Rule 10b-17 under the Exchange Act imposes, in certain circumstances, an affirmative notification requirement on issuers of securities that are publicly traded in the United States. For example, issuers with securities listed on the NYSE must provide notification, either to FINRA or in accordance with the relevant exchange procedures, of specified dividends, stock splits, reverse splits, rights or other subscription offerings no later than ten days prior to the record date involved or, in case of a rights subscription (or other offering if advance

p. 4-22

p. 4-23

notice is not practical), on or before the record date. [59] FINRA also requires compliance with Rule 10b-17 as a condition to trading on over-the-counter markets. [60]

[v] *Proxy Materials and Reports to Shareholders*

The Exchange Act and rules thereunder also set forth requirements with respect to the solicitation of proxies (written authorizations permitting other individuals to vote securities on behalf of securityholders) from holders of securities registered under the Exchange Act. [61] These provisions specify the information required to be disclosed to securityholders prior to or at the time of a proxy solicitation, the presentation of such information, the form of proxies and the treatment of proposals made by securityholders. They also prohibit certain proxy solicitations and false or misleading statements in proxy materials and require an annual report (containing financial statements and an MD&A largely equivalent to that required in a Securities Act registration statement) to be furnished to securityholders prior to or at the time of a proxy solicitation. [62]

Foreign companies are generally exempt from these provisions. [63] However, foreign companies that have securities listed on a national securities exchange are required by the relevant exchange to make annual reports that are required to be filed with the SEC available to U.S. holders of their listed securities. [64] The NYSE also has established rules requiring an "actively operating"

p. 4-23

p. 4-24

company to solicit proxies from its shareholders for all shareholder meetings, [65] although the NYSE may grant, in very limited circumstances, an exemption from this rule when applicable law precludes or makes virtually impossible the solicitation of proxies in the United States. [66] Foreign companies whose securities are not so listed are not subject to any requirement to provide reports or notices to securityholders in the United States. They nevertheless may choose to do so in accordance with their home-country laws and practices. Often, this will mean that notices will be given through publication in newspapers in an issuer's home country. If a foreign company has a sponsored ADR program, however, it will usually agree to make the notices or reports available to the depositary, which will agree in turn to forward them to the ADR holders. [67]

[vi] *Annual Special Disclosures on Conflict Minerals*

In order to comply with the Dodd-Frank Act, in 2012, the SEC adopted rules on specialized disclosure relating to the use of conflict minerals from

p. 4-24

p. 4-25

covered countries. [68] [69] These rules set forth additional requirements for periodic reporting. Section 4.08 discusses the framework and current status of these required disclosures.

Footnotes

4 *See* §§ 12(b) and 12(g) of the Exchange Act and Rules 12g-1 and 12g3-2(a) thereunder. *See also supra* Note 1 (describing conditions under which an Exchange Act registration statement is not required).

5 In general, a security is deemed to be held of record by each person identified as such in records of

securityholders maintained by or on behalf of the issuer. Rules 12g3-2(a) and 12g5-1 under the Exchange Act. There is no general duty of inquiry placed on issuers, and issuers may rely on such records, except when securities are held of record by a broker-dealer, securities depository (such as DTC), bank (including an ADR depositary) or a nominee for any of them. Rules 12g3-2(a) and 12g5-1 under the Exchange Act; SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Exchange Act Rules, Question 152.01 (Sept. 30, 2008). In such a case, the issuer must inquire of such financial intermediaries as to the ownership of such securities, and the securities are counted as held in the United States by the number of separate U.S. resident customer accounts for which the securities are held. Rule 12g3-2(a) under the Exchange Act. In addition, if the issuer is aware of the existence of an ADR facility for its bearer equity securities (whether sponsored or unsponsored), the issuer must contact the depositary for the ADR facility, request the number of U.S. holders on the depositary's records, and include this figure in its total number of U.S. securityholders. Rule 12g5-1(b)(1) under the Exchange Act. An issuer may rely in good faith on information about the residence of (i) the beneficial owner of securities held in "street name" that is furnished by the broker, dealer, bank or nominee that is the record holder of securities and (ii) the record holder of ADRs evidencing bearer securities that is furnished by the depositary for the ADR program. Rules 12g3-2(a) and 12g5-1(b)(1) under the Exchange Act.

6 *See* § 15(d) of the Exchange Act; *see also* SEC, Division of Corporation Finance, Staff Legal Bulletin No. 18 (Mar. 15, 2010), Fed. Sec. L. Rep. (CCH) ¶60,018 (confirming that reporting requirements are not triggered by an abandoned offering). Section 15(d) does not in fact provide that an exemption from registration is available for a foreign issuer if such foreign issuer has fewer than 300 U.S. holders, but instead provides for such exemption if the subject securities "are held of record by less than 300 persons or, in the case of a bank, a savings and loan holding company (as defined in § 10 of the Home Owners' Loan Act), or a bank holding company, as such term is defined in § 2 of the Bank Holding Company Act of 1956 (12 U.S.C. 1841), 1,200 persons" without distinguishing the type of issuer or where the holders are located. While the SEC staff interprets § 15(d) technically to refer to the number of holders worldwide, it has provided no-action relief to foreign issuers whose worldwide holders exceeded 300 in number but whose U.S. holders did not. *See, e.g.*, *Suncor Inc*. (avail. Mar. 11, 1982); *Super-Sol Ltd*. (avail. Jan. 4, 1982). The requirement to file periodic reports for the first fiscal year or for any subsequent year when there are 300 or more U.S. holders, even if not registered under the Exchange Act, does not apply to foreign government issuers.

7 Rule 12h-6 under the Exchange Act. *See* § 4.03[a][iii] for a discussion of the conditions required under Rule 12h-6.

8 §§ 12(a) and 12(b) of the Exchange Act. Prior to Nasdaq's transition to a national securities exchange on August 1, 2006, securities quoted on Nasdaq had to be registered under § 12(g) of the Exchange Act. *See* § 2.01, Note 2 for discussion of Nasdaq's transition to a national securities exchange.

9 § 12(d) of the Exchange Act.

10 § 12(g) of the Exchange Act and Rule 12g-1 thereunder; *see* s *upra* Note 6. The Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (the "JOBS Act"), which was signed into law on April 5, 2012, amended § 12(g) of the Exchange Act to increase the holder of record threshold from 500 persons to 2,000 persons. The JOBS Act also created a separate holder of record threshold for banks, bank holding companies and savings and loan holding companies, which is 2,000 persons with no limit on the number of investors that are not accredited investors. For all companies, the holder of record threshold was amended to exclude securities held by persons who received the securities pursuant to employee compensation plans in transactions exempt from Securities Act registration, but in adopting these changes into the Exchange Act rules, the SEC also amended Exchange Act Rule 3b-4 to clarify that employees must continue to be counted for purposes of determining a company's foreign private issuer status. *See* SEC Release No. 33-10075 (May 10, 2016); *see also* § 3.01, Note 1 for a definition of "foreign private issuer."

11 § 12(g) of the Exchange Act.

12 § 12(g) of the Exchange Act and Rules 12g-1 and 12g3-2(a) thereunder.

13 *See* § 4.02[3][a][iv] for a discussion of Rule 12g3-2(b) under the Exchange Act.

14 Although "succession" is defined for certain Exchange Act purposes to exclude the acquisition of control of a business not followed by the direct acquisition of its assets, *see* Rule 12b-2 under the Exchange Act, the SEC has found Rule 12g-3 to apply in cases where the successor entity ultimately holds all shares of the predecessor entity. *See*, *e.g.*, *Transocean Inc*. (avail. Sept. 26, 2007); *China Light & Power Company Limited* (avail. Jan. 2, 1998); *Grand Metropolitan Public Limited Company* (avail. Dec. 16, 1997).

15 Rule 12g-3 under the Exchange Act. *See* SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Exchange Act Rules, Question 150.01 (Sept. 30, 2008).

16 *See* § 4.02[3][c][i] for a discussion of the shortening in the required filing period from six months to four months.

17 Rule 12g-3(g) under the Exchange Act. In connection with a U.K. business combination, the SEC found Rule 12g-3 to apply to the entity, Diageo plc, formed by the merger of Grand Metropolitan Public Limited Company and Guinness PLC by way of a scheme of arrangement. The scheme of arrangement involved an exchange of shares of Diageo for shares of Grand Metropolitan. Before the succession, shares of Diageo were not registered pursuant to the Exchange Act, but shares of Grand Metropolitan were so registered. The SEC found the merger to be a succession for purposes of Rule 12g-3, and shares of Diageo were deemed registered pursuant to the Exchange Act following the merger. Registration under the Securities Act was not necessary because shares issued in a scheme of arrangement are exempt from the registration requirements under § 3(a)(10) of the Securities Act, provided certain conditions are met (*see* § 9.05[4][a], Note 164 for a discussion of the § 3(a)(10) exemption as applied to schemes of arrangement in the United Kingdom and similar mechanisms in other countries). As a successor registrant, Diageo was required to file an annual report with the SEC on Form 20-F following the effectiveness of the scheme. *See Grand Metropolitan Public Limited Company* (avail. Dec. 16, 1997).

18 Foreign bidders that do not have a class of equity securities registered under the Exchange Act sometimes exclude U.S. holders because of the necessity to register shares to be issued in the United States under the Securities Act. Rule 802 under the Securities Act, however, provides an exemption from Securities Act registration for the issuance of securities in connection with the acquisition of non-U.S. companies with limited U.S. share ownership. *See* § 9.03[9][c].

19 *See* Rule 12h-6(d) under the Exchange Act; SEC Release No. 34-55540 (Mar. 27, 2007); *see also* § 4.11[2] for a discussion of various conditions required under Rule 12h-6.

20 *See* SEC Release No. 34-55540 (Mar. 27, 2007); SEC Release No. 34-55005 (Dec. 22, 2006).

21 An issuer that has obtained an OTC Bulletin Board quotation would not be able to rely on the Rule 12g3-2(b) exemption.

22 *See supra* Note 5.

23 § 12(g) of the Exchange Act; *see* text accompanying *supra* Note 10; *see also* text accompanying *infra* Note 647.

24 Section 12(g) applies to any class of equity securities, so that a company with both ordinary shares and preference shares would need to have a separate exemption for each class to avoid registration. In an instruction to amended Rule 12g3-2(b), the SEC has said that compensatory stock options are automatically exempt if the underlying shares are exempt, even if the options would otherwise constitute a separate class.

25 Rule 12h-6(a)(3) under the Exchange Act defines the "primary trading market" for a class of securities to mean one or two foreign jurisdiction(s) in which at least 55% of the trading in such securities took place in, on or through the facilities of a securities market or markets during a recent 12-month period. If trading in two foreign jurisdictions is aggregated for the purpose of satisfying the 55% test, the trading market for the issuer's securities in at least one of the two foreign jurisdictions must be larger than the U.S. trading market for the same class of securities.

26 The amended rule also allows an issuer to publish the information through a freely accessible electronic delivery system established by a securities regulator in the issuer's primary trading market. The SEC's release cited the Canadian SEDAR system as an example of such a system.

27 The amended rule continues to provide that only "material" information must be published. Under the U.S. securities laws, information is generally considered "material" if it changes the overall mix of information available to the market, and if a reasonable investor would consider it important in making an investment decision. The amended rule provides a non-exhaustive list of information that would ordinarily be material, including information concerning: (i) results of operations or financial condition, (ii) changes in business, (iii) acquisitions or dispositions of assets, (iv) issuance, redemption or acquisition of securities, (v) changes in management or control, (vi) granting of options or payment of other remuneration to directors or officers and (vii) transactions with directors, officers or principal securityholders. *See* Rule 12g3-2(b)(3)(i) under the Exchange Act. *See also infra* Note 51.

28 The SEC staff views press releases, articles and advertisements (although not standard product advertisements) published in newspapers and magazines as information a company "distributes to its shareholders," even if they are not sent directly to the shareholders. Likewise, information that a company posts on an Internet website is considered to be information that the issuer has made public for purposes of Rule 12g3-2(b). *See* SEC, Division of Corporation Finance, Manual of Publicly Available Telephone Interpretations, Supplement, Exchange Act Rule 12g3-2(b), Question 9S (Mar. 1999).

29 At a minimum, an issuer is required to publish English translations of (i) its annual report, including or accompanied by annual financial statements, (ii) interim reports that include financial statements, (iii) press releases and (iv) all other communications and documents distributed directly to securityholders. *See* Rule 12g3-2(b)(3)(ii) under the Exchange Act.

30 The SEC did not define the term "promptly," but stated in the release accompanying the final rule that this will depend on the type of document and the amount of time required to prepare an English translation. It said that a foreign issuer must publish a material press release "on or around" the same business day on which the original language document is published. *See* SEC Release No. 34-58465 (Sept. 5, 2008).

31 *See infra* Note 57 and accompanying text. Such information is, however, subject to the antifraud provisions of § 10(b) of the Exchange Act and Rule 10b-5 thereunder.

32 *See* the discussion of registration of ADRs on Form F-6 in § 3.04[7][c].

33 SEC Release No. 34-58465 (Sept. 5, 2008). A foreign company with an unsponsored ADR program does not set the terms or conditions of the ADRs, nor does it have the ability to terminate the program directly. Moreover, if a company were to seek the establishment of a sponsored ADR program, it would require the termination of any existing unsponsored ADR program and, therefore, the cooperation of that unsponsored program's depositary bank.

34 *See* § 7.02[4][b].

35 *See* Rule 12g3-2(c) under the Exchange Act.

36 SEC Release No. 34-58465 (Sept. 5, 2008).

37 *See* § 4.04 for a discussion of Form 20-F. If registration under the Exchange Act is undertaken in connection with a public offering, a short-form registration statement on Form 8-A is used, which incorporates information from the prospectus contained in the corresponding Securities Act registration statement, the disclosure in which is derived primarily from the requirements of Form 20-F.

Under Regulation S-T, all documents filed with or furnished to the SEC by U.S. and, with certain exceptions, foreign issuers must be submitted electronically, using EDGAR. EDGAR filings are accessible by the public through the SEC's website, www.sec.gov. For a description of the documents that foreign issuers may continue to submit by paper, *see* Rule 101(b) of Regulation S-T and *infra* Note 55.

38 Unless such financial statements are prepared in accordance with U.S. GAAP or in accordance with IFRS as issued by the IASB, they must include a "U.S. GAAP reconciliation" (*i.e.*, a factual discussion and numerical indication of the material differences between U.S. GAAP and the accounting principles upon which the statements are based). *See* §§ 4.05[1] and [2] for a discussion of U.S. GAAP reconciliation and the SEC rule change to eliminate the U.S. GAAP reconciliation requirement for foreign issuers that prepare their financial statements in accordance with IFRS as issued by the IASB. Additionally, financial statement

requirements for foreign issuers that are considered emerging growth companies ("EGCs") under the JOBS Act are less burdensome. *See generally* Chapter 3 for a discussion of EGC requirements.

39 The section is titled "Operating and Financial Review and Prospects" in Form 20-F but, consistent with market practice, is referred to in this chapter as MD&A.

40 *See* § 4.04[2]. The SEC adopted a rule in 2008 that eliminated a distinction in financial statement requirements between Exchange Act and certain Securities Act filings, and instead requires all mandated U.S. GAAP reconciliations to be prepared under Item 18 of Form 20-F for the registrant's financial statements for fiscal years ending on or after December 15, 2011. This requires inclusion of full industry and geographical segment disclosure pursuant to SFAS 131, as well as other information required to be included by the relevant SFAS in an appropriate footnote (*e.g.*, with respect to the values of securities, funding of pension plans, accounting for derivatives and fair market values at risk). *See* SEC Release No. 33-8959 (Sept. 23, 2008). Despite this amendment, Item 17 is still available for separate financial statements of a non-reporting company other than the issuer (*e.g.*, an acquired company or an equity-method investee, for which financial statements may be required under Rule 3-05 or Rule 3-09 of Regulation S-X) and for pro forma information pursuant to Regulation S-X Article 11. *See* Item 18(b) of Form 20-F; SEC Release No. 33-8959; SEC, Division of Corporation Finance, FINANCIAL REPORTING MANUAL, Topic 6410.1.

41 *See* § 3.05[1] for a discussion of the disclosure requirements for securities issued or guaranteed by foreign government issuers.

42 §§ 12(b) and 15(d) of the Exchange Act. As noted above, the requirement to file periodic reports under § 15(d) of the Exchange Act as a result of registering securities for a public offering under the Securities Act does not apply to foreign government issuers.

43 *See* § 4.02[2].

44 *See* § 4.04 for a discussion of the disclosure requirements of Form 20-F. Foreign private issuers unable to file Form 20-F within the prescribed period are required to file a Form 12b-25 explaining the reasons for the delay in filing Form 20-F. Rule 12b-25 under the Exchange Act. The SEC has taken enforcement action in the past against issuers who have failed to file a Form 12b-25 explaining a late filing under the Exchange Act. *See*, *e.g.*, *SEC v. Learning Annex, Inc.*, SEC Litigation Release No. 12481 (May 21, 1990). In addition, the SEC has taken enforcement action against an issuer as a result of allegedly false and misleading statements contained in the issuer's Form 12b-25 filings. *See*, *e.g.*, *In re FFP Marketing Co., Inc.*, SEC Admin. Proc. File No. 3-11826 (Feb. 14, 2005).

The four-month deadline may be particularly challenging for a foreign company that must reconcile its financial statements to U.S. GAAP. However, an issuer that prepares financial statements under IFRS as issued by the IASB is not subject to this reconciliation requirement. *See* SEC Release No. 33-8879 (Dec. 21, 2007). The filing deadline thus provides an additional reason for a foreign issuer to switch from home-country GAAP to IFRS, especially if IFRS financial statements are acceptable for home-country reporting. The SEC in fact cited a desire to allow time for foreign issuers and foreign regulators to adopt IFRS as a reason for delaying the effectiveness of its amendment of Form 20-F in September 2008 to shorten the filing deadline from six months after the end of a fiscal year to four months.

As discussed in § 4.02[3][b][ii], to the extent required, foreign government issuers and guarantors use Form 18-K to file their annual reports under the Exchange Act's periodic reporting requirements.

45 *See* Rule 12b-2 under the Exchange Act for the definitions of an "accelerated filer" (generally, a company with a public float of at least $75 million but less than $700 million that has been publicly reporting for at least one year) and a "large accelerated filer" (generally, a company with a public float of at least $700 million that has been publicly reporting for at least one year); *see* Rule 405 under the Securities Act for the definition of a "well-known seasoned issuer." *See* § 3.02[3][a][ii] for a discussion of well-known seasoned issuer status.

46 *See* § 408 of the Sarbanes-Oxley Act.

47 Rule 13a-13 under the Exchange Act.

48 Rule 13a-16 under the Exchange Act.

49 *See* NYSE Listed Company Manual § 203.03; NASDAQ Marketplace Rules, Rule 5250(c)(2), NASDAQ Manual.

50 *See* Note 27 (discussing the interpretation of "material" information under the U.S. securities laws and the guidance with respect thereto contained in Rule 12g3-2(b)(3)(i) under the Exchange Act). In 2004, the SEC significantly expanded the list of items that U.S. issuers must disclose on Form 8-K. The expanded list requires disclosure of, among other things, the entry into or termination of material agreements not made in the ordinary course of business, the creation of, and events triggering, material direct or contingent financial obligations, material costs associated with exit or disposal activities, material impairments and determinations that an issuer's financial statements should not be relied upon because they must be restated as a result of an error. In addition, the SEC generally shortened the length of time during which U.S. issuers are required to file reports on Form 8-K to four business days after the occurrence of the events requiring disclosure. *See* SEC Release No. 33-8400 (Mar. 16, 2004). When the SEC amended Form 8-K in 2004, it did not amend Form 6-K to require new disclosures by foreign private issuers or to change the illustrative list of disclosure items in the instructions to Form 6-K. However, at a minimum, foreign private issuers should consider the expanded list of items in Form 8-K in deciding whether particular press releases or home-country filings are material (and thus covered by Form 6-K) and which Form 6-K reports should be incorporated into their Securities Act registration statements.

51 Form 6-K, General Instruction B. The information required by Form 6-K is comparable to that required under Rule 12g3-2(b) under the Exchange Act. For a discussion of the SEC's interpretation of information "distributed" to securityholders in the context of Rule 12g3-2(b), *see supra* Note 28.

52 Form 8-K, Items 2.01, 9.01. This information must generally be filed within four business days after the consummation of the acquisition or disposition, although the required financial statements may, under certain circumstances, be filed up to 71 days later.

53 Form 6-K, General Instruction B. However, if a foreign private issuer files a registration statement in connection with a public offering, it will be required to include financial statements with respect to any acquired business with a defined level of materiality (or with respect to a very substantial business whose acquisition is probable), as well as related *pro forma* financial information. *See* § 4.05[5][a] for a discussion of when the inclusion of such financial statements is required and how they must be prepared. Significant dispositions by foreign companies may trigger the requirement to include certain *pro forma* financial information. The SEC rarely waives these requirements. *See* § 9.05[4] for a discussion of certain limited exceptions to these disclosure requirements. As a general matter, foreign issuers that may wish to register a public offering in the United States should ascertain whether the financial statements of any significant company they propose to acquire are suitable for inclusion in a U.S. registration statement.

54 Form 6-K, General Instruction D(1). The SEC staff has informally indicated, however, that where the translation requirement would result solely from inclusion of consolidated financial information, full translation is not required if the consolidated financial information has been previously filed with or submitted to the SEC electronically *via* EDGAR. If, however, such consolidated financial information has not been so previously filed or submitted, the SEC staff has noted that an English summary of the document would be permissible so long as the summary contained a full translation of the portion of the document including the consolidated financial information.

55 Form 6-K, General Instruction D(2). Reports required to be furnished and made public under the laws of a foreign issuer's home country or the rules of any foreign stock exchange (other than press releases or documents that have been distributed directly to a foreign issuer's securityholders) may also be submitted in paper format, rather than electronically by EDGAR, to the extent any "material event" discussed in such report has already been the subject of a Form 6-K or other submission on EDGAR. Rule 101(b)(6) of Regulation S-T.

See Rule 12b-12(d)(2) under the Exchange Act for a list of those documents for which full translation is nevertheless required (including articles of incorporation, by-laws, instruments defining the rights of securityholders, voting agreements and certain contracts and financial information).

56 Filings on Form 6-K must be covered, however, by an issuer's disclosure controls and procedures under the Sarbanes-Oxley Act. *See* § 5.03[7][a].

57 If the information on Form 6-K is subsequently incorporated by reference into a registration statement on Form F-3, the information so incorporated would be subject to the liability provisions of the Securities Act. *See* the discussion of Form F-3 in § 3.02[1][b]. The required disclosure in current reports on Form 8-K by U.S. issuers should be considered by foreign issuers in deciding which filings on Form 6-K to incorporate into Securities Act filings.

58 In 1998, the SEC brought proceedings against Sony Corporation in which the SEC found that Sony and an officer of Sony responsible for disclosure matters had violated SEC reporting requirements by failing to describe, in Sony's annual report on Form 20-F and in its periodic earnings reports on Form 6-K, losses suffered by one of its subsidiaries, Sony Pictures. *In re Sony Corporation*, SEC Release No. 34-40305 (Aug. 5, 1998). The SEC found that Sony failed to identify greater than anticipated losses at Sony Pictures and to discuss a "known trend" involving cumulative losses of more than $1 billion. The SEC applied Exchange Act Rule 12b-20 to Sony's Form 6-K filing, which requires that Exchange Act periodic reports include any additional information "as may be necessary to make the required statements, in light of the circumstances under which they were made, not misleading." Rule 12b-20 under the Exchange Act. The SEC did not bring the proceedings under the antifraud provisions of Rule 10b-5 under the Exchange Act and has made it clear that, without alleging fraud or recklessness tantamount to fraud, it can bring an administrative proceeding, which could result in the imposition of substantial fines, if either a Form 20-F or a Form 6-K contains materially misleading information. Sony consented, among other things, to the payment of a fine of $1 million and to procedural changes in responsibility within the company for the preparation of its SEC periodic reports. The SEC also pursued claims against the individual Sony officer responsible for the disclosure. *SEC v. Sony Corp.*, SEC Litigation Release No. 15832 (Aug. 5, 1998).

59 *See*, *e.g.*, NYSE LISTED COMPANY MANUAL § 204.12.

60 *See* FINRA Regulatory Notice 10-38 (Aug. 2010). In the Level 1 ADR context, in which there is over-the-counter trading in the United Sates but no listing on a U.S. exchange, a foreign issuer does not have to comply with this requirement because the foreign issuer is not the issuer of the ADRs. The ADR program's depositary bank, on the other hand, needs to comply with this requirement because it sets the record dates for dividends and determines other related events as they apply to the traded ADRs. In the case of sponsored Level 1 ADRs, the foreign issuer may agree to comply with this requirement to facilitate the depositary bank's compliance with it. *See* § 3.04[1] for a general discussion of ADR programs. If a foreign issuer's ordinary shares or other securities underlying the ADRs were to trade on over-the-counter markets, compliance with this requirement would be a condition to such trading.

61 § 14(a) of the Exchange Act and Regulation 14A thereunder.

62 § 14(a) of the Exchange Act and Regulation 14A thereunder. *See* § 4.06 for a discussion of the requirements relating to MD&A.

63 Rule 3a12-3 under the Exchange Act; *see Schiller v. Tower Semiconductor Ltd.*, 449 F.3d 286 (2d Cir. 2006) (reaffirming the SEC's authority to create exemptions to proxy statement requirements under § 14(a) of the Exchange Act and upholding the exemptions for foreign private issuers under Rule 3a12-3).

64 A foreign private issuer is required to issue a press release announcing the filing of its annual report with the SEC, to make such annual report available on or through its website and to provide hard copies of its audited financial statements, in the case of NYSE-listed companies, and the full annual report, in the case of Nasdaq-listed companies, upon request to all shareholders. Foreign issuers do not need to satisfy these requirements if, with respect to NYSE-listed companies, they are subject to the U.S. proxy rules or provide the required information to shareholders in a way that is consistent with the physical or electronic delivery requirements set forth in Rules 14a-3 and 14a-16 of the U.S. proxy rules, or with respect to Nasdaq-listed companies, they mail the required information to shareholders or provide such information in a way that is consistent with the electronic delivery requirements set forth in Rule 14a-16 of the U.S. proxy rules. *See*

NYSE LISTED COMPANY MANUAL § 203.01; NASDAQ Marketplace Rules, Rule 5250(d)(1), NASDAQ MANUAL.

65 *See* NYSE LISTED COMPANY MANUAL § 402.04. The NYSE rules require proxy materials to be formatted and distributed as permitted or required by applicable law and regulations. *See* NYSE LISTED COMPANY MANUAL § 402.04(b). Given that the SEC's rules governing proxy solicitations are not applicable to foreign private issuers, foreign private issuers required to solicit proxies pursuant to the NYSE rules may follow their home country practices with respect to procedures.

66 The NYSE listing agreement for foreign private issuers requires the issuer to "solicit proxies for all meetings of stockholders," and the NYSE listing rules provide that "actively operating" companies are required to solicit proxies except where "applicable law precludes or makes virtually impossible the solicitation of proxies in the United States." NYSE LISTING AGREEMENT FOR FOREIGN PRIVATE ISSUER EQUITY SECURITIES; NYSE LISTED COMPANY MANUAL §402.04(A). Certain ADR depositaries take the view that the proxy solicitation requirement is satisfied by mailing voting instruction cards to registered holders (rather than beneficial owners) of the underlying securities; these registered holders typically pass along the voting instruction cards to beneficial owners. Other depositaries believe the NYSE requirement is only met if an issuer solicits proxies directly from beneficial owners, which is generally accomplished by sending owners a voting instruction card through a proxy solicitation firm, who then coordinates the delivery of the voting instruction card with The Depository Trust Company. *See also* NASDAQ Marketplace Rules, Rules 5615(a)(3) and 5620(b), NASDAQ MANUAL (requiring each company that is not a limited partnership to solicit proxies and provide proxy statements for all meetings of shareholders, but allowing foreign private issuers to follow home country practice in lieu of the Nasdaq's corporate governance rules).

67 While not subject to U.S. proxy requirements under the Exchange Act, foreign issuers are still subject to the antifraud provisions of § 10(b) of the Exchange Act. *See also* § 3.04[1][a], Note 502 for discussion as to the elimination of broker discretionary voting in uncontested director elections.

68 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,286 (Sept. 12, 2012).

69 [Reserved].

U.S. Regulation of the International Securities and Derivatives Markets, § 4.03, CONTENT OF SCHEDULE B

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 4.03 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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The requirements for disclosure in U.S. public offerings by foreign sovereign issuers, certain supranational issuers and certain issuers of foreign government-guaranteed securities are set out in Schedule B to the Securities Act.

Section 3.05[1] discusses Schedule B and the types of disclosures provided by foreign government filers.

U.S. Regulation of the International Securities and Derivatives Markets, § 4.04, CONTENT OF FORM 20-F

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 4.04 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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[1] Overview

Foreign private issuers file Form 20-F with the SEC for an initial registration of a class of securities under the Exchange Act and for annual reports under the Exchange Act. Form 20-F also is the basis for the disclosures required when a foreign private issuer registers a U.S. public offering under the Securities Act. Form 20-F consists of three parts. All three parts are required in annual reports, whereas only two parts are required when Form 20-F is used as a registration statement under the Exchange Act in connection with the listing of securities. [70] While Form 20-F elicits disclosures "as equal as practicable" to those provided by U.S. domestic issuers in Form 10-K reports or in their registration statements under the Securities Act and Exchange Act, certain accommodations have been made in Form 20-F to improve the accessibility of the U.S. capital markets to foreign issuers in light of the different national laws and accounting regulations to which such issuers are subject. [71] This section provides an overview of each part of Form 20-F. [72]

[2] Part I

p. 4-26

Part I calls for, among other items, a detailed description of the issuer's financial condition, risk factors, business operations and principal activities, organizational structure, properties, information regarding the company's management, information regarding major shareholders and related-party transactions, and the market risk exposure of the company. [73] Shareholders owning 5% or more of any class of voting securities must be identified if known, selected

p. 4-26

p. 4-27

financial data for five years must be furnished, [74] and all taxes, including withholding provisions to which U.S. securityholders are subject under the laws of the country where the company is organized, must be described.

Perhaps the most important requirement of Part I is the requirement in Item 5 that the filing contain an MD&A section, for the period covered by the financial statements included in the filing pursuant to Part III. The MD&A requires a discussion of liquidity, capital resources, results of operations and other information necessary for an understanding of the company's financial condition, changes in financial condition and results of operations. It is taken very seriously by the staff of the SEC, and if not prepared adequately, extensive comments may be received and revision required. Extensive guidance provided by the SEC and the adoption of disclosure rules under the Sarbanes-Oxley Act are evidence of the importance of this section. More information about the disclosure required in this section is described in § 4.06.

When Form 20-F is used as a registration statement, Part I also calls for a detailed description of the securities being registered, including ADRs. While not required by the form, in the case of registering equity securities, a practice has developed of describing the principal features of the foreign corporate law applicable to the issuer. Particular attention is given to the process by which directors are elected and the matters that must be submitted to a vote of the shareholders, as well as the rules applicable to the conduct of shareholder meetings.

[3] Part II

The requirements of Part II apply to annual reports filed on Form 20-F but do not apply in the case of a Form 20-F filed to register securities. [75] Part II requires an issuer to identify any of its indebtedness or indebtedness of a significant subsidiary with respect to which there has been, during the year, default in the payment of a principal, interest or sinking fund obligation or in the performance of any other material term not cured within 30 days if the amount of the indebtedness exceeds 5% of the total assets of the registrant and its consolidated subsidiaries. In addition, if the constituent instruments defining the rights of holders of any class of registered securities have been materially modified during the year, the modification and its effect must be described. Part II also requires disclosure, in the annual report on Form 20-F immediately following the first Securities Act registration statement filed by the issuer, regarding the use of

p. 4-27

p. 4-28

proceeds of the offering pursuant to that registration statement. Finally, Part II contains disclosure requirements adopted for reporting companies under the Sarbanes-Oxley Act, such as disclosure regarding audit committee financial experts and an issuer's code of ethics, as well as more recent disclosure requirements regarding the amount of fees paid to independent auditors for specified services and corporate governance matters.

A foreign issuer with securities listed on a national securities exchange must also include in Part II of its annual report on Form 20-F (but not on a Form 20-F used to register securities) a concise summary of any significant ways in which the issuer's corporate governance practices differ from those followed by U.S. domestic issuers under the listing standards of that exchange. [76] This requirement is similar to that imposed on listed foreign issuers by the New York Stock Exchange and Nasdaq. [77]

[4] Part III

Part III sets out the financial statement requirements. The basic provisions require audited income statements, cash flow statements and statements of changes in equity for the three most recent fiscal years, and audited balance sheets as of the three most recent fiscal year-ends generally must be included, in each case on a consolidated basis and otherwise in accordance with U.S. GAAP or IFRS as issued by the International Accounting Standards Board (the "IASB"), or reconciled to U.S. GAAP. [78] For first-time registrants, reconciliation to U.S. GAAP need only be for the two most recently completed fiscal years and any required interim periods. [79] These requirements, and limited exceptions thereto, are discussed below. [80]

Part III has two items that govern financial statement disclosure requirements—Item 17 and Item 18. Historically, Item 17 of Form 20-F was a less demanding alternative that omitted business segment data and permitted

p. 4-28

p. 4-29

limited reconciliation to U.S. GAAP. Modifications to Form 20-F in 2009 largely eliminated the relaxations that had been afforded by Item 17. [81]

Certain documents must be filed as exhibits to Form 20-F, including material contracts and instruments defining the rights of securityholders of the class being registered. [82] These exhibits are available to the public. Therefore, if any material contract contains sensitive information, confidential treatment that would allow the redaction of that information should be requested. [83]

Footnotes

70 *See* Form 20-F, General Instruction E. As a general matter, Parts I, II and III must be included in an annual report, but the specific instructions to sections included in those Parts may limit the information required in the case of annual reports. Only Parts I and III are required for registration statements filed under the Exchange Act. Registration statement forms under the Securities Act direct issuers to the disclosure requirements in Items of Form 20-F.

71 *See* § 3.03[1][b] for a discussion of the integrated disclosure system and Form 20-F. *See also* SEC Release No. 33-8959 (Sept. 23, 2008), 73 Fed. Reg. 58,300, 58,301 (Oct. 6, 2008) (the "2008 Form 20-F Reporting Enhancement Release").

72 On December 20, 2013, the SEC issued a staff report to Congress titled the "Report on Review of Disclosure Requirements in Regulation S-K " (the "Disclosure Report"), which was mandated by the JOBS Act. The purpose of the Disclosure Report was to analyze Regulation S-K, which provides the disclosure requirements for domestic companies for non-financial statement portions of registration statements and periodic reports, to find additional ways to modernize and simplify the SEC's disclosure requirements. After a detailed overview of the history and the structure of the SEC disclosure regime, the staff concluded in the Disclosure Report that it needs to develop a plan for systematic review of the SEC's disclosure requirements, including those under Regulation S-K and Regulation S-K, which provides the form and content requirements for financial statements included in registration statements and periodic reports, and that, after gathering sufficient information after such review, it would recommend any proposals for revisions of the disclosure rules to the SEC. In addition to the JOBS Act, the Fixing America's Surface Transportation Act (the "FAST Act"), which was signed into law on December 4, 2015, also directed the SEC to conduct a study on modernization and simplification of Regulation S-K and submit a report to Congress within 365 days. H.R. Rep. No. 114-279 (2015). As part of the initiative, on September 25, 2015, the SEC issued a request for comments on the effectiveness of financial disclosure requirements in Regulation S-K. SEC Release No. 33-9929 (Sept. 25, 2015). In 2016, the SEC issued a series of releases under the initiative, starting with a concept release on business and financial disclosure items in Regulation S-K in April 2016 (the "Concept Release"), followed by a June 2016 proposal to replace the disclosure requirements for SEC-registered mining companies, a July 2016 proposal to amend certain disclosure requirements that became "redundant, duplicative, overlapping, outdated, or superseded," an August 2016 request for comments on Subpart 400 of Regulation S-K (the "Subpart 400 Release") and an August 2016 proposed rule requiring hyperlinks to each exhibit filed under Item 601 of Regulation S-K. SEC Release Nos. 33-10064 (Apr. 13, 2016), 33-10098 (June 16, 2016), 33-10110 (July 13, 2016), 33-10198 (Aug. 26, 2016) and 33-10201 (Aug. 31, 2016). On November 28, 2016, the SEC issued the report required by the FAST Act, titled "Report on Modernization and Simplification of Regulation S-K " (the "Fast Act Report"). The Fast Act Report presented the SEC staff's recommendations on a number of items of Regulation S-K and reflected the staff's work on the Concept Release and the Subpart 400 Release. The Disclosure Report and the Fast Act Report do not provide a timeline for effecting any changes to the existing disclosure requirements. Generally, the review and comment process for such proposals, concept releases and requests for comments take considerable time and it is unclear what specific changes, if any, will result under the initiative or whether any such changes will affect foreign private issuers.

73 Item 11 of Form 20-F requires the issuer to provide, in its reporting currency, quantitative information about market risk-sensitive instruments (*e.g.*, derivatives, outstanding floating rate debt, fixed rate investments or investments or debt denominated in a currency other than its reporting currency) as of the end of the latest fiscal year. The issuer must also provide qualitative information concerning the issuer's primary market risk exposures (*e.g.*, interest rate and foreign currency exposure) and how those exposures are managed. *See* § 4.07[11] for a more complete discussion of derivatives disclosure requirements.

74 Selected financial data for one or more of the earliest three years of the relevant five-year period may be omitted in certain circumstances. *See* § 4.05[2].

75 Even if not strictly required by Form 20-F, issuers filing Form 20-F to register securities need to consider in any event whether this or any other information not strictly called for by the applicable form might need to be included to satisfy the general antifraud provisions of § 10(b) of the Exchange Act and Rule 10b-5 thereunder.

76 Form 20-F, Item 16G.

77 *See* NYSE LISTED COMPANY MANUAL § 303A.11; NASDAQ Stock Market Rules, IM-5615-3. Both the instructions to Item 16G and to the NYSE LISTED COMPANY MANUAL emphasize that the discussion should be brief and general, not a detailed, item-by-item analysis. Nasdaq requires disclosure of each corporate

governance requirement from which a company is exempted by Nasdaq and a description of the home country practice, if any, followed by the issuer in lieu of the requirements that would otherwise be applicable.

78 A balance sheet as of the end of the earliest of the three years is not required, however, if that balance sheet is not required by the registrant's home jurisdiction (or any other jurisdiction whose rules are applicable to the registrant outside the United States).

79 *See* SEC Release No. 33-7053 (Apr. 19, 1994). In each subsequent reporting year, an additional year of required financial statement data would need to be provided in accordance with U.S. GAAP or IFRS or reconciled to U.S. GAAP.

80 *See* § 4.05[1].

81 *See* § 4.05[1], [2] and [3].

82 A full English translation is required for exhibits in a foreign language, as set out in Rule 403(c)(2) under the Securities Act and Rule 12b-12(d)(2) under the Exchange Act. These exhibits include articles of incorporation, by-laws, instruments defining the rights of securities holders, voting agreements and certain contracts and financial information.

83 Public filings, if required, are made in redacted form while the confidential treatment process plays out. *See* Rule 406 under the Securities Act and Rule 24b-2 under the Exchange Act; SEC, Division of Corporation Finance, Staff Legal Bulletin No. 1A (Feb. 28, 1997), Fed. Sec. L. Rep. (CCH) ¶60,001 (Addendum included: July 11, 2001) (setting out the procedures for the SEC staff's handling of confidential treatment requests). In recent years, the SEC staff has questioned issuers on the amount of text redacted, requiring issuers to narrow their confidential treatment requests to very specific information.

U.S. Regulation of the International Securities and Derivatives Markets, § 4.05, FINANCIAL STATEMENTS IN SEC REGISTRATION STATEMENTS AND OTHER FILINGS

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 4.05 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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[1] Basis of Presentation (U.S. GAAP, IFRS and U.S. GAAP Reconciliation)

Financial statements of foreign companies may be prepared in accordance with U.S. GAAP, [84] IFRS as issued by the IASB, [85] or another comprehensive

p. 4-30

body of accounting principles, but in the last case a reconciliation of the financial statements to U.S. GAAP generally must be provided.

In 2007, the SEC decided to accept financial statements of foreign companies prepared in accordance with IFRS as issued by the IASB without requiring a reconciliation to U.S. GAAP. [86] The rules took effect with respect to fiscal years ending after November 15, 2007. This significant relaxation is only available to foreign companies that prepare financial statements in accordance with IFRS as issued by the IASB. For example, the reconciliation requirement still applies in the case of financial statements prepared in accordance with IFRS as adopted by the EU (but not in compliance with IFRS as issued by the IASB), which provide for certain departures from IASB-approved IFRS, including in the area of accounting for derivatives. [87]

p. 4-30

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p. 4-31

The FASB and IASB continue to work together on convergence projects to harmonize the accounting standards under U.S. GAAP and IFRS as issued by the IASB. In addition, the SEC had taken various steps to consider the adoption of IFRS as an option for presentation of financial statements for U.S. issuers. [88] Despite the efforts, in a May 2015 speech, then-SEC Chief Accountant James Schnurr acknowledged that feedback from various U.S. constituents revealed "virtually no support" for an SEC-mandated IFRS for all U.S. registrants and "little support" for an option to prepare financial statements under IFRS for U.S. registrants. [89] However, he continued to encourage IASB and FASB to work towards converging the financial accounting standards, viewing "continued collaboration [as] the only realistic path to further the objective of a single set of high-quality, global accounting standards." [90] In terms of adopting IFRS as an option for presentation of financial statements for U.S. issuers, SEC Chief Accountant Wesley R. Bricker noted in a December 2016 speech that "for at least the foreseeable future," financial reporting by U.S. issuers will continue to be based on U.S. GAAP, although he expressed an interest in continuing to consider whether to allow U.S. issuers to provide financial information based on IFRS as issued by the IASB as a supplement to their financial statements provided under U.S. GAAP. [91]

If a reconciliation of the financial statements to U.S. GAAP is required, the reconciliation must include an explanation of the principal differences between the accounting principles used and U.S. GAAP, a numerical reconciliation (except in limited circumstances in which a foreign issuer is permitted to elect Item 17 of Form 20-F [92]) of the differences in financial results and principal balance sheet items as reported under its accounting practices and under U.S. GAAP, and an explanation of the reasons for the differences. [93]

First-time foreign registrants are required to reconcile only the last two complete fiscal years of financial statements and the financial statements for any required interim periods. [94] For each subsequent reporting year, an additional year of reconciliation is required. Foreign companies are allowed to use a cash flow statement prepared in accordance with International Accounting Standard No. 7, Cash Flow Statements, as amended ("IAS 7"), without reconciliation to U.S. GAAP. [95]

p. 4-32

p. 4-33

Foreign companies also are required to reconcile to U.S. GAAP selected financial data in their Securities Act and Exchange Act registration statements and Exchange Act annual reports, but only for those periods for which they are required to reconcile the primary annual financial statements and any interim financial statements included in those registration statements or reports. [96]

[2] Required Financial Statements Under Item 8 of Form 20-F and Stale Financial Statements

Under the Item 8 requirements of Form 20-F, financial statements contained or incorporated in a filing generally must include audited balance sheets as of the end of each of the three most recent fiscal years and audited statements of income and cash flows for each of the three most recent fiscal years. [97] Form 20-F generally requires that a registration statement of a foreign issuer (whether under the Exchange Act, for an initial listing, or under the Securities Act, for an offering of securities) include audited financial statements no more than 15 months old (and in the case of an initial public offering ("IPO"), 12 months old). [98] Issuers generally must also include in a filing five years of selected financial data. [99]

Accommodations from the audited financial statement and selected financial data requirements described above are available in certain limited circumstances. Foreign emerging growth companies ("EGCs") are permitted to

p. 4-33

p. 4-34

provide only two years of audited financial statements, and only those two years (rather than five) of selected financial data in IPO registration statements. [100]

The SEC also permits first-time foreign issuer registrants that prepare their primary financial statements in accordance with U.S. GAAP to include financial statements for the two most recent fiscal years, rather than three years. Selected financial data for five fiscal years is still required, although SEC staff guidance permits one or more of the oldest three years to be presented in home country GAAP if U.S. GAAP financial data is not available for those years. [101]

Lastly, foreign issuers that adopt IFRS as issued by the IASB, in their first year after adoption, are permitted to file two years rather than three years of audited financial statements, with appropriate related disclosure. [102] In their second year of reporting under IFRS as issued by the IASB and thereafter, three years of audited financial statements must be provided. [103] This accommodation does not apply to issuers that transition to IFRS as issued by the IASB from a different IFRS accounting body. [104] Foreign private issuers relying on the

p. 4-34

p. 4-35

first-time IFRS adopter exception need include only the two years of selected financial data and may omit the prior three years of selected financial data. [105]

As for interim financial statements, Item 8 of Form 20-F requires that if a registration statement becomes effective more than nine months after the end of the last audited fiscal year, it must contain interim financial statements covering at least the first six months of the following year. The interim financial statements may be unaudited, but they must include a U.S. GAAP reconciliation if they are presented in accordance with home-country GAAP other than IFRS as issued by the IASB. [106] Accordingly, the last effective date for a calendar-year issuer to avoid including interim financial statements is September 30.

As a result of these requirements, a foreign issuer can find itself "blacked out," *i.e.*, unable to have a registration statement become effective, beginning on April 1, for example, for an issuer reporting on a calendar fiscal year, if it is not yet prepared to provide audited financial statements for all or part of the previous year and to be blacked out beginning on October 1 if it is not yet prepared to provide financial statements, which may be unaudited, for an interim period. This is similar to the requirements applicable in most cases to a U.S. domestic issuer. [107] Furthermore, as noted above, if a foreign issuer is making its IPO (meaning that before the offering the foreign issuer is public in neither the United States nor its home country), the last audited financial statements must be no older than 12 months prior to the filing of the registration statement, although the instructions to Item 8 specify that the SEC will consider waiving this requirement in particular cases. [108] This is stricter than the requirements applicable to a U.S. issuer. [109]

The principal difficulty with providing interim financial statements and thereby avoiding the "black-out" caused by financial statements that are outdated under the SEC's rules has been with preparing interim reconciliations to U.S. GAAP. As a result of the SEC's 2007 adoption of the amendments to eliminate U.S. GAAP reconciliation requirements for financial statements prepared under IFRS as issued by the IASB, issuers that no longer need to reconcile to U.S. GAAP should generally be able to avoid all or almost all of the obstacles that impede preparation of timely interim financial statements needed to satisfy SEC requirements. The acceleration of the 20-F annual report filing deadline to four months after the end of an issuer's fiscal year has also reduced the potential impact of these issues.

Finally, if a foreign issuer prepares and discloses to its shareholders or otherwise makes public interim financial information that is more current than the interim financial statement requirements described in this section, the registrant is required to include the more current interim financial information in its registration statement (but not in an annual report on Form 20-F). [110] This requirement covers any publication of financial information that includes, at a minimum, revenue and income information. Unless the foreign issuer prepares its financial statements in accordance with IFRS as issued by the IASB, this information must be accompanied by: (i) a description of any ways in which the accounting principles, practices and methods used in preparing the interim financial information vary materially from the principles, practices and methods accepted in the United States, and (ii) a quantification of any material variations, unless they are already quantified because they appear elsewhere in other financial statements included in the registration statement. [111]

For certain continuous offerings in which the effects of a "black-out" period as described above could be especially adverse, there is an instruction

extending the periods from 15 months to 18 months for audited financial statements and from 9 months to 12 months for interim financial statements. [112] The offerings covered are (i) rights offerings, (ii) offerings pursuant to dividend or interest reinvestment plans and (iii) offerings pursuant to convertible securities or warrants issued by the issuer or an affiliate. The extension beyond 16 months for audited financial statements is no longer meaningful in light of the accelerated Form 20-F annual report deadline.

[3] Segment Information

Both U.S. and foreign issuers are required to include in their financial statements segment financial information. For issuers reporting under, or reconciling to, U.S. GAAP, the accounting standards on this topic are set forth in Accounting Standards Codification 280, Segment Reporting ("ASC 280") (formerly Statement of Financial Accounting Standards ("SFAS") No. 131). [113] For foreign issuers following IFRS as issued by the IASB, IFRS 8 applies.

A reportable operating segment is defined as (i) a component of a business enterprise the operating results of which are regularly reviewed by the enterprise's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance, (ii) for which discrete financial information is available and (iii) that accounts for (a) 10% or more of the combined revenue of the enterprise (including both sales to external customers and inter-segment sales), (b) 10% or more of the operating profit or loss of all of the enterprise's operating segments or (c) 10% or more of the combined assets of all of the enterprise's operating segments. The definition under IFRS as issued by the IASB is substantially consistent. [114] For each reportable segment there must be provided a measure of segment profit or loss, certain specific revenue and expense items and segment assets. The following are the specific revenue and expense items that must be disclosed for each reportable segment if management includes them in measuring profit or loss: revenues from external customers; revenues from other operating segments; depreciation, depletion and amortization; and significant noncash items other than depreciation, depletion and amortization. [115]

[4] Currency in Which Financial Statements Are Reported

p. 4-37

p. 4-38

Special rules applicable to foreign issuers govern the currency in which their financial statements must be presented. [116] Rule 3-20 of Regulation S-K permits a foreign issuer to state the amounts in its primary financial statements using any currency that it deems appropriate. [117] The reporting currency must be prominently disclosed on the face of the financial statements. [118] The rule requires specific disclosure in the financial statements if the currency in which the company expects to declare dividends is different from the reporting currency or there are material exchange restrictions or controls affecting the reporting currency, the currency of the issuer's domicile or the currency in which dividends are paid. [119]

[5] Required Financial Statements of Other Entities Under Regulation S-K

[a] Financial Statements Relating to Acquired Businesses

A registrant may be required to include in a Securities Act registration statement certain audited financial statements in connection with any "significant" business acquisition by the registrant. [120] The "significance" of an acquired business is evaluated based on (i) the amount of the registrant's investment in the acquired business, (ii) the total assets of the acquired business and (iii) the pre-tax income of the acquired business. Each of these is compared with the comparable item in the registrant's most recent audited financial statements. [121] In the case of an acquisition consummated within the preceding 75-day period or whose acquisition is probable at the time the final prospectus or prospectus supplement relating to the offering is completed, financial statements will be required only if the acquired business is "significant" at a 50% level—that is, if the issuer's investment in, or the assets or pre-tax income of, the acquired

p. 4-38

p. 4-39

business equals at least 50% of the registrant's assets or income. [122] Beyond the 75-day period, the registrant must include one, two or three years of financial statements for an acquired business at 20%, 40% and 50% significance levels, respectively, and financial statements for any interim periods required under Rules 3-01 and 3-02 of Regulation S-K. [123] In addition, *pro forma* financial information is required by Article 11 of Regulation S-K to depict the effect of a business acquisition if the financial statements of the acquired business are required to be furnished under these standards. [124]

For purposes of applying the rules described above, the acquisition of "related businesses" (those under common ownership or management or whose acquisitions are conditional on each other or on a single common condition) are treated as a single business combination. [125] In addition, if the registrant has, since the date of its latest audited balance sheet, acquired businesses which, although unrelated and individually insignificant, are significant in the aggregate

p. 4-39

p. 4-40

at a level exceeding 50%, one year of audited financial statements covering the substantial majority of such businesses must be included in the registration statement. [126]

[b] Financial Statements of Certain Unconsolidated Subsidiaries and Equity-

Method Investees

A registrant is required to file separate financial statements of any "significant" majority-owned subsidiary that is not consolidated with the registrant. [127] The "significance" of an unconsolidated subsidiary is evaluated based on (i) the amount of the registrant's investment in the subsidiary, (ii) the total assets of the subsidiary and (iii) the pre-tax income of the subsidiary. If any of these items exceeds a 20% significance level when compared with the comparable item in the registrant's most recent audited financial statements, the registrant must file separate financial statements of the subsidiary. [128]

Similarly, a registrant must file separate financial statements of any "significant" 50%-or-less owned investee that is accounted for by the equity method. [129] An investee will be deemed "significant" if either the first or third condition of the test above is met at the 20% significance level. [130]

p. 4-40

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p. 4-41

Where practicable, the financial statements of the subsidiary or investee required by these rules must be as of the same dates and for the same periods as the audited financial statements of the registrant. [131] However, the separate financial statements need only be audited for those fiscal years in which the relevant 20% significance test was met.

Where financial statements of two or more unconsolidated subsidiaries or two or more 50%-or-less owned investees are required, combined or consolidated financial statements of such persons may be included, subject to principles of inclusion or exclusion that clearly exhibit the financial position, cash flows and results of operations of the combined or consolidated group. [132]

[c] Financial Statements of Guarantors and Issuers of Guaranteed Securities

A Securities Act registration statement for an offering of guaranteed debt securities generally must include audited financial statements of both the issuer and the guarantor of the securities. [133] Rule 3-10 of Regulation S-K provides certain exceptions to this general rule where (i) the issuer is a parent company issuing securities guaranteed by one or more wholly owned subsidiaries, (ii) the issuer is a wholly owned subsidiary issuing securities guaranteed by its parent, or (iii) the issuer is a wholly owned subsidiary issuing securities guaranteed by its parent and one or more other wholly owned subsidiaries. [134] The exceptions allow the inclusion of condensed consolidating financial information in lieu of separate financial statements of a subsidiary issuer or subsidiary guarantor and, in certain cases, allow the omission altogether of separate financial information with respect to the relevant subsidiary.

The threshold requirements for each of the exceptions in Rule 3-10 [135] are that (i) the subsidiary issuer or subsidiary guarantor must be 100%-owned by its parent company (*i.e.*, all of its outstanding voting shares are owned, either

p. 4-41

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p. 4-42

directly or indirectly, by its parent company) [136] and (ii) the guarantee or guarantees must be full and unconditional. [137] Where these requirements are satisfied, the following exceptions are applicable.

Where the issuer is a finance subsidiary [138] issuing securities guaranteed only by its parent company, separate financial statements of the finance subsidiary are not required if the parent company's financial statements are filed and include a footnote stating that the issuer is a 100%-owned finance subsidiary and the parent company has fully and unconditionally guaranteed the securities. [139]

Where the issuer is an operating subsidiary [140] issuing securities guaranteed only by its parent company, separate financial statements of the operating subsidiary are not required if the parent company's financial statements are filed and include, in a footnote, condensed consolidating information for the parent company and the subsidiary issuer. [141] Condensed consolidating information may be omitted if the financial statements include a footnote stating that the parent company has no independent assets or operations, the guarantee is full and

p. 4-42

p. 4-43

unconditional and any assets of subsidiaries other than the subsidiary issuer are minor. [142]

Where the issuer is a subsidiary issuing securities guaranteed, jointly and severally, by its parent company and one or more other subsidiaries of its parent company, separate financial statements of the subsidiaries are not required if the parent company's financial statements are filed and include, in a footnote, condensed consolidating information for the parent company, the subsidiary issuer and the subsidiary guarantors. [143] Condensed consolidating information may be omitted if the financial statements include a footnote stating that the parent company has no independent assets or operations, the subsidiary issuer is a 100%-owned finance company, the parent company and all of the parent company's other subsidiaries have guaranteed the securities jointly and severally and all of the guarantees are full and unconditional. [144]

Where the issuer is a parent company issuing securities guaranteed by a single subsidiary guarantor, separate financial statements of the subsidiary guarantor are not required if the parent company's financial statements are filed and include, in a footnote, condensed consolidating information for the parent company and the subsidiary guarantor. [145] Condensed consolidating information may be omitted if the financial statements include a footnote stating that the parent company has no independent assets or operations, the guarantee is full and unconditional and any subsidiaries other than the subsidiary guarantor are minor. [146]

p. 4-43

p. 4-44

Where the issuer is a parent company issuing securities guaranteed, jointly and severally, by multiple subsidiary guarantors, separate financial statements of the subsidiary guarantors are not required if the parent company's financial statements are filed and include, in a footnote, condensed consolidating information for the parent company and the subsidiary guarantors. [147] Condensed consolidating information may be omitted if the financial statements include a footnote stating that the parent company has no independent assets or operations, the guarantees are full and unconditional and joint and several and any subsidiaries other than the subsidiary guarantors are minor. [148]

The SEC has adopted a special rule for recently acquired subsidiary issuers or subsidiary guarantors that would otherwise meet the conditions for omission of separate financial statements pursuant to one of the exceptions described above. [149] Where such a subsidiary (i) has not been included in the audited consolidated results of its parent company for at least nine months of the most recent fiscal year and (ii) has a net book value [150] or purchase price, whichever is greater, of 20% or more of the principal amount of the securities being registered, then separate audited financial statements of the subsidiary must be filed for the subsidiary's most recent fiscal year preceding the acquisition. In addition, unaudited interim financial statements must be filed for any interim period specified by Rules 3-01 and 3-02 of Regulation S-K.

In connection with the amendments to Rule 3-10 described above, the SEC has exempted from Exchange Act reporting requirements subsidiary issuers or subsidiary guarantors that (i) are permitted to omit separate financial statements by Rule 3-10 of Regulation S-K or (ii) would be permitted to omit financial statements under Rule 3-10 but are required to file pre-acquisition financial statements under Rule 3-10(g). [151]

[d] Financial Statements of Affiliates Whose Securities Collateralize Registered Securities and Financial Statements of Other Persons Where Material to an Investment Decision

p. 4-44

p. 4-45

A registrant is required to file separate financial statements of any affiliate whose securities constitute a "substantial portion" of the collateral for any securities being registered. [152] For purposes of this rule, securities of an affiliate constitute a "substantial portion" of collateral if the aggregate principal amount, par value, book value or market value of such securities, whichever is greater, is equivalent to 20% or more of the principal amount of the secured class of securities. [153]

In addition, the SEC may require the inclusion of financial statements of other persons in any case where they are "necessary or appropriate for an adequate presentation of the financial condition of any person whose financial statements are required." [154] Regulation AB provides a special registration and disclosure regime for asset-backed securities, including disclosure requirements for assets meeting 10% and 20% concentration levels. [155]

The SEC also has required parent bank financial statements, prepared in accordance with IFRS as issued by the IASB or in accordance with or reconciled to U.S. GAAP, to be included in registration statements for offerings by special purpose subsidiaries of the bank intended to strengthen the bank's capital (and therefore not guaranteed by the bank) where payments on the securities depend exclusively on the income generated from assets acquired from the bank with the proceeds of the offering and bank regulators may require the bank to "claw back" those assets if certain financial regulatory events occur with respect to the bank. [156]

Under certain circumstances, the credit of a third party is so significant that the SEC has required the third party to become a co-registrant with the issuer and therefore to provide the complete business and financial information required by the applicable registration form. For example, where an issuer's business (typically a special purpose issuer) consists principally of purchasing securities from a third party (or affiliated third parties) with the proceeds from the sale of the securities to be registered under the Securities Act, the issuer will be deemed to

p. 4-45

p. 4-46

be an underwriter of the securities of the third party, which in turn would be required to become a co-registrant with the issuer. [157]

[6] Accounting Topics

[a] Convenience Translations and Historical Exchange Rates

Financial statements in registration statements may include "convenience" translations of the issuer's home currency to U.S. dollars for the most recent fiscal year and any subsequent interim period, using for this purpose an exchange rate as of the date of the most recent balance sheet included in the filing or, if materially different, as of the most recent practicable date. [158] The filing must include the historical exchange rates between the financial reporting currency and U.S. dollars, including (i) the exchange rate at the latest practicable date, (ii) the high and low exchange rates during the previous six months and (iii) the average exchange rates for each of the five most recent fiscal years and any subsequent interim period. [159] If the filing relates to equity securities, it must also contain a five-year history of dividends declared per share in both the financial

p. 4-46

p. 4-47

reporting currency and U.S. dollars (based on exchange rates in effect on the payment dates). [160]

[b] Accounting for Inflation Under Rule 3-20 of Regulation S-K

If the financial statements of a foreign company (i) are denominated in a currency of a country that has experienced cumulative inflationary effects exceeding 100% over the most recent three-year period and (ii) have not been recast or otherwise supplemented to include information on a historical cost/constant currency or current cost basis prescribed or permitted by generally accepted accounting principles, the issuer must present supplementary information to quantify the effects of changing prices upon its financial condition and results of operations. [161]

[c] Accounting for Operations in a Hyperinflationary Environment

Under U.S. GAAP, financial results of operations conducted in the currency of a country with a hyperinflationary environment must be measured in the issuer's reporting currency. [162] By contrast, most other accounting principles permit measurement in the local currency restated to reflect changing prices; that measurement is then translated into the reporting currency.

A "hyperinflationary environment" is defined as one that had cumulative inflation of approximately 100% or more over the most recent three-year period. [163] Under Items 17 and 18 of Form 20-F, the SEC does not require that an issuer in a hyperinflationary environment include a reconciliation that quantifies the effects on its financial statements under U.S. GAAP that result from its use of the restate-translate method so long as the methodology used is consistently applied and is in conformity with International Accounting Standard No. 21, The Effects of Changes in Foreign Exchange Rates, as amended in 1993 ("IAS 21"), using the historical cost/constant currency method. IAS 21 requires restatement of measurements in local currency to account for changing prices in accordance with International Accounting Standard No. 29, Financial Reporting in Hyperinflationary Economies, as amended in 2008, and then translation of such adjusted measurements to the reporting currency.

[d] Revenue Recognition

p. 4-47

p. 4-48

SEC Staff Accounting Bulletin No. 104—Revenue Recognition ("SAB 104") (updating SEC Staff Accounting Bulletin No. 101—Revenue Recognition in Financial Statements ("SAB 101")) provides specific guidelines on revenue recognition, presentation and disclosure that registrants should follow in preparing their financial statements. [164] In SAB 104, the SEC staff indicated that "revenue should not be recognized until it is realized or realizable and earned." According to SAB 104, revenue generally is realized or realizable and earned when all of the following criteria are met: (i) persuasive evidence of an arrangement exists, (ii) delivery has occurred or services have been rendered, (iii) the seller's price to the buyer is fixed or determinable, and (iv) collection is reasonably assured. [165]

The specific guidelines provided in SAB 104 are aimed at limiting the discretion companies have in deciding when to recognize and report revenue in their financial statements. [166] SAB 101 was initially adopted in large part due to the SEC staff's concern that companies were prematurely and improperly recognizing revenue in an attempt to improve earnings reported in financial statements. [167] SAB 104 is one of three staff accounting bulletins aimed at addressing earnings management problems. [168]

Revenue recognition has also been an important area of focus in the IFRS and U.S. GAAP convergence efforts. The objective of the FASB and IASB revenue recognition joint project was to develop a common revenue standard for both U.S. GAAP and IFRS. On May 28, 2014, the IASB and FASB jointly issued a converged standard on the recognition of revenue from contracts with

p. 4-48

p. 4-49

customers. [169] Although the general principles of revenue recognition were similar between IFRS and U.S. GAAP, the previous U.S. accounting standards contained significant detailed industry-specific requirements that previous IFRS standards did not have. [170] The new converged standard eliminates the industry-specific requirements under U.S. GAAP. In a joint press release, the IASB and FASB noted that the new converged standard will provide "substantial enhancements to the quality and consistency of how revenue is reported while also improving comparability in the financial statements of companies reporting using IFRS and U.S. GAAP." [171] As the new revenue recognition standard becomes effective for public companies, issuers should expect continued SEC scrutiny of their revenue recognition accounting and related disclosure. [172]

[e] Lease Accounting

p. 4-49

p. 4-50

In 2016, both the IASB and the FASB issued new lease accounting standards to align lessor accounting with certain changes in the lessee model and the new revenue recognition standard. [173] In January 2016, the IASB issued IFRS 16, Leases, and in February 2016, the FASB issued Accounting Standards Update No. 2016-02, Leases ("ASU 2016-02"). Both standards require entities to reflect practically all leases on their balance sheet, but there are some differences. The IASB requires companies to present all leases (other than short-term leases or "small ticket" leases) in a way that is similar to prior accounting for financing leases, such that more of the lessee's expenses would be reflected up front. The FASB instead retained a dual model, including financing leases, similar to the prior standard's capital leases, and operating leases, with expenses recognized on a straight-line basis. Lessees will need to classify their leases under the FASB approach based on guidance similar to the classification model under current U.S. GAAP. [174]

ASU 2016-02 will become effective for public companies, certain not-for-profits and benefit plans for interim and annual reporting periods beginning after December 15, 2018. [175] IFRS 16 will become effective for annual reporting periods beginning on or after January 1, 2019. [176]

[f] Cheap Stock

Common stock or options or warrants relating to such stock are often issued as compensation for services or otherwise. Issuances of such securities proximate to a company's IPO may raise questions as to whether the securities were issued at a price below their fair value. If the securities were issued at a price below their fair value, the SEC staff will require the issuer to charge the difference between fair value and issuance price to its income statement under compensation expense and include the shares issued or, in the case of options or warrants, assumable in calculating earnings per share. The SEC staff has long focused, and has continued to focus, on this issue. A number of factors will be relevant in considering whether a company has such a "cheap stock" problem, perhaps the most important of which are the amount of time between the issuance and the company's IPO and the extent of the difference between the issuance price and the IPO price of the company's common stock. Issuances within one year prior to the IPO are presumed to raise this question. Historical financial

p. 4-50

p. 4-51

statements prepared without recognition of this additional compensation expense and increase in outstanding shares will need to be revised if the SEC staff concludes that there is a "cheap stock" problem, possibly delaying the offering process and, in any event, reducing the company's operating and net income (or increasing its operating or net loss) and reducing earnings per share. Also, if vested stock were purchased for less than fair market value, the discount would be taxable income to the employee under U.S. tax law.

[g] Loss Contingencies

Under U.S. GAAP, Accounting Standards Codification 450, Contingencies ("ASC 450") (formerly SFAS No. 5) requires disclosure of contingent liabilities arising out of litigation, arbitration or regulatory actions if there is a "reasonable possibility" of a material loss with respect to such contingency. An accrual of an estimated loss is required if it is both "probable" that a material liability will be incurred and the amount of loss can be "reasonably estimated." [177] The required disclosures include a description of the nature of the loss contingency, an estimate of the loss or range of loss if reasonably estimable, and a statement that an estimate of the loss cannot be made if it is not reasonably estimable.

Under IFRS as issued by the IASB, International Accounting Standards, Provisions, Contingent Liabilities and Contingent Assets ("IAS 37") requires disclosure of contingent liabilities arising out of litigation, arbitration or regulatory actions if the obligation is possible and the likelihood of an outflow of resources is more than remote. [178] Like ASC 450, accrual is required under IAS 37 when payment is "probable" and a "reliable estimate can be made of the amount of the obligation," [179] but the definitions of probable differ. IAS 37 defines probable as "more likely than not to occur," [180] whereas, ASC 450 defines probable as "likely to occur." [181] Given that "likely" under U.S. GAAP is generally considered a higher threshold (*i.e.*, approximately 80%) than "more likely than not" under IFRS, which is typically considered to represent a greater than 50% probability, accrual of contingent liabilities is more likely under IAS 37. [182]

p. 4-51

p. 4-52

The SEC staff remains focused on the adequate disclosure and accrual of loss contingencies and the Division of Corporation Finance has been issuing comment letters to both U.S. and foreign issuers seeking adequate disclosure of estimates of reasonably possible losses or ranges of reasonably possible losses under current ASC 450 or International Accounting Standard No. 37, Provisions, Contingent Liabilities and Contingent Assets, respectively. [183]

Footnotes

84 In response to § 108 of the Sarbanes-Oxley Act, which requires the SEC to recognize accounting principles established by a standard setting body as "generally accepted" accounting principles, the SEC designated the U.S. Financial Accounting Standards Board (the "FASB") as a standard setting body and confirmed that the FASB's financial accounting and reporting standards are "generally accepted" for purposes of the U.S. federal securities laws. *See* SEC Release No. 33-8879 (Dec. 21, 2007). The Sarbanes-Oxley Act requires the standard setting body to be organized as a private entity and to have a board of trustees, the majority of whom are not and have not been associated persons at a registered public accounting firm during the prior two years. It also requires the standard setting body to adopt procedures to ensure prompt consideration of necessary changes to accounting principles by a majority vote and to consider the need to keep standards current. *See* SEC Release No. 33-8221 (Apr. 25, 2003).

85 In reviewing the financial statements of registrants, the SEC staff will comment not only on the adequacy of U.S. GAAP reconciliation matters, but also on whether it believes that home-country principles or IFRS have been applied correctly. *See* Lynn E. Turner, Chief Accountant, SEC, Office of the Chief Accountant, Financial Reporting Issues Critical to European SEC Registrants/Users of U.S. GAAP (Apr. 8, 1999).

86 SEC Release No. 33-8879 (Dec. 21, 2007). This decision followed several years of coordinated efforts by the SEC and the FASB with the International Accounting Standards Committee (the "IASC") and its successor, the IASB, including through the International Organization of Securities Commissions (IOSCO), to develop a core set of international accounting standards for cross-border capital raising and listing purposes in all global markets. In 2000, the SEC issued a concept release, International Accounting Standards, SEC Release No. 33-7801 (Feb. 16, 2000), that sought, *inter alia*, to identify the important issues that would be raised by an acceptance of the IASC "core standards" program. The SEC expressed support for the core standards project, but indicated that there were three key elements that must be present if financial statements prepared under such standards were to be accepted in Securities Act registration statements without U.S. GAAP reconciliation: (i) they must include a core set of accounting pronouncements that constitutes a comprehensive, generally accepted basis of accounting, (ii) they must be of a high quality, resulting in comparability and transparency, and they must provide for "full disclosure," and (iii) they must be rigorously interpreted and applied. These elements have continued to be relevant to the SEC in its consideration of IFRS. Subsequently, in 2002 the IASB and the FASB agreed to a Memorandum of Understanding on convergence between their respective accounting standards and thereafter published a roadmap for developing common accounting standards and developed plans and milestone targets for completing the major Memorandum of Understanding projects in 2011. FASB and IASB Reaffirm Commitment to Memorandum of Understanding—A Joint Statement of the FASB and IASB (Nov. 5, 2009). On May 28, 2014, the IASB and FASB issued a converged standard of revenue recognition. *See* § 4.05[8][d]; *see also* News Release, IASB and FASB, IASB and FASB Seek to Reduce Differences in Classification and Measurement Models for Financial Instruments (Jan. 27, 2012).

87 EU companies listed on a regulated market have been required since 2005 to prepare their consolidated accounts in accordance with IFRS. As of December 2007 when the rules were adopted, the only difference

between IFRS as issued by the IASB and IFRS as adopted by the EU relates to International Accounting Standard No. 39, Financial Instruments: Recognition and Measurement ("IAS 39"), whereby IFRS as adopted by the EU offers greater flexibility with respect to hedge accounting for certain financial instruments than does IFRS as issued by the IASB. As a practical matter, this difference applies only to foreign financial institutions, and the vast majority of EU issuers listed in the United States do not make use of this carve-out available under the EU-endorsed IFRS. There are concerns, however, that EU issuers may not be able to establish compliance in the future if the timing of the EU's endorsement of new standards, or an EU decision not to endorse a standard, were to create differences between EU IFRS and IFRS as issued by the IASB such that compliance with EU IFRS necessarily precluded compliance with IFRS as issued by the IASB. *See* SEC Release No. 33-8879 (Dec. 21, 2007), 73 Fed. Reg. 986, 993 n.75 (Jan. 4, 2008). IAS 39 will be superseded by IFRS 9, Financial Instruments. IFRS 9 includes requirements for recognition and measurement, derecognition and hedge accounting. The final version of IFRS 9 was issued on July 24, 2014. The IASB has assigned a mandatory effective date of January 1, 2018, but the EU has not yet assigned a mandatory effective date.

The SEC made available temporary transition relief to European issuers that had already utilized the IAS 39 carve-out in financial statements previously filed with the SEC. These issuers were permitted to file financial statements for their first two fiscal years that ended after November 15, 2007 without U.S. GAAP reconciliation if their financial statements otherwise complied with IFRS as issued by the IASB and an audited reconciliation to IFRS as issued by the IASB was provided. European issuers were required to include reconciliations to U.S. GAAP or otherwise comply with the requirements in Item 18(a) for fiscal years after the transition period. *See* Form 20-F, Instructions to Item 18; *see also* SEC Release No. 33-8879 (Dec. 21, 2007).

88 In 2008, following issuance of a concept release seeking input as to whether U.S. issuers should be permitted to elect to prepare their financial statements in accordance with IFRS, the SEC proposed a roadmap for the potential use of financial statements prepared in accordance with IFRS as issued by the IASB by U.S. issuers for purposes of their filings with the SEC. *See* SEC Release Nos. 33-8831 (Aug. 7, 2007) and 33-8982 (Nov. 14, 2008). In February 2010, the SEC directed its staff to develop and execute a work plan related to the proposed roadmap and in May 2011, the SEC's Office of the Chief Accountant published a staff paper outlining a possible approach for incorporation of IFRS into the U.S. financial reporting system. On July 13, 2012, the SEC's Office of the Chief Accountant published its Final Staff Report on the work plan (the "Final Staff Report"), which included no decision or time frame regarding whether to allow U.S. companies to present financial statements according to IFRS. *See* SEC, Office of the Chief Accountant, Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers: Exploring a Possible Method of Incorporation (May 26, 2011); Final Staff Report (July 13, 2012). The Final Staff Report summarized the staff's key findings regarding the potential incorporation of IFRS into U.S. financial reporting, but did not make any recommendation to the SEC. The issues discussed in the report included the diversity in how accounting standards are interpreted and applied in various jurisdictions, the potential cost to U.S. issuers of adopting IFRS, investor education and governance.

89 James Schnurr, Chief Accountant (2014-2016), SEC, Remarks before the 2015 Baruch College Financial Reporting Conference (May 7, 2015).

90 James Schnurr, Chief Accountant (2014-2016), SEC, Remarks Before the 2015 AICPA National Conference on Current SEC and PCAOB Developments (Dec. 9, 2015).

91 Wesley R. Bricker, Chief Accountant, SEC, Keynote Address before the 2016 AICPA Conference on Current SEC and PCAOB Developments (Dec. 5, 2016).

92 *See* Notes 41, 124, 131.

93 Form 20-F, Item 18 (Item 18 requires disclosure of all information in Item 17 as well as certain additional information. *See* Item 17(c) for a description of the information referenced here).

94 SEC, Division of Corporation Finance, FINANCIAL REPORTING MANUAL, Topic 6410.2. If a foreign registrant's

financial statements are prepared in accordance with U.S. GAAP, audited statements of income and cash flows need only be provided for the last two complete fiscal years and not for the last three complete fiscal years required if the financial statements were prepared in accordance with home-country (or IFRS) accounting principles.

95 Form 20-F, Item 17(c)(2)(iii). Although there are differences between a cash flow statement prepared in accordance with IAS No. 7 and one prepared in accordance with U.S. GAAP, the SEC concluded that most of the differences involve classification and are readily apparent, and that the remaining differences should not significantly detract from an investor's understanding of the company's cash flows. Two other International Accounting Standards have been adopted by the SEC: (i) portions of International Accounting Standard No. 22, Business Combinations (as amended in 1993) (superseded by IFRS 3, *Business Combinations*, as amended by Annual Improvements to IFRSs 2010-2012 Cycle, which became effective on July 1, 2014), regarding the method of accounting for a business combination and the determination of the amortization period for goodwill and negative goodwill, and (ii) portions of International Accounting Standard No. 21, The Effects of Changes in Foreign Exchange Rates (as amended in 1993), regarding translation of amounts stated in a currency of an entity in a hyperinflationary economy.

96 *See* Form 20-F, Instruction 2 to Item 3.A.

97 A balance sheet as of the end of the earliest of the three years is not required, however, if that balance sheet is not required by a jurisdiction outside the United States. Form 20-F, Instruction 1 to Item 8.A.2.

98 Form 20-F, Item 8.A.4. In 2001, the SEC issued a release adopting a technical amendment to Item 8.A.4 of Form 20-F clarifying that the last audited financial statements must be annual financial statements and that an issuer cannot satisfy this requirement by filing interim audited financial statements. The amendment deletes language in Instruction 1 of Item 8.A.4 that incorrectly implied that audited financials for a period of less than a full year could be used to satisfy the 15-month rule. *See* SEC Release No. 34-44406 (June 11, 2001).

99 *See* Form 20-F, Item 3.A. Issuers may present the five years of selected financial data (or fewer than five years if an accommodation is available) required in the registration statement on the basis of their home-country GAAP rather than five years of U.S. GAAP selected financial data. *See* Form 20-F, Instruction 2 to Item 3.A. However, if the issuer uses a basis of accounting other than IFRS as issued by the IASB, it must include a reconciliation of the selected financial data to U.S. GAAP for (i) those periods for which the issuer is required to reconcile the primary annual financial statements in a filing under the Securities Act or the Exchange Act, and (ii) any interim periods. *See* Form 20-F, Instruction 2 to Item 3.A. The SEC will entertain a waiver for the earliest two years of the five-year period if an issuer is unable to provide such selected financial data. An issuer seeking a waiver must submit a required representation to the SEC before or at the time the form omitting such information is filed and disclose in the document that data for the earliest two years have been omitted and explain the reasons for the omission. Form 20-F, Instruction 2 to Item 3.A.

100 Similarly, the JOBS Act permits an EGC to cover only two years of financial information in the MD&A section of its IPO registration statement. *See* Chapter 3 for discussion of the JOBS Act, pursuant to which this accommodation was adopted, and other accommodations available to EGCs. However, underwriters may sometimes advise EGCs not to take advantage of certain aspects of the further disclosure relief given the potential usefulness of the additional financial information and data for marketing purposes. The JOBS Act's provisions modifying the selected financial data and MD&A disclosure requirements do not on their face apply directly to a foreign private issuer using Form 20-F or the Securities Act forms that refer to Form 20-F for their content; however, the SEC has indicated that a foreign private issuer that qualifies as an EGC may comply with the scaled disclosure provisions available to EGCs to the extent relevant to the form requirements for foreign private issuers. SEC, Division of Corporation Finance, Generally Applicable Questions on Title I of the JOBS Act (Sept. 28, 2012, May 3, 2012 and Apr. 16, 2012) ("SEC EGC FAQs") 8.

101 Form 20-F, Instruction 3 to Item 8.A.2; *see also* SEC Release No. 33-8567 (Apr. 12, 2005); *supra* Note 94 and accompanying text. *See also* SEC, Division of Corporation Finance, FINANCIAL REPORTING MANUAL,

Topic 6410.2(c).

102 *See* Form 20-F, General Instruction G. First-time adopters of IFRS must present (i) the note required by IFRS 1, First-Time Adoption of International Financial Reporting Standards, containing a reconciliation from the company's previous GAAP to IFRS, in a form and content sufficient to explain all material adjustments to the balance sheet and income statement and, if presented under the company's previous GAAP, the cash flow statement and (ii) to the extent the primary financial statements reflect the use of exceptions permitted or required by IFRS 1, identification of each exception used, including an indication of the items or class of items to which the exception was applied and a description of what accounting principle was used and how it was applied.

Management should not include in the MD&A any discussion relating to financial statements prepared in accordance with the company's previous GAAP unless the company has elected to include or incorporate by reference such previous GAAP financial information as permitted by the SEC's rules. Form 20-F, General Instruction G.

103 *See* SEC Release No. 33-8567 (Apr. 12, 2005); SEC Release No. 33-8879 (Dec. 21, 2007).

104 *See* SEC Release No. 33-8879 (Dec. 21, 2007) ("We believe that an issuer may rely on the provisions of General Instruction G if and only if that issuer has not previously stated its reliance on IFRS 1. Further, an issuer may only rely on the provisions of General Instruction G once.")

105 *See* Center for Audit Quality International Practices Task Force, Highlights (Nov. 24, 2009), at 11, https://www.iasplus.com/en/binary/usa/caq/0911caqinternational.pdf.

106 Form 20-F, Item 8.A.5. In a meeting with the AICPA SEC Regulations Committee's International Practices Task Force, the SEC staff has noted that when financial statements are updated in order to comply with the age of financial statements requirements set forth in Item 8 of Form 20-F, an issuer must also update other "financial" information, including MD&A, Quantitative and Qualitative Disclosure of Market Risk, financial statements required under Rule 3-10 of Regulation S-K and Selected Financial Data. *See* AICPA, SEC Regulations Committee's International Practices Task Force, Highlights, Item 2 (Mar. 9, 2004).

107 U.S. registrants generally are "blacked-out" earlier than foreign issuers, except in the case of IPOs, in which case the foreign issuer requirements are stricter, as described below.

108 To obtain such a waiver, the issuer must be able to represent adequately to the SEC that it is not required to comply with the 12-month requirement in any other jurisdiction outside the United States and that compliance is impracticable or involves undue hardship. The representation must be filed as an exhibit to the registration statement. If the SEC waives the 12-month requirement, the company must comply with the 15-month requirement instead. *See* Form 20-F, Instruction 2 to Item 8.A.4.

109 U.S. registrants must include audited financial statements no older than one year and 45 days at the date the registration statement becomes effective for registration statements filed under the Securities Act or filed on Form 10. *See* Rule 3-12 of Regulation S-K.

110 Form 20-F, Item 8.A.5.

111 If the published financial information is reconciled to U.S. GAAP, the SEC will generally require comparative prior period information to be included in the registration statement (even if the issuer provides the U.S. GAAP reconciliation voluntarily). Notably, if a foreign issuer prepares primary financial statements in accordance with U.S. GAAP and releases information in its local market based on local GAAP, the SEC will require such issuer to reconcile such information to U.S. GAAP unless the issuer provides a reverse reconciliation (from U.S. GAAP to local GAAP) for at least the most recent fiscal year. The SEC has noted that once a foreign issuer reconciles published financial information to U.S. GAAP, an MD&A is required with respect to both the current and comparative periods as well as, to the extent applicable, *pro forma* financial statements pursuant to Rule 11-02 of Regulation S-K. *See* SEC, Division of Corporation Finance, International Reporting and Disclosure Issues, Part III(C) (Nov. 1, 2004). Companies preparing their financial statements in accordance with IFRS as issued by the IASB need not provide either descriptive or quantified U.S. GAAP reconciling information under Item 8.A.5 of Form 20-F. *See* Form 20-F, Instructions to Item 8.A.5; *see also* SEC Release No. 33-8879 (Dec. 21, 2007); *supra* Note 86 and accompanying text.

112 *See* Form 20-F, Instruction 2 to Item 8.

113 *See infra* § 4.09, Note 492 and accompanying text for a discussion of non-GAAP financial measures and presentation of segment information.

114 *See* PwC, A PRACTICAL GUIDE TO SEGMENT REPORTING 5, 9 (Sept. 2008).

115 *See* ASC 280. If an issuer changes its segments after a given year end but before filing its annual report on Form 10-K or Form 20-F with respect to such year, the Form 10-K or Form 20-F segment disclosures should be based on the segments in place at the year end. However, if after changing segments the issuer were to conduct a registered offering, it would be required to include in the registration statement for the offering (or file on a Form 8-K, in the case of a U.S. issuer, or Form 6-K, in the case of a foreign issuer, and incorporate by reference) annual audited financial statements with a revised segment footnote to reflect the new reportable segments, together with business and MD&A disclosure reflecting the change (but no prior SEC filings would need to be amended).

116 Rule 3-20 of Regulation S-K.

117 Rule 3-20(a) of Regulation S-K. Rule 3-20 also provides that changes in reporting currency require the financial statements of periods prior to the change to be recast comprehensively as if the new reporting currency had been used. Rule 3-20(e) of Regulation S-K. The decision to make such a change and the reason for the change must be disclosed in a note to the financial statements. *See* § 4.05[8][c] for a discussion of the requirements relevant in hyperinflationary environments.

118 Rule 3-20(b) of Regulation S-K.

119 Rule 3-20(b) of Regulation S-K.

120 Rule 3-05 of Regulation S-K.

121 Rule 1-02(w) of Regulation S-K.

122 Rule 3-05(b)(2)(iv) and Rule 3-05(b)(4)(i) of Regulation S-K. If an issuer, other than a foreign issuer permitted to furnish reports on Form 6-K, omits the financial statements of an acquired business from the prospectus or prospectus supplement because the "significance" of the acquired business is less than 50%, the omitted financial statements and any *pro forma* financial information required by Article 11 of Regulation S-K must be furnished under cover of Form 8-K no later than 75 days after the consummation of the acquisition. Rule 3-05(b)(4)(ii) of Regulation S-K. *See also* Form 8-K, Item 9.01(a).

123 Rule 3-05(b)(2) of Regulation S-K. The annual financial statements must be audited in accordance with U.S. auditing standards. The financial statements must be presented in accordance with U.S. GAAP or, when the acquired business is a foreign private issuer, reconciled to U.S. GAAP. The financial statements of an acquired business need not, however, contain a reconciliation to U.S. GAAP if those financial statements are prepared using IFRS as issued by the IASB or if the business does not exceed the 30% significance level. *See* Form 20-F, Item 17(c)(2)(v); § 4.05[1].

124 *Pro forma* financial information may be required by Article 11 in connection with certain transactions other than acquisitions or business combinations, even if separate financial statements are not required under Rule 3-05. *See* Rule 11-01(a) of Regulation S-K.

The financial statement requirements of Rule 3-05 and the *pro forma* requirements of Article 11 of Regulation S-K do not apply to annual reports on Form 20-F or Form 10-K under the Exchange Act. *See* Form 20-F, Items 17(a) and 18; Form 10-K, Item 8. Both requirements do, however, apply to Securities Act registration statements and to Exchange Act registration statements, such as registration statements on Form 20-F, when being used to register securities under the Exchange Act in connection with a listing that does not involve a public offering. *See* Form F-1, Items 4 and 4A(b); Form F-3, Item 5(b); Form 20-F, Items 17(a) and 18; Form 10, Item 13.

In 2005, the SEC adopted rules that, subject to certain exceptions in the context of business combinations and change-of-domicile transactions, require the filing of a report on Form 20-F by an Exchange Act-reporting foreign issuer shell company in connection with entering into a transaction that causes it to cease being a shell company. The report is required to be filed within four business days of the completion of the transaction and must contain the same information (including financial information) that would be required in a registration statement on Form 20-F covering all classes of the registrant's securities that are subject to Exchange Act reporting obligations. *See* SEC Release No. 33-8587 (July 15, 2005); Form 20-F, General Instruction A(d).

125 Rule 3-05(a)(3) of Regulation S-K.

126 Rule 3-05(b)(2)(i) of Regulation S-K.

127 Rule 3-09(a) of Regulation S-K. The financial statement requirements of Rule 3-09 apply both to registration statements under the Securities Act and the Exchange Act and to annual reports under the Exchange Act.

128 For a registrant that has experienced a pre-tax loss in a given year, the foregoing "significance" test may have the effect of causing a subsidiary to be deemed "significant" despite its relative financial unimportance to the registrant. This is because the registrant would not be entitled to employ an income figure based on the average of its preceding five fiscal years when performing the "significance" calculations (in contrast to issuers with pre-tax income, as set out in the computational notes to Rule 1-02(w) of Regulation S-K), causing the "significance" test to be measured against the given year's pre-tax loss only, as measured in absolute terms and on a U.S. GAAP basis or, for issuers that report in accordance with IFRS as issued by the IASB, on that basis. Thus, a registrant that has pre-tax income of $100 in each of its four earliest fiscal years, followed by a pre-tax loss of $5 in the most recent fiscal year, would measure significance by reference to $5. If, on the other hand, the registrant had pre-tax income of $5 in the most recent fiscal year, significance would be measured by reference to $81 (the five-year income average). *See* Rule 1-02(w) of Regulation S-K, Computational Note 2.

129 Rule 3-09(a) of Regulation S-K.

130 For the purposes of making the calculations required in the significance tests, issuers that report their financial statements using U.S. GAAP or reconcile to U.S. GAAP must make calculations under the test using U.S. GAAP. Issuers that report using IFRS as issued by the IASB should make calculations under IFRS. *See* Note to paragraph (w) of Rule 1-02(w) of Regulation S-K. The financial statements of a 50%-or-less owned investee need not contain a reconciliation to U.S. GAAP if the registrant prepares its financial statements using IFRS as issued by the IASB or if the first and third conditions of the significance test do not exceed 30%. *See* Form 20-F, Item 17(c)(2)(vi).

131 *See* Rule 3-09(b) of Regulation S-K. Thus, interim financial statements of the subsidiary or investee are not required under Rule 3-09. Instead, under Rule 10-01(b)(1) of Regulation S-K, an issuer's interim financial statements should include summarized income statement information relating to each significant subsidiary or investee. However, such summarized information need not be furnished for a subsidiary or investee that would have qualified as a foreign issuer if it were a registrant.

132 Rule 3-09(c) of Regulation S-K.

133 Rule 3-10(a) of Regulation S-K ; *see also* SEC Release No. 33-7878 (Aug. 4, 2000). Under the Securities Act, guarantees of securities are themselves securities and in connection with an offering of guaranteed securities both the securities and the guarantees must be either registered or exempt from registration.

134 Rule 3-10(b), (c), (d), (e) and (f) of Regulation S-K ; *see* SEC Release No. 33-7878 (Aug. 4, 2000).

135 Rule 3-10(b), (c), (d), (e) and (f) of Regulation S-K.

136 The SEC declined to include an exception to this rule for companies organized in jurisdictions that require directors to own shares or that prescribe a minimum number of shareholders. The SEC has, however, granted no-action relief in a case in which the non-parent company ownership was at the minimum level required by law. *See Crown Cork & Seal Company, Inc*. (avail. Mar. 10, 1997). The SEC has indicated its intention to continue to recognize the exception presented in *Crown Cork & Seal Company, Inc.* and to consider future no-action requests based on substantially similar facts. SEC Release No. 33-7878 (Aug. 4, 2000); *see*, *e.g.*, *Melco Crown Entertainment Ltd.* (avail. Oct. 18, 2010); *Axtel, S.A. de C.V.* (avail. July 21, 2004); *Maxcom Telecommunicaciones, S.A. de C.V.* (avail. Oct. 31, 2001).

137 A guarantee is "full and unconditional" if, "when an issuer of a guaranteed security has failed to make a scheduled payment, the guarantor is obligated to make the scheduled payment immediately and, if it does [not], any holder of the guaranteed security may immediately bring suit directly against the guarantor for payment of all amounts due and payable." Rule 3-10(h)(2) of Regulation S-K. A guarantee can be full and unconditional even if it includes a "savings" clause to prevent the guarantee from being considered a fraudulent conveyance under U.S. law. SEC Release No. 33-7878 (Aug. 4, 2000), 65 Fed. Reg. 51,692, 51,696 (Aug. 24, 2000). A guarantee will be considered full and unconditional if the savings clause limits the guarantee to the highest amount that would not render it a fraudulent conveyance, but not if the guarantee is limited to a specified dollar amount or percentage of the guarantor's assets.

138 A subsidiary is a "finance subsidiary" if it has no assets, operations, revenues or cash flows other than those related to the issuance, administration and repayment of the security being registered and any other securities guaranteed by its parent company. Rule 3-10(h)(7) of Regulation S-K.

139 Rule 3-10(b)(4) of Regulation S-K. The footnote must also include certain narrative disclosures prescribed by Rule 3-10(i)(9) and (10) of Regulation S-K.

140 A subsidiary is an "operating subsidiary" if it is not a "finance subsidiary." Rule 3-10(h)(8) of Regulation S-K.

141 Rule 3-10(c)(4) of Regulation S-K. The condensed consolidating information must cover the same periods as the parent's financial statements with separate columns for (i) the parent company, (ii) the subsidiary issuer, (iii) any other subsidiaries of the parent on a combined basis, (iv) consolidating adjustments and (v) the total consolidated amounts.

142 Note 1 to Paragraph (c) of Rule 3-10 of Regulation S-K. The footnote must also include certain narrative disclosures prescribed by Rule 3-10(i)(9) and (10) of Regulation S-K.

143 Rule 3-10(d)(4) of Regulation S-K. The condensed consolidating information must cover the same periods as the parent's financial statements with separate columns for (i) the parent company, (ii) the subsidiary issuer, (iii) the guarantor subsidiaries of the parent company on a combined basis, (iv) any other subsidiaries of the parent on a combined basis, (v) consolidating adjustments and (vi) the total consolidated amounts.

If any of the subsidiary guarantees is not joint and several with the guarantees of the other subsidiaries, then each subsidiary guarantor whose guarantee is not joint and several need not include separate financial statements, but the condensed consolidating financial information must include a separate column for each subsidiary guarantor whose guarantee is not joint and several. Rule 3-10(i) of Regulation S-K ; *see* SEC Release No. 33-7878 (Aug. 4, 2000), 65 Fed. Reg. 51,692, 51,699 (Aug. 24, 2000).

144 Note 5 to Paragraph (d) of Rule 3-10 of Regulation S-K. The footnote must also include certain narrative disclosures prescribed by Rule 3-10(i)(9) and (10) of Regulation S-K.

145 Rule 3-10(e) of Regulation S-K. The condensed consolidating information must cover the same periods as the parent's financial statements with separate columns for (i) the parent company, (ii) the subsidiary guarantor, (iii) any other subsidiaries of the parent on a combined basis, (iv) consolidating adjustments and (v) the total consolidated amounts.

146 The footnote must also include certain narrative disclosures prescribed by Rule 3-10(i)(9) and (10) of Regulation S-K.

147 Rule 3-10(f) of Regulation S-K. The condensed consolidating information must cover the same periods as the parent's financial statements with separate columns for (i) the parent company, (ii) the subsidiary guarantors on a combined basis, (iii) any other subsidiaries of the parent on a combined basis, (iv) consolidating adjustments and (v) the total consolidated amounts.

If any of the subsidiary guarantees is not joint and several with the guarantees of the other subsidiaries, then each subsidiary guarantor whose guarantee is not joint and several need not include separate financial statements, but the condensed consolidating financial information must include a separate column for each subsidiary guarantor whose guarantee is not joint and several. Rule 3-10(i) of Regulation S-K ; *see* SEC Release No. 33-7878 (Aug. 4, 2000), 65 Fed. Reg. 51,692, 51,699 (Aug. 24, 2000).

148 Note 1 to Paragraph (f) of Rule 3-10 of Regulation S-K. The footnote must also include certain narrative disclosures prescribed by Rule 3-10(i)(9) and (10) of Regulation S-K.

149 Rule 3-10(g) of Regulation S-K.

150 The significance test should be computed using the net book value of the subsidiary as of the most recent fiscal year preceding the acquisition. Rule 3-10(g)(3)(i) of Regulation S-K.

151 Rule 12h-5 under the Exchange Act. In the absence of this relief, the issuer and the guarantor would generally be required to file separate periodic reports under the Exchange Act pursuant to § 12 or § 15(d) thereof. 65 Fed. Reg. 51,692, 51,703–04 (Aug. 24, 2000).

152 Rule 3-16(a) of Regulation S-K. A parent registrant must continue to provide such financial statements in its subsequent annual reports on Form 10-K or Form 20-F, as applicable, together with all material changes to such financial statements in any subsequent registration statement filed by the parent registrant.

153 Rule 3-16(b) of Regulation S-K.

154 Rule 3-13 of Regulation S-K.

155 Subpart 1100 of Regulation S-K ; SEC Release No. 33-8518 (Dec. 22, 2004).

156 SEC, Division of Corporation Finance, Current Issues and Rulemaking Projects, at 73 (Nov. 14, 2000).

157 Rule 140 under the Securities Act; *see also* SEC, Division of Corporation Finance, Current Issues and Rulemaking Projects, at 73 (Nov. 14, 2000) (stating that under certain circumstances the SEC staff may require co-registration in the context of structured financings to strengthen bank capital).

158 Rule 3-20(b) of Regulation S-K. In response to concerns that the literal application of Rule 3-20(b) could result in potentially misleading presentations when a currency has declined significantly after the most recent balance sheet date (for example, convenience translations could depict an issuer's debt level at a much lower U.S. dollar amount than the debt service requirements), the SEC staff will not object if an issuer uses the exchange rate at the date of the most recent balance sheet in preparing a convenience translation for inclusion in an annual report on Form 20-F or a registration statement, or if it omits a convenience translation. *See* SEC, Division of Corporation Finance, International Reporting and Disclosure Issues, Part VIII(D) (Nov. 1, 2004). The SEC staff has further stated that if convenience translations are presented in a registration statement that includes all required financial statements, such as Form F-1, the same exchange rate should be used for the most recent fiscal year presented and any subsequent interim period. If an issuer files a registration statement that incorporates by reference financial statements previously filed on Form 20-F, the staff will not require amendment of the previously filed financial statements to reflect a convenience translation based on a more current exchange rate. *See* SEC, Division of Corporation Finance, International Reporting and Disclosure Issues, Part VIII(D) (Nov. 1, 2004).

159 Form 20-F, Item 3.A.3. An issuer is permitted to use any reliable source for the exchange rates as long as it identifies the source. One example the SEC provides is the noon buying rate in New York City for cable transfers in foreign currencies as certified for customs purposes by the Federal Reserve Bank of New York, which is published on the Board of Governors of the Federal Reserve website weekly. *See* SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Exchange Act Forms, Question 110.01.

160 Form 20-F, Item 3.A.2.

161 Rule 3-20(c) of Regulation S-K.

162 This is an exception to the general rule that the results of operations be measured in the currency of the "primary economic environment" in which business is conducted, with gain or loss then measured in the translation of that currency to the reporting currency. Rule 3-20(d) of Regulation S-K.

163 Rule 3-20(d) of Regulation S-K.

164 *See* SEC, Staff Accounting Bulletin No. 104 (Dec. 17, 2003), Fed. Sec. L. Rep. (CCH) ¶75,571; *see also* SEC, Staff Accounting Bulletin No. 101 (Dec. 3, 1999), Fed. Sec. L. Rep. (CCH) ¶75,565. SAB 104 (i) integrates the staff's interpretive guidance previously provided with respect to SAB 101, including as set forth in SEC, Office of the Chief Accountant, Frequently Asked Questions and Answers about Staff Accounting Bulletin No. 101—Revenue Recognition in Financial Statements (Oct. 12, 2000), Fed. Sec. L.

Rep. (CCH) ¶75,568 and (ii) recognizes the role of the Emerging Issues Task Force consensus on Issue 00-21, Accounting for Revenue Arrangements with Multiple Deliverables.

165 SAB 104.

166 *See* SAB 104.

167 In a fact sheet discussing the background to SAB 101, the SEC noted its concern that a substantial portion of financial reporting fraud cases brought by the SEC have involved improper revenue recognition. *See* SEC, Fact Sheet: Staff Accounting Bulletin No. 101—Revenue Recognition (Dec. 3, 1999); *see also infra* Note 180 (noting the staff's continued concern with revenue recognition policies).

168 The other two are Staff Accounting Bulletin No. 99 (Aug. 12, 1999), Fed. Sec. L. Rep. (CCH) ¶75,563, discussed in § 11.04[2][a], and Staff Accounting Bulletin No. 100 (Nov. 24, 1999), Fed. Sec. L. Rep. (CCH) ¶75,564.

169 *See* FASB, Project Updates: Revenue Recognition—Joint Project of the FASB and IASB (last updated June 3, 2014); *see also* FASB, ASU No. 2015-14 (Aug. 12, 2015) and IASB, "Effective Date of IFRS 15" (Sept. 11, 2015), deferring the effective dates of the new revenue recognition standard. For U.S. GAAP public companies, Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers (Topic 606), will become effective for annual periods beginning after December 15, 2017, including interim reporting periods therein, with early adoption permitted for annual reporting periods beginning after December 15, 2016. For U.S. GAAP non-public companies, the new standard will become available for annual periods beginning after December 15, 2018, with earlier adoption permitted for annual reporting periods beginning after December 15, 2016. For IFRS companies, the new standard will become effective for annual periods beginning on or after January 1, 2018, and early adoption is permitted. The new standards require U.S. and foreign public companies to adopt either a "full retrospective" or "modified retrospective" approach upon adoption. Under the full retrospective approach, companies will be required to apply the new standards retrospectively to each prior reporting period. If a company selects the modified retrospective approach, it will be required to apply the new standards only to the current period, but it will need to recognize the cumulative effect of initially applying the new standards as an adjustment to the opening balance of retained earnings. Given the scale of the required restatement, companies will need to determine their retrospective presentation well in advance of issuing their first set of financials after adopting these new standards. *See* AICPA, *New Revenue Recognition Accounting Standard—Learning and Implementation Plan*, Financial Reporting Center (Sept. 2016); Ernst & Young, A CLOSER LOOK AT THE NEW REVENUE RECOGNITION STANDARD (updated Sept. 2016).

170 *See* Ernst & Young, U.S. GAAP VS. IFRS—THE BASICS (Nov. 6, 2013).

171 News Release, IASB and FASB, IASB and FASB Issue Converged Standard on Revenue Recognition (May 28, 2014).

172 Wesley R. Bricker, then-SEC Deputy Chief Accountant, Remarks before the 2016 Baruch College Financial Reporting Conference (May 5, 2016) (noting that "[b]ecause of its importance, the SEC staff has been, and will likely continue to be, focused on the reporting of revenue arrangements and the related disclosures.").

Private securities class action filings that allege faulty revenue recognition have also been significant in recent years. For example, the percentage of such filings was 42% in 2015, 38% in 2014 and 39% in 2013. *See* PricewaterhouseCoopers LLP, 2015 SECURITIES LITIGATION STUDY (Apr. 2016); PricewaterhouseCoopers LLP, 2014 SECURITIES LITIGATION STUDY (Apr. 2015); PricewaterhouseCoopers LLP, 2013 SECURITIES LITIGATION STUDY (Apr. 2014).

173 *See* PwC, LEASES 1-2 (Mar. 31, 2016).

174 *See* PwC, LEASES 1-3–1-4 (Mar. 31, 2016).

175 *See* PwC, LEASES 10-2 (Mar. 31, 2016).

176 *See* PwC, LEASE ACCOUNTING—KEY DEVELOPMENTS IN LEASE ACCOUNTING.

177 If the reasonable estimate is a range, an accrual of the best estimate is required, unless no amount within the range is a better estimate than any other amount, in which case the minimum amount in the range must

be accrued. ASC 450. *But see* IAS 37 (requiring accrual of the mid-point of the range when no amount within a range of best estimates is the better estimate).

178 Deloitte, *International Financial Reporting Standards: Provisions, pensions and share based payments*, The Ohio State University, 13 (Apr. 1, 2011).

179 Paragraph 14 of IAS 37.

180 Paragraph 23 of IAS 37.

181 *See* ASC 450-20-20.

182 Deloitte, *Contingencies: Key differences between U.S. GAAP and IFRSs* (IASPlus), http://www.iasplus.com/en-us/standards/ifrs-usgaap/contingencies.

183 *See Financial Reporting Alert 11-1, SEC's Focus on Compliance With Loss Contingency Disclosures* (Deloitte, 2011); *see also SEC Comment Letters—Including Industry Insights Constructing Clear Disclosures* (Deloitte, Dec. 5, 2013); *SEC Comment Letters on Foreign Private Issuers Using IFRSs—A Closer Look* (Deloitte, 2012).

U.S. Regulation of the International Securities and Derivatives Markets, § 4.06, MD&A DISCLOSURE

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 4.06 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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Each registration statement and Form 20-F filing is required to contain an MD&A for the periods covered by the financial statements included in the filing, including interim periods. [184] The MD&A is a discussion of results of operations, liquidity, capital resources and other information necessary to an understanding of a company's financial condition, changes in financial condition and operating results. The MD&A requirements are intentionally general, reflecting the SEC's view that a flexible approach elicits more meaningful disclosure and avoids boilerplate discussions.

The MD&A is intended to provide, in one section of the filing, narrative disclosure of material historical and prospective information that enables investors to assess the financial condition and results of operations of the issuer, with particular emphasis on its future prospects. The SEC requires a narrative explanation of the financial statements, because it believes the numerical presentation and accompanying footnotes contained in financial statements may be insufficient for an investor to judge the quality of an issuer's earnings and the likelihood that past performance is indicative of future performance.

The SEC has designed the MD&A requirement to give investors an opportunity to look at the company through the eyes of management. For that reason, management is required to identify and analyze qualitative and quantitative factors necessary for an understanding and evaluation of an issuer's history and prospects, in both the short term and long term. Since the SEC considers the MD&A requirement one of the most significant disclosure requirements, it

p. 4-53

reviews a company's response carefully and often issues comments seeking clarification or further explanation. [185]

[1] General SEC Interpretive Guidance on MD&A—Presentation and Content

Because of the flexible and general nature of the MD&A disclosure requirement, the SEC has provided continued guidance on what information

p. 4-53

p. 4-54

should be disclosed and how to present such information to most effectively convey material items to investors. In particular, the SEC interpretive releases from May 1989 and December 2003 provided guidance on the presentation, content and form of MD&A disclosures the SEC requires. A focus of each release was how issuers should incorporate disclosures about prospective information, the reasonably likely material results of trends, and how to disclose when current results are not indicative of expected future results.

[a] 1989 Interpretive Guidance

In 1988, the SEC commenced a review of certain filings to evaluate compliance with the MD&A requirements. In 1989, the SEC published a release summarizing the results of the project and explaining its views on several areas of

p. 4-54

p. 4-55

disclosure required in the MD&A. [186] In particular, the SEC determined that interpretive guidance was needed regarding treatment in the MD&A of prospective information, analysis of long- and short-term liquidity and capital resources, material changes in financial statement line items, required interim period disclosure, analysis of what constitutes a segment, participation in high yield financings, highly leveraged transactions or noninvestment grade loans and investments, the effects of U.S. federal financial assistance upon the operations of financial institutions and preliminary merger negotiations. With respect to prospective information, the SEC distinguished between (i) "currently known trends, events, and uncertainties that are reasonably expected to have material effects" [187] and (ii) "future trend[s] or event[s] or ... less predictable impact[s] of a known event, trend or uncertainty." [188] If an issuer's management cannot determine that a currently known trend, event or uncertainty will not materialize, the management must assume that the trend, event or uncertainty will eventuate and must disclose its reasonably likely and material effects on the issuer's financial condition or operations. An issuer need not, but may, disclose other forward-looking information, such as future trends and events. [189]

Statements in filings with the SEC that (i) project an issuer's revenues or other financial items, (ii) delineate management's plans and objectives for future operations, (iii) contain statements about an issuer's future economic performance in the MD&A discussion or (iv) disclose the assumptions underlying or relating to any statement in categories (i) through (iii) will generally fall within a safe-harbor exemption for forward-looking information in the SEC's rules from the civil liability provisions of the Securities Act and the Exchange Act. In order to qualify for the exemption, such statements must be made with a reasonable basis and disclosed in good faith. [190] This safe harbor applies to both prospective information the SEC requires and prospective information an issuer voluntarily discloses.

The Private Securities Litigation Reform Act of 1995 [191] created a statutory safe harbor for any forward-looking statement that is identified as such and accompanied by "meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement." [192] In part because of an absence of guidance as to what

would constitute "meaningful cautionary statements" and certain other difficulties with respect to the interpretation and application of the safe harbor, [193] the willingness of registrants to include forward-looking disclosure in SEC filings, which generally has been limited to filings in connection with mergers and acquisitions, remains limited. The statutory safe harbor also does not apply to certain transactions, including, in particular, IPOs or tender offers. Further, it does not apply to information contained in financial statements prepared in accordance with generally accepted accounting principles.

As noted, however, certain forward-looking information may be required, especially in MD&A. The SEC, through the comment process and otherwise, has encouraged the inclusion of forward-looking information or suggested it is required as part of MD&A.

[b] 2003 Interpretive Guidance

[i] *Presentation of MD&A*

The SEC's 2003 MD&A Interpretive Guidance provided new guidance on the presentation, content and focus of MD&A disclosure. [194] In the 2003 MD&A Interpretive Guidance, the SEC stated that MD&A is often unnecessarily lengthy, difficult to understand and confusing. In order to make the MD&A more clear and understandable, the SEC recommends the following:

- tabular presentations of relevant financial or other information; [195]
- headings to assist its flow and understanding;
- introductory sections or overviews; [196] and

- a "layered" approach to emphasize the most important information and analysis. [197]

The SEC favors an introduction or overview that provides a balanced, executive-level discussion identifying the most important themes or other significant matters that management is concerned with when evaluating a company's financial condition and operating results. According to the 2003 MD&A Interpretive Guidance, a good introduction or overview would:

- include economic or industry-wide factors relevant to the company;
- serve to inform investors about how the company earns revenues and income and generates cash;
- to the extent necessary or useful to convey this information, discuss the company's lines of business, locations of operations and principal products and services; and
- provide insight into material opportunities, challenges and risks, such as those presented by known material trends and uncertainties, on which the company's executives are most focused for both the short and long term, as well as the actions they are taking to address these opportunities, challenges and risks. [198]

p. 4-57

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p. 4-58

Because these matters do not generally remain static from period to period, the SEC expects the introduction to change over time to remain current. As with all sections of the MD&A, the SEC does not consider boilerplate disclaimers and other generic language generally to be helpful in providing useful information or achieving balance, and stated in the 2003 MD&A Interpretive Guidance that such disclosure detracts from the purpose of an introduction or overview. [199] The SEC also expects an introduction's discussion and analysis of financial condition and operating performance to address both past and prospective matters. [200]

[ii] *Content of MD&A*

The SEC reaffirmed general disclosure principles in the 2003 MD&A Interpretive Guidance by stating that companies could improve MD&A disclosure by focusing on their most important information. Disclosure should emphasize material information that is required, or promotes understanding, and de-emphasize (or, if appropriate, delete) immaterial information that is not required and does not promote understanding. [201] Although any particular MD&A will turn upon company-specific facts and circumstances, the 2003 MD&A Interpretive Guidance presents the SEC's view of generally applicable MD&A practice.

A theme of the 2003 MD&A Interpretive Guidance is that the MD&A should not be limited to financial information given that non-financial measures may be key indicators of a company's financial condition and operating performance. Examples of relevant non-financial measures could include interest rates or economic growth rates and their anticipated trends, and may include company or common industry specific measures. Importantly, non-financial key measures may be contained outside a company's SEC filings— *e.g.*, in earnings releases or

p. 4-58

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p. 4-59

financial analysts' calls—and, accordingly, companies should consider all their communications to determine what information is material. The SEC also encouraged companies to consider non-financial measures when determining whether disclosable material trends or uncertainties have developed. [202]

Following on from the SEC's earlier guidance, a further theme of the 2003 MD&A Interpretive Guidance is prospective disclosure. Companies are required to disclose known material events and uncertainties that could cause reported financial information not to be necessarily indicative of future operating performance or future financial condition. [203] The 2003 MD&A Interpretive Guidance encourages disclosure of forward-looking information where it "will provide useful material information for investors that promotes understanding." [204] Importantly, the 2003 MD&A Interpretive Guidance appears to recommend quantitative prospective disclosure, stating that such disclosure "can promote understanding" and "should be considered and may be required to the extent material if … reasonably available." [205]

The SEC paid particular attention in the 2003 MD&A Interpretive Guidance to intermediate effects of trends, events, demands, commitments and uncertainties in terms of the MD&A's required "analysis." The SEC cites as an example company financial statements that reflect materially lower revenues resulting from a decline in the volume of products sold when compared to a prior period. In this instance, the SEC stated that the MD&A should not only identify the decline in sales volume, but should also analyze the reasons for the decline when the reasons are material and determinable (such as difficulties in manufacturing processes, declines in product quality, loss of competitive position and market share, or a combination of factors). [206]

The 2003 MD&A Interpretive Guidance further cautioned companies to consider MD&A disclosure in light of any reasonable likelihood that reported financial information is not indicative of future financial condition or future operating performance due, for example, to the levels of subjectivity and judgment necessary to account for highly uncertain matters and the susceptibility of such matters to change. [207] For example, if a change in an estimate has a materially favorable impact on earnings, the change and the underlying reasons should be disclosed so that investors do not incorrectly attribute the effect to operational improvements. In addition, if events and transactions reported in the financial statements reflect material unusual or non-recurring items, aberrations

or other significant fluctuations, the SEC directed companies to consider the extent of variability in earnings and cash flow, and provide disclosure where necessary for investors to ascertain whether past performance is indicative of future performance. Companies also should consider whether the economic characteristics of any of their business arrangements, or the methods used to account for them, materially impact their results of operations or liquidity in a structured or unusual fashion, where disclosure would be necessary to understand the amounts depicted in their financial statements. [208]

[2] Critical Accounting Policies

Generally speaking, with respect to critical accounting policy disclosures, the SEC expects issuers to disclose the role of subjectivity and importance of judgment in the preparation of financial statements. In particular, the SEC has noted that although financial reports may appear to be precise and objective, and to suggest continuity from one period to the next, in reality they turn on judgments and estimates that may be subject to significant uncertainty and rapid change. As a result of such factors, reports representing a correct application of GAAP may nonetheless fail to communicate important information unless accompanied by disclosure about the company's financial status and the possibility, likelihood and implication of changes to the company's financial and operating status. [209]

To remedy this deficiency, the SEC has cautioned issuers to provide full, plain English explanations [210] of their critical accounting policies, the judgments

and uncertainties affecting the application of those policies and the likelihood that if different conditions or different assumptions were applicable to the reports, materially different results would be reported. [211] The SEC understands critical accounting policies to be those policies that are the most important to the portrayal of a company's results and financial condition and those that require management's "most difficult, subjective or complex judgments." [212]

In 2001, the SEC cautioned management, auditors, audit committees and advisers to provide investors with full transparency of critical accounting policies and their effects and, in 2002, proposed rules to require companies to make extensive disclosures in filings about the application of critical accounting policies. [213] While the 2002 proposed rules were never adopted, the cautionary advice, together with later interpretive guidance issued by the SEC, [214] provides insight into the SEC's expectations with respect to critical accounting policy disclosure. [215]

In addition, it is clear from the proposals that the SEC's attention on critical accounting policies focused at least in part on those policies that involved critical estimates. The SEC believes estimates are critical if (i) they require the company to make assumptions about highly uncertain matters and (ii) the financial statements would be materially affected by different estimates the company reasonably could have used, or by changes in the estimates that are reasonably likely to occur. [216] Furthermore, it is clear from the proposed rules that the SEC

p. 4-61

p. 4-62

was concerned, in particular, about newly adopted and recently changed accounting policies, to the extent such policies have a material impact on the company's financial statements. The SEC has also emphasized selectivity by companies in making this disclosure (suggesting that the vast majority of companies would have somewhere in the range of three to five critical accounting estimates). [217]

In December 2003, the SEC provided interpretive guidance that reaffirmed its prior statements on critical accounting policy disclosure, stating that companies should consider enhanced discussion and analysis of critical accounting estimates and assumptions that (i) supplements, but does not duplicate, the description of accounting policies in the notes to the financial statements and (ii) provides greater insight into the quality and variability of information regarding financial condition and operating performance. With respect to the former, the SEC stated that while the notes to the financial statements generally describe the method used to apply an accounting principle, the MD&A disclosure should present a company's analysis of the uncertainties involved in applying a principle at a given time or the variability that is reasonably likely to result from its application over time. With respect to the latter, the SEC stated that a company should address specifically the risk that its accounting estimates or assumptions may change (*e.g.*, because there is an uncertainty attached to the estimate or assumption or simply because the estimate or assumption is difficult to measure). [218]

The SEC expects the evaluation of critical accounting policies to be the subject of particular focus by each company's management and auditors, with auditors gaining an understanding of the judgments management has made in selecting and applying accounting principles and methods, and management being able to defend the quality and reasonableness of such policies. Auditors, in turn, must be assured of the selection, application and disclosure of such policies. [219]

[3] Liquidity, Capital Resources, Debt, Funding and Short-Term Borrowings

The bulk of MD&A for most companies addresses results of operations. The SEC has consistently sought to obtain enhanced disclosures about liquidity,

p. 4-62

p. 4-63

capital resources and debt in MD&A disclosures. The SEC has been particularly focused on these disclosures during and following market downturns over the past decade, as disclosures about liquidity and related matters are of heightened importance during such periods, particularly in the event of a sudden liquidity crisis, as occurred during the most recent financial crisis.

In 2002, following a petition by major accounting firms for interpretive guidance regarding disclosure areas of particular concern brought to light by the collapse of Enron Corp., the SEC issued a statement calling for better quality disclosure in several areas of the MD&A (the "2002 MD&A Statement"). [220] In the 2002 MD&A Statement, the SEC suggested that MD&A should, among other things, contain enhanced disclosure with respect to liquidity and capital resources (including off-balance sheet arrangements and contractual obligations). [221] Although the 2002 MD&A Statement did not establish new legal requirements, it clarified the SEC's views regarding existing disclosure obligations, and suggested specific formats for disclosing certain kinds of information. The SEC's 2003 MD&A Interpretive Guidance provided additional clarification concerning liquidity and capital resources disclosure. In September 2010, the SEC proposed rules and provided interpretive guidance relating to disclosures of short-term borrowings after concern that, during the preceding financial crisis, issuers had failed to disclose short-term borrowing obligations sufficiently and, at times, used financing structures to mask their financial condition. [222] All of these actions evidence the SEC's ongoing concern with disclosures relating to liquidity and related risks.

[a] SEC 2002 Statement Regarding Better Quality MD&A and the 2003 Interpretive Guidance

p. 4-63

p. 4-64

[i] *Sources of Liquidity and Related Risks*

With respect to sources of liquidity and related risks, the 2002 MD&A Statement cautioned issuers against MD&A disclosure that is "overly general." The SEC noted, for example, that it is not enough for an issuer to merely state that it "has sufficient short-term funding to meet its liquidity needs for the next year." Instead, issuers should describe their sources of short-term funding and disclose the circumstances that are reasonably likely to affect those sources of liquidity. Similarly, issuers were encouraged to provide informative disclosure concerning matters that could affect the extent of funds needed over the short and long term. [223]

In the 2002 MD&A Statement, the SEC cited three examples to illustrate factors that issuers should consider in evaluating risks that could impair access to sources of liquidity:

- issuers that rely on operating cash flows as their principal source of liquidity should consider the extent to which declines or fluctuations in demand for their products could reduce liquidity;
- issuers that rely on commercial paper as a principal source of liquidity should consider disclosing how such facilities could be affected by ratings downgrades or declines in financial ratios or other measures of financial performance; and
- if an issuer's liquidity is dependent on off-balance sheet arrangements, such as securitization of receivables or obtaining access to assets through special purpose entities, the MD&A should include a discussion of factors that are reasonably likely to affect the company's ability to continue to use this source of financing. [224]

The 2003 MD&A Interpretive Guidance further directed issuers to provide disclosure on historical financing arrangements and their importance to cash flows, including material information not included in the financial statements. The SEC stated that such disclosure could consist of a discussion and analysis of:

p. 4-64

p. 4-65

- external debt financing arrangements;
- off-balance sheet arrangements;
- issuances or purchases of derivative instruments linked to a company's stock;
- the use of stock as a form of liquidity; and
- the potential impact of known or reasonably likely changes in credit ratings or ratings outlook (or the inability to achieve changes). [225]

In addition to these historical items, the SEC stated in the 2003 MD&A Interpretive Guidance that discussion and analysis of the types of financing that are, or that are reasonably likely to be, available (or that a company would want to use but that are, or are reasonably likely to be, unavailable), and the impact on the company's cash position and liquidity, should be considered and may be required. For example, where a company has decided to raise material equity or debt financing, or if it is reasonably likely to do so in the future, discussion and analysis of the amounts involved, the nature and terms of the financing and the impact on the company's cash position and liquidity (as well as on results of operations in the case of factors such as interest payments) should be considered and may be required. [226]

The SEC has also reminded issuers that they must disclose and objectively evaluate the consequences of any known trend, demand, commitment, event or uncertainty that could materially affect liquidity, unless management can determine that such circumstances are not reasonably likely to occur. [227] This determination must be objectively reasonable, as viewed at the time when made. In particular, the SEC called upon issuers in the 2002 MD&A Statement to evaluate

p. 4-65

p. 4-66

carefully the terms of their financing and other contracts to identify circumstances that could adversely impact liquidity. The SEC singled out the following factors as matters requiring close scrutiny:

- provisions in financial guarantees or commitments, debt or lease agreements or other arrangements that could trigger a requirement for an early payment, additional collateral support, changes in terms, acceleration of maturity or the creation of an additional financial obligation (triggers could include adverse changes in the issuer's credit rating, financial ratios, earnings, cash flows or stock price, or changes in the value of underlying, linked or indexed assets);
- circumstances that could impair the issuer's ability to continue to engage in transactions that have been integral to historical operations or are financially or operationally essential, or that could render that activity commercially impracticable (these may include the inability to maintain a specified investment grade credit rating, level of earnings, earnings per share, financial ratios or collateral);
- factors specific to the issuer and its markets that it expects to be given significant weight in the determination of its credit rating or will otherwise affect the issuer's ability to raise short- and long-term financing;
- guarantees of debt or other commitments to third parties; and
- written options on non-financial assets (for example, real estate puts). [228]

[ii] *Cash Requirements and Uses of Cash*

The 2003 MD&A Interpretive Guidance also emphasized the need for attention to disclosure of cash requirements. In order to identify and disclose known material cash requirements, the SEC directed companies to consider whether the following information would have a material impact on liquidity (cautioning that discussion of immaterial matters, and especially generic or boilerplate disclosure, should be avoided):

- funds necessary to maintain current operations, complete projects underway and achieve stated objectives or plans;
- commitments for capital or other expenditures; and

p. 4-66

p. 4-67

- the reasonably likely exposure to future cash requirements associated with known trends or uncertainties, and an indication of the time periods in which resolution of the uncertainties is anticipated. [229]

For example, if a company has incurred debt in material amounts, it should explain the reasons for incurring that debt and the use of the proceeds, and analyze how the incurrence of that debt fits into its overall business plan, in each case to the extent material. [230] Where debt has been incurred for general working capital purposes, the anticipated amount and timing of working capital needs should be discussed, to the extent material. [231]

The SEC does not intend for a company's discussion and analysis of its cash flows to be a mere recitation of changes and other information evident from its cash flow statement. To that end, the SEC recommended in the 2003 MD&A Interpretive Guidance a discussion of operating cash flows that goes beyond the face of the statement of cash flows and addresses material changes in underlying drivers (for example, cash receipts from the sale of goods and services and cash payments to acquire materials for manufacture or goods for resale). In this regard, an appropriately detailed MD&A would contain more than a mere description of reconciling items, in the case of the indirect method of presenting cash flows, by additionally presenting primary drivers and other material factors necessary to an understanding of a company's cash flows and the indicative value of historical cash flows. The SEC directed companies to consider further whether the MD&A should be expanded to address the cash requirements of, and the cash provided by, reportable segments and other subdivisions of a company's business, including issues related to foreign subsidiaries, as well as the indicative nature of those results. [232]

[iii] *Debt Instruments, Guarantees and Related Covenants*

The 2003 MD&A Interpretive Guidance provided two scenarios for companies to consider whether discussion and analysis of material covenants related

p. 4-67

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p. 4-68

to outstanding debt (or guarantees or other contingent obligations) may be required. [233]

First, companies that are, or are reasonably likely to be, in breach of such covenants must disclose material information about that breach and analyze the impact on the company if material. That analysis should include, as applicable and to the extent material:

- the steps the company is taking to avoid the breach;
- the steps the company intends to take to cure, obtain a waiver of or otherwise address the breach;
- the impact or reasonably likely impact of the breach (including the effects of any cross-default or cross-acceleration or similar provisions) on the company's financial condition or operating performance; and
- alternate sources of funding to pay off resulting obligations or replace funding. [234]

Second, the 2003 MD&A Interpretive Guidance directed companies to consider the impact of debt covenants on their ability to undertake additional debt or equity financing. Examples of these covenants include, but are not limited to, debt incurrence restrictions, limitations on interest payments, restrictions on dividend payments and various debt ratio limits. If these covenants limit, or are reasonably likely to limit, a company's ability to undertake financing to an extent that has a material impact, a company would be required to discuss the covenants in question and the consequences of the limitation on the company's financial condition and operating performance. Disclosure of alternate sources of funding and, to the extent material, the consequences (including but not limited to the cost) of accessing such sources should also be considered and may be required. [235]

[b] Short-Term Borrowings: “Dear CFO” Letters, the 2010 Interpretive Guidance and the September 2010 Proposed Rules

p. 4-68

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p. 4-69

During the recent financial crisis, the SEC increasingly employed a new tool — "Dear CFO" Letters — to comment on disclosure practices, remind CFOs of specific disclosure obligations and elicit information from company CFOs. [236] "Dear CFO" Letters differ from prior SEC practice as they are neither formal interpretive guidance—a tool the SEC has often used in the past to comment on disclosure practices of concern—nor comments on the specific disclosures of any particular company (as an issuer might receive in a comment letter), but instead provide, in a publicly available format, more informal guidance about disclosure practices of concern to the SEC staff. Nonetheless, despite their more informal nature, "Dear CFO" letters alert companies to the SEC's expectations as to what is required in the disclosures under existing standards and highlight specific

p. 4-69

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p. 4-70

aspects of certain disclosures upon which a company should focus. The SEC has also used "Dear CFO" Letters to elicit information about disclosure practices in certain areas and used the information to inform its rulemaking efforts. [237]

One of the "Dear CFO" letters published in March 2010 focused on disclosures of short-term borrowing practices. Following the release of the Lehman Brothers' Examiner report that described Lehman Brothers' use of "Repo 105" transactions to reduce the assets and liabilities on its balance sheet by as much as $50 billion at a time in 2007 and 2008, [238] the SEC sent a "Dear CFO" Letter to certain public companies seeking information regarding how those companies treated repurchase agreements, securities lending transactions and other similar transactions involving transfers of assets with an obligation to repurchase. The letter particularly sought information on the accounting treatment for such transactions, and asked for a detailed analysis of such transactions that were accounted for as sales. [239]

Following the collection of information provided from responses to the Repo Dear CFO Letter, on September 17, 2010, the SEC proposed new disclosure rules regarding short-term borrowing practices ("Short-Term Borrowing Proposed Rules") and published interpretive guidance (the "2010 MD&A Interpretive Guidance") on the SEC's current MD&A disclosure requirements related to liquidity and capital resources. [240] The purpose of these actions was in part to prevent undisclosed "window dressing" of balance sheets by companies, which

p. 4-70

p. 4-71

might otherwise have incentives to decrease the amount of their short-term borrowings at each quarter's end in order to present a better liquidity picture to investors.

The 2010 MD&A Interpretive Guidance is designed to emphasize and implement the SEC's position that companies may not use financing structures to mask their financial condition. The guidance notes that, for example, if a company's borrowings during the reporting period were materially different than the period-end amounts recorded in the financial statements, disclosure about the intra-period variations would be required. [241] It also clarifies the appropriate manner of presentation of leverage and other financial ratios [242] and reminds registrants of existing obligations regarding disclosure of known trends and uncertainties. For example, the release highlighted examples of trends relating to liquidity companies might consider discussing in their MD&A, including difficulties accessing the debt markets, reliance on commercial paper or other short-term financing arrangements, maturity mismatches between borrowing sources and the assets funded by those sources, changes in terms requested by counterparties, changes in the valuation of collateral and counterparty risk. [243]

Short-term borrowings are used by many companies as a regular part of their financing activities and may include borrowing from the Federal Reserve or commercial banks, commercial paper or repurchase agreements. Currently, bank holding companies must annually disclose the daily average amount outstanding, the month-end maximum amounts outstanding and the average weighted interest rates of their short-term borrowings, according to the terms of SEC Industry Guide 3. [244] The SEC proposed additional rules regarding short-term borrowing in 2010 that would have required public reporting companies to provide increased quantitative and qualitative disclosure of their short-term borrowings on a quarterly basis and would have expanded the universe of companies required to provide disclosure regarding their short-term borrowings, which is currently limited to bank holding companies. The SEC withdrew the Short-Term Borrowing Proposed Rules from its agenda in July 2013, however, because the SEC did not consider it likely that it would consider the proposed rules in the following 12 months, although it may do so in the future. [245]

[4] Fair Value MD&A Disclosure

p. 4-71

p. 4-72

SFAS No. 157, Fair Value Measurements ("SFAS No. 157") (which was later codified in Accounting Standards Codification 820 ("ASC 820"), Fair Value Measurements and Disclosures), became effective for financial statements issued for fiscal years beginning after November 15, 2007. [246] SFAS No. 157 introduced a single definition of fair value for GAAP purposes (to replace the various definitions that preceded SFAS No. 157), established a framework for measuring fair value and expanded required disclosures about fair value measurements. The statement created a three-level fair value hierarchy that prioritizes the use of market-based data obtained from sources independent of the issuer (so-called "observable inputs") over the use of the issuer's own assumptions about market participant assumptions based on the best information available in the circumstances (so-called "unobservable inputs"). As a result, SFAS No. 157 required issuers in certain circumstances to switch from using valuations based on internal models to valuations based on market data, generating substantial accounting losses in some cases, particularly during the recent financial crisis.

Because of the difficulty of estimating fair value in periods of market stress and the potential importance of fair value disclosures and related losses by certain financial institutions during the recent financial crisis, the SEC paid particular attention to such disclosures during that period. In particular, during 2008, the Division of Corporation Finance made public two "Dear CFO" letters it sent to a number of public companies identifying various disclosure issues associated with SFAS No. 157 for the issuers to consider in connection with preparing MD&A for their then-upcoming quarterly reports. [247] The first, sent in March 2008, among other things, reminded issuers that actual market prices (*i.e.*, observable inputs) should be used in making fair value measurements, even when the market for the relevant asset or liability was less liquid than it had been historically and that unobservable inputs should be relied upon only in the absence of observable inputs. In light of the credit crisis then prevailing, the letter noted that current market conditions could well require the use of significant unobservable inputs. The Division emphasized the need for detailed disclosure in connection with fair value measurements, including in respect of values based on unobservable inputs. The second letter, sent in September 2008, followed a review conducted by the SEC of fair value disclosures. The letter focused on disclosures of how credit risk affected fair value measurements, explanations of how market illiquidity was factored into fair value determinations and the use of brokers or pricing services in developing fair value measurements.

p. 4-72

p. 4-73

The virtues of the fair value accounting standards under SFAS No. 157 have been a continuing subject of debate. [248] During the financial crisis, some critics asserted that these standards contributed to the instability of financial markets and to the failure of certain financial institutions. Partially in response to such critiques but also to provide practical guidance, the SEC and FASB took various steps in late September and early October of 2008 to clarify how SFAS No. 157 should be applied to the fair value measurement of financial instruments when there is no active market for a security. [249]

As part of the Emergency Economic Stabilization Act of 2008, the SEC was mandated to conduct a study of mark-to-market accounting standards under SFAS No. 157. [250] In its December 30, 2008 report, the SEC concluded that fair value accounting standards should be improved but not suspended. [251] The study recommended reconsidering the accounting for impairments under fair value standards and developing additional guidance for determining fair value of investments in inactive markets, including situations where market prices are not readily available. [252]

The 2002 MD&A Statement called for greater transparency regarding trading in OTC commodity contracts accounted for at fair value, especially with respect to methods used to determine fair value. In the absence of market quotations for such contracts, companies often have significant discretion in determining their value using fair value estimation methods. The SEC suggested that

p. 4-73

p. 4-74

issuers consider furnishing information, quantified to the extent practicable, which does the following:

- disaggregates realized and unrealized changes in fair value;
- identifies changes in fair value attributable to changes in valuation techniques;
- disaggregates estimated fair values at the latest balance sheet date based on whether fair values are determined directly from quoted market prices or are estimated; and

- indicates the maturities of contracts at the latest balance sheet date (*e.g.*, within one year, within years one through three, within years four and five and after five years). [253]

[5] Off-Balance Sheet Arrangements and Contractual Obligations

In 2003, the SEC adopted rules to implement § 401(a) of the Sarbanes-Oxley Act that require each U.S. and non-U.S. reporting company, with limited exceptions, [254] to include specified MD&A disclosures on off-balance sheet arrangements and contractual obligations in registration statements, annual reports and proxy or information statements. [255]

[a] Disclosure of Off-Balance Sheet Arrangements

p. 4-74
p. 4-75

An off-balance sheet arrangement is any transaction, agreement or other contractual arrangement [256] to which an entity unconsolidated with the issuer is a party, under which the issuer has:

- any obligation under a guarantee contract that meets certain criteria specified in FIN 45; [257]
- a retained or contingent interest in assets transferred to an unconsolidated entity or similar arrangement that serves as credit, liquidity or market risk support to that entity for those assets;
- any obligation, including a contingent obligation, under a contract that would be accounted for as a derivative instrument but for the fact that it is both indexed to the issuer's own stock and classified as stockholders' equity in the issuer's balance sheet; [258] or

p. 4-75
p. 4-76

- any obligation, including a contingent obligation, arising out of a "variable interest" in an unconsolidated entity that is held by, and material to, the issuer, where that entity provides financing, liquidity, market risk or credit risk support to, or engages in leasing, hedging or research and development services with, the issuer. [259]

Contingent liabilities arising out of litigation, arbitration or regulatory actions are excluded from the definition of off-balance sheet arrangements for purposes of the rules. [260]

In 2009, FASB issued statements No. 166 (Accounting for Transfers of Financial Assets) and No. 167 (Amendments to FASB Interpretation No. 46(R)), [261] which substantially changed the standards under U.S. GAAP for determining whether entities are consolidated and assets and liabilities are carried on- or off-balance sheet. These standards became effective for fiscal years beginning after November 15, 2009 (or January 1, 2010 for companies with calendar year-ends) and are particularly relevant with regard to accounting for securitizations and special-purpose entities.

Statement No. 166 requires greater transparency about transfers of financial assets and a company's continuing involvement in transferred financial assets. Under Statement No. 167, the quantitative approach previously used to determine the primary beneficiary of a variable interest entity based on receipt of a majority of an entity's expected residual returns was replaced with a qualitative analysis that identifies the primary beneficiary based on a qualitative analysis of the entities that have the power to direct the activities of a variable interest entity and the obligation to absorb losses or the right to receive benefits from a variable interest entity. Statement No. 167 requires ongoing reassessments of whether an enterprise is the primary beneficiary of a variable interest entity, while historically reconsideration of whether an enterprise is the primary beneficiary of a variable interest entity was only required when specific events occurred.

p. 4-76
p. 4-77

The terms "guarantee contract" and "variable interest" are defined in the rules by reference to U.S. GAAP, and the SEC has emphasized that foreign issuers whose primary financial statements are prepared in accordance with home-country GAAP are required to refer to U.S. GAAP for the purpose of determining which guarantee contracts and variable interests are required to be disclosed. [262] On the other hand, the rules permit such foreign issuers to apply home-country GAAP for the purpose of determining which obligations indexed to the issuer's own stock are classified as stockholders' equity and therefore must be disclosed as off-balance sheet arrangements under the new rules. The SEC has reminded foreign issuers that their MD&As, while generally permitted to focus on the primary financial statements, also are required to include a discussion of U.S. GAAP-reconciled information (if U.S. GAAP reconciliation is required) to the extent necessary to an understanding of the financial statements as a whole. [263] The SEC has further called attention to the fact that this general requirement must be considered in connection with off-balance sheet arrangements disclosed on the basis of determinations made under non-U.S. GAAP. [264]

[i] *Disclosure Threshold*

The rules require a discussion of any off-balance sheet arrangements of an issuer that have or are reasonably likely to have a current or future effect on the issuer's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors. [265] When it adopted the rules, the SEC reiterated its long-standing positions that (i) a determination by management of an issuer as to whether an arrangement is reasonably likely to have a material effect must be

p. 4-77

p. 4-78

objectively reasonable, viewed as of the time the determination is made and (ii) "reasonably likely" is a lower threshold than "more likely than not." [266]

[ii] *Specific Disclosure Requirements*

With respect to any arrangements that fall within the definition of "off-balance sheet arrangement" and cross the "reasonably likely" disclosure threshold, the rules require disclosure of the following items to the extent necessary to an understanding of the arrangements and their effect on the specified financial statement-related matters:

- the nature and business purpose to the issuer of the arrangement (*e.g.*, reduction of the liabilities recognized on the face of the balance sheet); [267]
- the importance to the issuer of the arrangements in respect of its liquidity, capital resources, market risk support, credit risk support or other benefits (*e.g.*, how often it securitizes financial assets, whether it has materially increased or decreased securitizations from past periods and, if so, why);
- the amounts of revenues, expenses and cash flows of the issuer arising from the arrangements; the nature and amounts of any interests retained, securities issued and other indebtedness incurred by the issuer (*e.g.*, the amount of securities issued by the issuer to the off-balance sheet entity or the amounts of guarantees, lines of credit or similar arrangements); and the nature and amounts of any other obligations or liabilities (including contingent obligations or liabilities) of the issuer arising from the arrangements that are or are reasonably likely to become material and the triggering events or circumstances that could cause them to arise; [268]
- any known event, demand, commitment, trend or uncertainty that will result or is reasonably likely to result in the termination, or material reduction in availability to the issuer, of its off-balance sheet arrangements that provide

p. 4-78

p. 4-79

material benefits to it, and the course of action that the issuer has taken or proposes to take in response to any such circumstances; [269] and

- such other information as the issuer believes is necessary to an understanding of the arrangements and their effect on the specified financial statement-related matters. [270]

[iii] *Presentation*

The rules require issuers to aggregate off-balance sheet arrangements in groups or categories that provide material information in an efficient and understandable manner, with repetition or disclosure of immaterial information avoided. Effects that are common or similar with respect to a number of off-balance sheet arrangements must be analyzed in the aggregate to the extent aggregation increases understanding. Distinctions in arrangements and their effects must be discussed to the extent the information is material, but the discussion should avoid repetition and disclosure of immaterial information. [271] Repetition in the MD&A of information contained in the notes to the financial statements is not required, so long as the MD&A includes a cross-reference to that information and integrates the substance of the notes into the discussion in a manner designed to inform readers of the significance of that information. [272]

p. 4-79

p. 4-80

The SEC has cautioned issuers, however, to ensure that the quality of the discussion of off-balance sheet arrangements is not diminished as a result of cross-referencing to the financial statements. [273]

The disclosure in annual reports required by the rules generally must cover the most recent fiscal year, but it also should discuss changes from the previous year where such a discussion is necessary to an understanding of the disclosure. [274]

[b] Tabular Disclosure of Known Contractual Obligations

The SEC's rules with respect to contractual obligations require tabular disclosure in the MD&A with respect to the issuer's known contractual obligations as of the latest balance sheet date. [275] The rules mandate certain disclosure categories but permit issuers to disaggregate the specified categories, so long as all obligations of the issuer that fall within the specified categories are included in the tabular presentation. Appropriate footnote disclosure about provisions that create, increase or accelerate obligations, or other pertinent data, may accompany the table to the extent necessary to an understanding of the timing and amount of the specified contractual obligations. [276]

The rules define "long-term debt," "capital lease obligations," "operating leases" and "other long-term liabilities" by reference to U.S. GAAP for U.S. domestic issuers, while foreign issuers are instructed to base their disclosures about these categories of contractual obligations on the classifications used in the GAAP under which they have prepared their primary financial statements. [277] For

p. 4-80

p. 4-81

both U.S. domestic and foreign issuers, the term "purchase obligations" is defined directly in the rules rather than by reference to accounting standards. [278]

The 2010 MD&A Interpretive Guidance addressed discrepancies in the way public companies satisfied requirements regarding the presentation of contractual obligations, contingent liabilities and commitments by reminding them of the purpose of the table. [279] The SEC noted it has not issued general guidance on the disclosures in this area as questions tend to be fact-specific and closely related to a registrant's particular business and circumstances. [280]

[c] Applicability of Statutory Safe Harbor for Forward-Looking Statements

The rules governing disclosure of off-balance sheet arrangements and contractual obligations provide that all forward-looking statements made in such disclosures will have the benefit of the statutory safe harbor exemptions from the civil liability provisions of the Securities Act and Exchange Act to the same extent as other forward-looking statements, and that all information provided in response to the rules, except for historical facts, will be deemed to constitute "forward-looking statements" within the meaning of the safe harbor. [281] In addition, the rules provide that disclosure about off-balance sheet transactions is deemed to satisfy the "meaningful cautionary statements" element of the safe harbor if it satisfies all of the requirements of the rules. On the other hand,

p. 4-81

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p. 4-82

forward-looking statements made in required disclosures about contractual obligations are not automatically deemed to satisfy the "meaningful cautionary statements" element of the safe harbor solely by reason of compliance with the requirements of the rules. Issuers, therefore, must ensure that those disclosures otherwise contain such "meaningful cautionary statements" as are necessary in the circumstances. [282]

Footnotes

184 According to published highlights of a meeting of the AICPA SEC Regulations Committee's International Practices Task Force, the SEC staff has noted that when financial statements are updated in order to comply with the age of financial statements requirements applicable to registration statements as set forth in Item 8 of Form 20-F, an issuer must also update other "financial" information, including its MD&A. *See* AICPA, SEC Regulations Committee's International Practices Task Force, Highlights, Item 2 (Mar. 9, 2004).

185 The SEC has initiated proceedings against issuers with respect to their MD&A disclosure. In 1998, the SEC brought proceedings against Sony Corporation in which the SEC found that Sony and an officer of Sony responsible for disclosure matters had violated SEC reporting requirements by failing to describe, in Sony's annual report on Form 20-F and in its periodic earnings reports on Form 6-K, losses suffered by one of its subsidiaries, Sony Pictures. *In the Matter of Sony Corporation*, SEC Release No. 34-40305 (Aug. 5, 1998). The SEC found that Sony failed to identify greater-than-anticipated losses at Sony Pictures, which Sony had acquired in late 1989. Although it is unclear whether Sony was technically required under SFAS No. 14 to report the results of Sony Pictures as a separate business segment, the SEC found that Sony failed to discuss a "known trend" involving cumulative losses of more than $1 billion through June 30, 1994 attributable to Sony Pictures. These losses led Sony to announce in November 1994 the write-off of $2.7 billion of goodwill associated with the acquisition of Sony Pictures. No mention of a possible write-off had been included in the 6-K reports regarding earnings filed in June and early September 1994 or in the Form 20-F filed in late September 1994. In fact, according to the SEC, these filings included conspicuously positive statements about various aspects of Sony Pictures' performance. Pursuant to an SEC order and the settlement of a related civil action brought by the SEC, Sony agreed, among other things, to provide an independent auditor's report on the MD&A included in its Form 20-F for the fiscal year ending March 31, 1999, to ensure that its chief financial officer would be primarily responsible for the accuracy of Sony's public financial disclosures and its compliance with applicable legal and accounting requirements, and to pay a fine of $1 million. *SEC v. Sony Corp.*, SEC Litigation Release No. 15832 (Aug. 5, 1998).

In 1992, the SEC brought proceedings against Caterpillar, Inc., finding Caterpillar to have presented an inadequate MD&A discussion in its 1989 annual report on Form 10-K and its quarterly report on Form 10-Q for the first quarter of 1990. Caterpillar gained an unusually large percentage of its 1989 overall profit from its operation in Brazil. The impact of the Brazilian operation on overall results was not evident from the company's financial statements, which were presented on a consolidated basis. Although the fact that the Brazilian operation had a significant impact on 1989 profits and the 1990 forecast was discussed extensively in several meetings of the company's board of directors prior to the filing of the two reports, there was no mention of it in the MD&A section of either report. The SEC found that information about the impact of the company's Brazilian subsidiary was necessary to an understanding of the company's performance in 1989 and its prospects in 1990 and therefore should have been included in the MD&A sections of both the 1989 Form 10-K and the Form 10-Q for the first quarter of 1990. *In the Matter of Caterpillar, Inc.*, SEC Release No. 34-30532 (Mar. 31, 1992).

In 2014, the SEC announced a settled cease-and-desist proceedings against Bank of America Corporation for failing to disclose "known uncertainties" in the MD&A sections of its quarterly reports on Form 10-Q. Between 2004 and the first half of 2008, Bank of America and certain subsidiaries sold approximately $2.1 trillion of mortgage loans and residential mortgage backed securities. Some of the loans were securitized and some of the securitized loans contained credit enhancements provided by monoline insurers. In connection with these securitizations and credit enhancements, Bank of America made representations and warranties regarding the underlying mortgage loans. If a purchaser of securitized loans or a monoline insurer determined that these representations and warranties were breached, the purchaser or the monoline insurer could demand that Bank of America repurchase the related mortgage loan at its outstanding unpaid principal balance. Between the third quarter of 2008 and the third quarter of 2009, there was a significant increase in the amount of claims for repurchase by the Federal National Mortgage Association ("Fannie Mae"), which was one of the primary government-sponsored enterprises that purchased mortgage loans from Bank of America. During the same period, claims for repurchase by the monoline insurers had also steadily increased. As a result, the SEC claimed that, during the second and third quarters of 2009, there was a known uncertainty as to whether Bank of America's increasing obligation to repurchase the mortgage loans from Fannie Mae and the monoline insurers would have a material effect on its future income and continuing operations. According to the SEC, by failing to disclose these known uncertainties in the MD&A sections of its quarterly reports on Form 10-Q for the second and third quarters of 2009, Bank of America violated § 13(a) of the Exchange Act and Rules 12b-20 and 13a-13 thereunder. Bank of America agreed to settle by paying a $20 million penalty and admitting the facts set out by the SEC. *In the Matter of Bank of America Corporation*, SEC Release No. 34-72888 (Aug. 21, 2014).

See also In the Matter of the PNC Financial Services Group, Inc., SEC Release No. 34-46225 (July 18, 2002) (finding violations of, among others, the financial reporting and antifraud provisions of the federal securities laws, including with respect to MD&A disclosure, owing to PNC's failure to account properly for certain transactions with special purpose entities); *In the Matter of The Coca-Cola Company*, SEC Release No. 34-51565 (Apr. 18, 2005) (announcing a settled cease-and-desist proceeding against The Coca-Cola Company relating to its failure to disclose, including in MD&A, certain quarter-end sales practices used to meet earnings expectations).

The SEC can also bring proceedings against individual officers for inadequate MD&A disclosure. In 2005, the SEC filed civil charges against two former top Kmart executives for materially false and misleading disclosures about the company's liquidity and related matters in the MD&A section of Kmart's Form 10-Q, and in an earnings conference call with analysts and investors. *SEC v. Conaway*, SEC Litigation Release No. 19344 (Aug. 23, 2005); *see also In the Matter of Timothy E. Nolan*, SEC Release No. 34-47802 (May 6, 2003) (finding violations of § 13(a) of the Exchange Act and Rules 13a-13 and 12b-20 thereunder, including with respect to inadequate MD&A disclosure).

186 SEC Release No. 33-6835 (May 18, 1989) (the "1989 MD&A Release").

187 1989 MD&A Release, 54 Fed. Reg. 22,427, 22,429 (May 24, 1989).

188 1989 MD&A Release, 54 Fed. Reg. 22,427, 22,429 (May 24, 1989).

189 1989 MD&A Release, § III.B, 54 Fed. Reg. 22,427, 22,428–30 (May 24, 1989).

190 Rule 175 under the Securities Act and Rule 3b-6 under the Exchange Act; *see* § 11.03[5].

191 Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995).

192 § 27A(c)(1)(A)(i) of the Securities Act and § 21E(c)(1)(A)(i) of the Exchange Act. Statements included in a financial statement prepared in accordance with generally accepted accounting principles, however, are not covered by the safe harbor. *See* § 27A(b)(2)(A) of the Securities Act and § 21E(b)(2)(A) of the Exchange Act.

193 *See* § 11.03[5] for a discussion of various issues arising in connection with the statutory safe harbor.

194 SEC Release No. 33-8350 (Dec. 19, 2003), 68 Fed. Reg. 75,056 (Dec. 29, 2003) (the "2003 MD&A Interpretive Guidance"). The 2003 MD&A Interpretive Guidance reiterated the SEC's concerns with those issues previously addressed in its 2002 review of the annual reports of Fortune 500 companies. During that review, the SEC noted that it had (i) requested clarification on how such companies recognize revenue, (ii)

asked such companies to justify or explain more fully their accounting for restructuring charges, and to expand their disclosure of such matters in the financial statements and MD&A, (iii) issued a significant number of comments related to impairment charges, focusing on charges related to long-lived assets, securities held for investment and goodwill, (iv) asked such companies to explain the assumptions used to determine their amount of pension income or expense, (v) issued a significant number of comments on determination of operating segments in financial statements and MD&A, (vi) requested greater detail on the use of non-GAAP measures, securitization transactions and off-balance sheet arrangements and (vii) requested expanded disclosure on environmental and product liability issues. SEC, Division of Corporation Finance, Summary by the Division of Corporation Finance of Significant Issues Addressed in the Review of the Periodic Reports of the Fortune 500 Companies (Feb. 27, 2003).

195 This might include a tabular comparison of a company's results in different periods, which could include line items and percentage changes, as well as other information determined by the company to be useful, followed by a narrative discussion and analysis of known changes, events, trends, uncertainties and other matters; or a tabular presentation, in one location, of a company's various material interest and discount rate assumptions to assist in fair value calculations or discounted cash flow figures. 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,059 (Dec. 29, 2003).

196 As a general matter, an introduction or overview would presumably include the most important matters on which a company's executives focus in evaluating financial condition and operating performance and provide the context for the discussion and analysis of the financial statements. Accordingly, the SEC cautions that an introduction or overview should not be a duplicative layer of disclosure that merely repeats the more detailed discussion and analysis that should follow. 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,059 (Dec. 29, 2003).

197 Using an overview or introduction is one example of a layered approach. Another is to begin a section containing detailed analysis, such as an analysis of period-to-period information, with a statement of the principal factors, trends or other matters that are the principal subjects covered in more detail in the section. 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,059 (Dec. 29, 2003).

198 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,059 (Dec. 29, 2003).

199 The SEC further stated that the introduction or overview, by its very nature, cannot disclose everything and should not be considered by itself in determining whether a company has made full disclosure. The SEC further stated that the failure to include disclosure of every material item in an introduction or overview should not trigger automatically the application of the "buried facts" doctrine, in which a court would consider disclosure to be false and misleading if its overall significance is obscured because material is "buried," such as in a footnote or an appendix. 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,059 (Dec. 29, 2003).

200 With respect to prospective matters, Form 20-F, Item 5.D requires disclosure of material trends and uncertainties.

201 In the 2003 MD&A Interpretive Guidance, the SEC asked companies to evaluate whether information in the MD&A is still material and useful, or whether it should be deleted (*e.g.*, when there has been a change in a company's business or the information has become stale). The 2003 MD&A Interpretive Guidance continued by recommending that companies consider the materiality of segment data, avoid excessively duplicative or unnecessary line item disclosure and assess the extent to which materiality standards for annual and quarterly report disclosure may differ. 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,059 (Dec. 29, 2003).

202 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,060 (Dec. 29, 2003).

203 *See* Form 20-F, Item 5.D.

204 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,059 (Dec. 29, 2003).

205 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,062 (Dec. 29, 2003).

206 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,062 (Dec. 29, 2003).

207 The SEC has also addressed this concern in connection with critical accounting policy disclosure. *See* § 4.06[2].

208 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,062 (Dec. 29, 2003).

209 SEC Release No. 33-8040 (Dec. 12, 2001), 66 Fed. Reg. 65,013, 65,013 (Dec. 17, 2001) ("2001 Cautionary Advice"). *See also* 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,064–65 (Dec. 29, 2003).

210 In a 2002 rule proposal discussed further below, the SEC extended its cautionary advice by proposing that a quantitative sensitivity analysis of reasonably possible changes in critical accounting estimates or underlying assumptions be included in MD&A. The sensitivity analysis would require, for each critical accounting estimate, (i) a quantitative discussion of the effect of certain changes on the company's overall financial performance and, to the extent material, individual line items in the financial statements and the company's liquidity or capital resources and (ii) a quantitative and qualitative discussion of any material changes made to each critical accounting estimate in the past three years, including the reasons for the changes and the effect on the company's overall financial performance and on individual line items in the financial statements. SEC Release No. 33-8098 (May 10, 2002). While no specific rules providing for quantitative sensitivity analysis have been adopted, the 2003 MD&A Interpretive Guidance affirmed the SEC's continued interest in quantitative disclosure of critical accounting estimates. In that guidance, the SEC stated that companies should provide quantitative disclosure where the information is reasonably available and will be material to investors. For example, if reasonably likely changes in the long-term rate of return used in accounting for a company's pension plan would have a material effect on the financial condition or operating performance of a company, the impact that could result given the range of reasonably likely outcomes should be disclosed and, because of the nature of estimates of long-term rates of return, quantified. *See* 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,065 (Dec. 29, 2003).

211 The SEC has reminded issuers that, to a certain extent, such disclosure is required by (i) pre-existing accounting standards that require financial statements to include information regarding accounting principles and methods used by the company and the risks and uncertainties inherent in certain estimates and (ii) existing rules governing MD&A requiring disclosure about trends, events or uncertainties known to management that would have a material impact on reported financial information. *See* 2001 Cautionary Advice, 66 Fed. Reg. 65,013, 65,013 (Dec. 17, 2001).

212 2001 Cautionary Advice, 66 Fed. Reg. 65,013, 65,013 (Dec. 17, 2001).

213 2001 Cautionary Advice, 66 Fed. Reg. 65,013, 65,013 (Dec. 17, 2001); SEC Release No. 33-8098 (May 10, 2002). Also in December 2001, the SEC issued cautionary advice on the use of so-called *pro forma* financial measures (or non-GAAP financial measures), which was later superseded by rules implementing § 401(b) of the Sarbanes-Oxley Act. *See* § 4.09.

214 *See* 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,064–65 (Dec. 29, 2003).

215 In addition, following its 2002 review of Form 10-Ks filed by Fortune 500 companies, the SEC noted the need for greater disclosure on critical accounting policies relating to: (i) revenue recognition, (ii) restructuring charges, (iii) impairments, (iv) depreciation and amortization, (v) income tax liabilities, (vi) retirement and post retirement liabilities, (vii) pension income and expense, (viii) environmental liabilities, (ix) repurchase obligations, (x) stock-based compensation, (xi) insurance loss reserves and (xii) inventory reserves and allowances for doubtful accounts. SEC, Division of Corporation Finance, Summary by the Division of Corporation Finance of Significant Issues Addressed in the Review of the Periodic Reports of the Fortune 500 Companies (Feb. 27, 2003).

216 *See* SEC Release No. 33-8098 (May 10, 2002), 67 Fed. Reg. 35,620, 35,621 (May 20, 2002).

217 *See* SEC Release No. 33-8098 (May 10, 2002), 67 Fed. Reg. 35,620, 35,626 (May 20, 2002).

218 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,065 (Dec. 29, 2003).

219 2001 Cautionary Advice, 66 Fed. Reg. 65,013, 65,013 (Dec. 17, 2001). Rules adopted by the SEC to implement the auditor independence and related provisions of the Sarbanes-Oxley Act independently

require public accounting firms to report to audit committees, among other things, all critical accounting policies and practices used by an issuer and all alternative treatments within GAAP for policies and practices related to material items that have been discussed with an issuer's management. *See* § 5.03.

220 SEC Release No. 33-8056 (Jan. 22, 2002), 67 Fed. Reg. 3746, 3751 (Jan. 25, 2002).

221 Rules passed by the SEC to implement § 401(a) of the Sarbanes-Oxley Act thereafter codified and superseded the 2002 MD&A Statement with respect to off-balance sheet arrangements and contractual obligations, and are discussed in § 4.06[5] below. The 2002 MD&A Statement had also called for enhanced disclosure on contingent liabilities and commitments. The SEC stated, however, that meaningful disclosure of such items may not necessarily be accomplished by its previously proposed aggregated disclosure format, and, among other things, rules adopted to implement § 401(a) of the Sarbanes-Oxley Act, together with the implementation of FASB Interpretation No. 45 (Nov. 2002), Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others ("FIN 45"), and FASB Interpretation No. 46 (revised Dec. 2003), Consolidation of Variable Interest Entities ("FIN 46(R)"), could be expected to obviate the need for such disclosure. SEC Release No. 33-8182 (Jan. 28, 2003), 68 Fed. Reg. 5982, 5986–87 (Feb. 5, 2003). Nevertheless, the SEC stated that it would continue to assess the costs and benefits of such a disclosure requirement and suggested that issuers continue to refer to the 2002 MD&A Statement to consider whether it would be beneficial to investors to include the tabular disclosure of contingent liabilities and commitments proposed therein. SEC Release No. 33-8182 (Jan. 28, 2003), 68 Fed. Reg. 5982, 5987 (Feb. 5, 2003). In practice, this tabular disclosure has not been used.

222 SEC Release No. 33-9143 (Sept. 17, 2010). On July 1, 2013, the SEC withdrew the proposal from its agenda of rulemaking actions. SEC, Regulatory Flexibility Agenda, 78 Fed. Reg. 44,408 (July 23, 2013). *See* § 4.06[3][b].

223 2002 MD&A Statement, 67 Fed. Reg. 3746, 3748 (Jan. 25, 2002).

224 2002 MD&A Statement, 67 Fed. Reg. 3746, 3748 (Jan. 25, 2002).

225 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,064 (Dec. 29, 2003). Although the Dodd-Frank Act eliminated former Rule 436(g) under the Securities Act, under which an issuer that referred to a credit rating in a Securities Act registration statement or prospectus for a registered offering did not need to file the consent of the rating agency, an issuer not subject to Regulation AB disclosure requirements may still disclose changes to a credit rating, the liquidity of the registrant, the cost of funds for a registrant or the terms of agreements that refer to credit ratings, and therefore should be able to disclose the adverse effect that a hypothetical downgrade would have, in the liquidity portion of the MD&A. *See* SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Securities Act Rules, Question 233.04 (July 27, 2010); *see also* § 3.02[7], Note 396.

226 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,064 (Dec. 29, 2003). The SEC noted in the 2003 MD&A Interpretive Guidance that it believes disclosure satisfying its MD&A requirements can be made consistent with the restrictions on gun-jumping in § 5 of the Securities Act. *See*, *e.g.*, Rule 135c under the Securities Act (discussed in § 7.02[3][b]). 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,064 n.54 (Dec. 29, 2003).

227 2002 MD&A Statement, 67 Fed. Reg. 3746, 3748 (Jan. 25, 2002). The SEC has clarified that "reasonably likely" is a lower threshold than "more likely than not."

228 2002 MD&A Statement, 67 Fed. Reg. 3746, 3748 (Jan. 25, 2002).

229 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,063 (Dec. 29, 2003). The SEC recommended its required tabular disclosure of known contractual obligations as a starting point for this disclosure. *See* § 4.06[5][b].

230 As an example, the SEC cites debt issued to fund the construction of a new plant, which will allow a company to expand its operations into a specific geographic area. Understanding that relationship and the expected commencement date of plant operations puts the cash requirement for the debt into an appropriate context to understand the hypothetical company's liquidity. 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,063 n.47 (Dec. 29, 2003).

231 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,063 (Dec. 29, 2003).

232 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,063–64 (Dec. 29, 2003). *See also* Item 303(a) of Regulation S-K under the Securities Act.

233 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,063 (Dec. 29, 2003). *See also In the Matter of America West Airlines, Inc.*, SEC Release No. 34-34047 (May 12, 1994) (holding that a company failed to discuss uncertainties regarding its ability to comply with covenants). Companies also must take a similar approach to discussion and analysis with respect to mandatory prepayment provisions, "put" rights and other similar provisions.

234 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,063–64 (Dec. 29, 2003).

235 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,063–64 (Dec. 29, 2003).

236 The SEC maintains sample letters on its website, which are available at https://www.sec.gov/divisions/corpfin/cfdisclosure.shtml. *See* SEC, Sample Letter Sent to Public Companies on MD&A Disclosure Regarding the Application of SFAS 157 (Fair Value Measurements) (Mar. 2008) ("Fair Value Dear CFO Letter"); SEC, Sample Letter Sent to Public Companies on MD&A Disclosure Regarding the Application of SFAS 157 (Fair Value Measurements) (Sept. 2008) ("Fair Value Dear CFO Letter Addendum"); SEC, Sample Letter Sent to Public Companies on MD&A Disclosure Regarding Provisions and Allowances for Loan Losses (Aug. 2009) ("Loan Losses Dear CFO Letter"); SEC, Sample Letter Sent to Public Companies Asking for Information Related to Repurchase Agreements, Securities Lending Transactions, or Other Transactions Involving the Transfer of Financial Assets (Mar. 2010) ("Repo Dear CFO Letter"); SEC, Sample Letter Sent to Public Companies on Accounting and Disclosure Issues Related to Potential Risks and Costs Associated with Mortgage and Foreclosure-Related Activities or Exposures (Oct. 2010) ("Foreclosures Dear CFO Letter"); SEC, Sample Letter Sent to Public Companies Regarding XBRL Requirement to Include Calculation Relationships and Staff Observations of Custom Tag (July 2014).

The Fair Value Dear CFO Letter and Fair Value Dear CFO Letter Addendum are discussed in more detail in § 4.06[4].

The Loan Losses Dear CFO Letter focused on the disclosures of certain public companies in MD&A regarding provisions and allowances for loan losses. The letter highlighted that the economic environment at the time might require companies to reassess the accounting and disclosures they made with respect to allowances for loan losses, and noted that additional information about higher-risk loans might be useful to an understanding of the risks associated with the company's loan portfolio and to evaluating any known trends or uncertainties that could have a material impact on results of operations. The letter also gave several examples of the types of information about higher-risk loans that a company might consider disclosing. In addition, the letter reminded CFOs that it would be "inconsistent with GAAP" if a company were to delay recognizing credit losses that could be estimated based on current information and events.

The Foreclosures Dear CFO Letter sent in October 2010 reminded certain public companies of their disclosure obligations in light of continued concerns about potential risks and costs associated with mortgage and foreclosure-related activities or exposures. The letter focused on obligations relating to various representations and warranties made in connection with securitization transactions and whole loan sales, intended in part to address ASC 450 disclosure with respect to any related litigation contingencies.

237 *See* Repo Dear CFO Letter, discussed in § 4.06[3][b].

238 Report of Examiner Anton R. Valukas, *In re Lehman Brothers Holdings, Inc.* at 732 (Mar. 2010). In a "repo" transaction, one party transfers securities to another as collateral for a short-term borrowing of cash, while simultaneously agreeing to repay the cash and take back the securities at a specific time in the future. When the repo matures, the borrower repays the funds it borrowed plus an agreed interest payment and takes back the securities it transferred as collateral. The securities transferred typically represent more than 100% of the value of the cash borrowed, the overcollateralization typically referred to as the "haircut" (the "haircut" providing security to the institution lending cash in the event the value of the collateral declines and the borrowing institution fails to repurchase the securities). In the "Repo 105" transactions, the haircut

employed by Lehman was 5%, higher than typically used in other similar repo transactions. Although more like a collateralized loan, Lehman Brothers treated such arrangements as a sale. In doing so, the securities sold in "Repo 105" transactions were temporarily taken off Lehman's balance sheet and the obligation to repurchase was not recorded as a liability, as would have been the case with a collateralized loan or similar transaction. Lehman would use the cash from the "Repo 105" transaction to pay down liabilities, thereby reducing the leverage it reported on its quarterly reports. A few days after the end of a quarter or year end, Lehman would borrow money again to repurchase the securities and pay interest on the loan of money. Often these "Repo 105" transactions were employed at the end of a reporting period, temporarily removing securities from Lehman's balance sheet, and gave investors a "materially misleading" picture of its financial condition. Report of Examiner Anton R. Valukas, *In re Lehman Brothers Holdings, Inc.* at 747 (Mar. 2010).

239 *See* Repo Dear CFO Letter.

240 *See* SEC Release No. 34-62932 (Sept. 17, 2010); SEC Release No. 34-62934 (Sept. 17, 2010).

241 2010 MD&A Interpretive Guidance, 75 Fed. Reg. 59,894, 59,895 (Sept. 28, 2010).

242 2010 MD&A Interpretive Guidance, 75 Fed. Reg. 59,894, 59,895–96 (Sept. 28, 2010).

243 *See* 2010 MD&A Interpretive Guidance, 75 Fed. Reg. 59,894, 59,894–95 (Sept. 28, 2010). Some of these topics had been addressed previously in the 2002 MD&A Statement and the 2003 MD&A Interpretive Guidance. *See* § 4.06[3][a].

244 *See* § 4.07[8].

245 SEC, Regulatory Flexibility Agenda, 78 Fed. Reg. 44,408 (July 23, 2013).

246 SFAS No. 157.

247 Fair Value Dear CFO Letter; Fair Value Dear CFO Letter Addendum.

248 *See*, *e.g.*, Andrew Ross Sorkin, *Are Bean Counters to Blame?*, NY TIMES, July 1, 2008; Louise Story, *A Values Debate (Not the Political Kind)*, N.Y. TIMES, May 16, 2008.

249 On September 30, 2008, the SEC and FASB staffs issued a joint press release clarifying various issues related to fair value measurements. *See* Press Release, SEC, SEC Office of the Chief Accountant and FASB Staff Clarifications on Fair Value Accounting (Sept. 30, 2008). Soon after, on October 10, 2008, the FASB issued guidance on the matter and provided an example that illustrated the key considerations for issuers to consider when determining the fair value of a financial asset that did not have an active market. *See* FASB Staff Position 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active (Oct. 10, 2008).

250 *See* § 133(a) of the Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, Division A, 122 Stat. 3765, 3798 (2008).

251 SEC, Report and Recommendations Pursuant to § 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting (Dec. 30, 2008).

252 Following the financial crisis, the FASB has continued to implement various amendments to fair value accounting standards. As part of the convergence of U.S. GAAP and IFRS, various revisions to fair value guidance were adopted in May 2011. *See* FASB ASU 2011-04, Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs. For many of the requirements, the FASB stated that it does not intend for the amendments to result in a change in the application of the requirements in ASC 820. Areas covered by the guidance include clarification as to how a principal market for a security is determined under U.S. GAAP, addressing the fair value measurement of instruments with offsetting market or counterparty credit risks and the concept of valuation premise and highest and best use, extending the prohibition on blockage factors to all three levels of the fair value hierarchy and requiring additional disclosures.

253 The 2002 MD&A Statement included examples of two tables that could be used together to accomplish this result. The first is a table that reconciles fair value at the beginning of the period to fair value at the end of the period. The table shows changes in fair value according to category depending on the source of the change in fair value and includes a category for changes due to changes in valuation methods. The second

table breaks down contracts by the source of the fair value estimation (prices actively quoted, prices from external sources, prices based on models and other valuation methods) and by maturity period (within one year, within years one through three, within years four and five and after five years). 2002 MD&A Statement, 67 Fed. Reg. 3746, 3750 (Jan. 25, 2002).

254 The rules apply to all reporting companies under the Exchange Act, but do not apply to investment companies registered under § 8 of the Investment Company Act, which are exempt from § 401 of the Sarbanes-Oxley Act. In addition, while the rules do apply to annual reports on Form 40-F filed by eligible Canadian companies under the U.S.-Canadian multijurisdictional disclosure system discussed in Chapter 13, they do not apply to Securities Act registration statements filed under that system. *See* SEC Release No. 33-8182 (Jan. 28, 2003).

255 Items 303(a)(4) and 303(a)(5) of Regulation S-K under the Securities Act; Form 20-F, Items 5.E and 5.F; Form 40-F, General Instructions B.(11) and B.(12). The Sarbanes-Oxley Act applied the off-balance sheet requirements to Exchange Act filings. The Rules adopted by the SEC extend § 401(a)'s mandate to include registration statements filed under the Securities Act.

256 The rules provide that a disclosure obligation would arise in respect of an off-balance sheet transaction only when a definitive agreement that is unconditional or subject only to customary closing conditions exists or, if there is no such agreement, when settlement of the transaction occurs. Form 20-F, Instruction 1 to Item 5.E.

257 Specifically, an "off-balance sheet arrangement" would include any guarantee contract that has any of the characteristics identified in paragraph 3 of FIN 45 and that is not excluded from the initial recognition and measurement provisions of FIN 45 pursuant to paragraph 6 or 7 thereof. The types of contracts that are described in paragraph 3 of FIN 45 are (i) certain contracts that contingently require the guarantor to make payments to the guaranteed party based on changes in an "underlying" (as defined in FIN 45) that is related to an asset, a liability or an equity security of the guaranteed party, (ii) contracts that contingently require the guarantor to make payments to the guaranteed party based on another entity's failure to perform under an obligating agreement, (iii) indemnification agreements (contracts) that contingently require the indemnifying party (guarantor) to make payments to the indemnified party (guaranteed party) based on changes in an "underlying" that is related to an asset, a liability or an equity security of the indemnified party, or (iv) indirect guarantees of the indebtedness of others, which arise under an agreement that obligates one entity to transfer funds to a second entity upon the occurrence of specified events, under certain conditions.

Examples of the types of contracts covered by FIN 45 include financial standby letters of credit, market value guarantees, performance guarantees and keepwell agreements.

Paragraphs 6 and 7 of FIN 45 exclude a number of narrowly defined types of guarantees from the application of FIN 45, including among others product warranties, a parent's guarantee of a subsidiary's debt to a third party and a subsidiary's guarantee of a parent's or affiliated company's debt to a third party.

Although Form 20-F still references FIN 45, FIN 45 is now codified in Accounting Standards Codification 460, Guarantees.

258 Contracts having these characteristics are excluded from the scope of Accounting Standards Codification 815, Derivatives and Hedging ("ASC 815"), and therefore are not necessarily disclosed in the financial statements or notes thereto.

259 Form 20-F, Item 5.E.2. The term "variable interest" is used in the rules as referenced in FIN 46(R).

260 Form 20-F, Instruction 3 to Item 5.E. For a discussion of accounting matters regarding contingent liabilities arising out of litigation, arbitration or regulatory actions, *see* § 4.05[7].

261 FASB Statement No. 166 ("FAS 166") is contained in ASU No. 2009-16, which amends Accounting Standards Codification 860, Accounting for Transfers of Financial Assets. FASB Statement No. 167 ("FAS 167") is contained in ASU No. 2009-17, which amends Accounting Standards Codification 810, Improvements to Financial Reporting by Enterprises Involved with VIEs. FAS 166 and FAS 167 were codified as ASU No. 2009-16 and ASU No. 2009-17, respectively, when FASB reorganized and codified its

existing U.S. accounting and reporting standards issued by the FASB and other related private-sector standard setters in late 2009.

262 SEC Release No. 33-8182 (Jan. 28, 2003), 68 Fed. Reg. 5982, 5992 (Feb. 5, 2003). Foreign issuers whose primary financial statements are prepared in accordance with IFRS as issued by the IASB are not asked to look to U.S. GAAP in the same way, but they are asked in Instruction 5 to Item 5 of Form 20-F to "provide disclosure that satisfies the objective of the Item 5 disclosure requirements" regarding off-balance sheet arrangements when providing information that refers to pronouncements of the FASB.

263 *See*, *e.g.*, Form 20-F, Instruction 2 to Item 5.

264 In addition to affecting the off-balance sheet disclosures, FAS 166 and 167 affect financial statement disclosure regarding off-balance sheet transactions. *See supra* Note 86 and accompanying text for a discussion of the SEC's decision to accept financial statements of foreign companies prepared in accordance with IFRS as issued by the IASB without requiring a reconciliation to U.S. GAAP. As a general matter, issuers filing financial statements that comply with IFRS as issued by the IASB are instructed to, when responding to paragraphs in Item 5 that refer to FASB pronouncements, provide disclosure that satisfies the objective of the Item 5 disclosure requirement and need not repeat information contained in the IFRS financial statements. Form 20-F, Instruction 5 to Item 5.

265 Form 20-F, Item 5.E.1.

266 SEC Release No. 33-8182 (Jan. 28, 2003), 68 Fed. Reg. 5982, 5988 n.99 (Feb. 5, 2003).

267 This disclosure should explain to investors why the issuer engages in off-balance sheet arrangements and provide the information that investors need to understand the business activities advanced through those arrangements. SEC Release No. 33-8182 (Jan. 28, 2003), 68 Fed. Reg. 5982, 5989 (Feb. 5, 2003).

268 While the adopting release with respect to the rules, SEC Release No. 33-8182 (Jan. 28, 2003), 68 Fed. Reg. 5982, 5989 (Feb. 5, 2003), did not mention any specific examples of such "triggering events," the proposing release indicated that adverse changes in the issuer's credit rating or financial ratios or changes in the value of underlying or indexed assets were potential examples. SEC Release No. 33-8144 (Nov. 4, 2002), 67 Fed. Reg. 68,054, 68,061 (Nov. 8, 2002).

269 If, for example, a specified decline in the issuer's credit ratings would give rise to an obligation to purchase assets from, or assume liabilities of, an unconsolidated entity, the adopting release with respect to the rules indicates that they would require the issuer to discuss known circumstances that are reasonably likely to cause the specified decline in ratings and its material consequences. SEC Release No. 33-8182 (Jan. 28, 2003), 68 Fed. Reg. 5982, 5989 (Feb. 5, 2003).

270 SEC Release No. 33-8182 (Jan. 28, 2003), 68 Fed. Reg. 5982, 5989 (Feb. 5, 2003); Form 20-F, Item 5.E.1. In December 2007, the Division of Corporation Finance made public an illustrative letter that it sent to a number of public companies using non-consolidated conduits, structured investment vehicles and off-balance sheet collateralized debt obligation structures for financing purposes. The division highlighted a number of specific items for possible disclosure, including: the categories, ratings and weighted-average life of the off-balance sheet assets; the forms of funding and weighted-average life of the funding held by an off-balance sheet entity; any material difficulties an off-balance sheet entity has experienced in issuing its commercial paper or other financing; any material write-downs or downgrades of assets held by an off-balance sheet entity; the issuer's obligations under liquidity facilities related to the off-balance sheet arrangements; and the potential impact on debt covenants, capital ratios, credit ratings or dividends should the issuer be required to consolidate an off-balance sheet entity or incur significant losses associated with it. SEC, Division of Corporation Finance, Sample Letter Sent to Public Companies That Have Identified Investments in Structured Investment Vehicles, Conduits or Collateralized Debt Obligations (Off-balance Sheet Entities) (Dec. 2007).

271 Form 20-F, Instruction 2 to Item 5.E.

272 Form 20-F, Instruction 5 to Item 5.E.

273 *See* SEC, Office of the Chief Accountant, Office of Economic Analysis and Division of Corporation Finance,

Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 on Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers at 98 (June 15, 2005). The report noted that a greater proportion of issuers report off-balance sheet arrangements in the notes to the financial statements, as compared to the off-balance sheet section of the MD&A. While recognizing that there may be a good reason for this in the case of FIN 45 guarantees (not all of which are covered by the MD&A line-item requirements), the staff nevertheless observed that issuers may not have identified all of the off-balance sheet arrangements that are required to be discussed in the off-balance sheet section of the MD&A.

274 Form 20-F, Instruction 4 to Item 5.E.

275 Unlike the required disclosures on off-balance sheet arrangements, the required tabular disclosure on contractual obligations is not required to appear in a separately captioned section of the MD&A. Form 20-F, Item 5.F.

276 Form 20-F, Item 5.F.1.

277 *See* Form 20-F, Instruction 2 to Item 5.F. If the GAAP used in the primary financial statements does not distinguish between capital (finance) leases and operating leases, all leases should be presented under a single category.

278 "Purchase obligation" is defined as "an agreement to purchase goods or services that is enforceable and legally binding on the registrant that specifies all significant terms, including: fixed or minimum quantities to be purchased; fixed, minimum or variable price provisions; and the approximate timing of the transaction." Item 303(a)(5)(ii)(D) of Regulation S-K under the Securities Act; Form 20-F, Item 5.F.2. The adopting release with respect to the rules provides that, among other things, if any purchase obligation is subject to variable price provisions, the issuer must provide estimates of payments due and footnote disclosure identifying payments subject to market risk (if material). SEC Release No. 33-8182 (Jan. 28, 2003), 68 Fed. Reg. 5982, 5991 (Feb. 5, 2003).

279 In the 2010 MD&A Interpretive Guidance, the SEC noted that the "obligations table is to provide aggregated information about contractual obligations and contingent liabilities and commitments in a single location so as to improve transparency of a registrant's short-term and long-term liquidity and capital resources needs and to provide context for investors to assess the relative role of off-balance sheet arrangements" and that "registrants should prepare the disclosure consistent with that objective." *See* 2010 MD&A Interpretive Guidance, 75 Fed. Reg. 59,894, 59,896 (Sept. 28, 2010).

280 For U.S. domestic issuers, Item 303(a)(5) of Regulation S-K requires a tabular disclosure of contractual obligation. In the Fast Act Report, the SEC staff recommended replacing such table with a hyperlink to the relevant financial statement notes that provide substantially similar disclosure.

281 Form 20-F, Item 5.G; *see also* § 4.06[1][a] (discussing safe harbor provisions under the Securities Act and the Exchange Act for forward-looking statements contained in MD&A). The statutory safe harbor provisions would not apply in all instances, including with respect to forward-looking statements contained in MD&As for IPOs. *See* SEC Release No. 33-8182 (Jan. 28, 2003), 68 Fed. Reg. 5982, 5993 n.146 (Feb. 5, 2003).

282 SEC Release No. 33-8182 (Jan. 28, 2003), 68 Fed. Reg. 5982, 5993 & n.148 (Feb. 5, 2003).

U.S. Regulation of the International Securities and Derivatives Markets, § 4.07, OTHER SIGNIFICANT DISCLOSURE ISSUES IN SEC FILINGS

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 4.07 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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[1] Plain English Principles

In 1998, the SEC issued a release (the "Plain English Release") [283] adopting a number of rules and rule amendments intended to reduce the complexity and enhance the clarity of prospectus disclosure. The Plain English Release requires companies to use "Plain English" principles in writing the front and back cover pages, summary and risk factor sections of prospectuses. [284] The Plain English Release identifies six such "Plain English" principles: active voice; short sentences; definite, concrete, everyday language; tabular presentation and "bullet lists" for complex material whenever possible; no legal jargon or highly technical business terms; and no multiple negatives. [285] In addition to these specific requirements, the Plain English Release amended Rule 421(b) under the Securities Act to require the general use of "Plain English" drafting techniques throughout a prospectus. [286] The SEC has since adopted "Plain English" principles for certain other documents. [287]

Many practitioners believe the "Plain English" initiative has improved disclosure. However, in its early years the "Plain English" initiative sometimes led to delays in SEC staff review of registration statements as "Plain English" comments were made and responded to. The number of such comments has declined significantly, and delays attributable to "Plain English" comments have essentially disappeared.

[2] Risk Factors

p. 4-83

Form 20-F requires foreign registrants to include material risk factors that are specific to the company, its industry and, in the case of an offering, the securities being offered. [288] Unlike Item 503(c) of Regulation S-K, which requires disclosure of risk factors for U.S. registrants and is silent on the ordering of risk factors, Form 20-F specifically encourages the companies to list the risk factors according to priority. The illustrative list of factors listed in Form 20-F includes:

- the nature of the business in which it is engaged or proposes to engage;
- factors relating to the countries in which it operates;
- the absence of profitable operations in recent periods;
- the financial position of the company;
- the possible absence of a liquid trading market for the company's securities;
- reliance on the expertise of management;
- potential dilution;
- unusual competitive conditions;
- pending expiration of material patents, trademarks or contracts; or
- dependence on a limited number of customers or suppliers.

The SEC has also encouraged companies to include a risk factor covering cybersecurity, if such risk is material to the investors in the company. [289] Under the Plain English Release, companies are required to draft risk factors in plain English. Although Form 20-F is not explicit on these points, foreign registrants should refer to Item 503(c) of Regulation S-K for guidance, which requires the use of subcaptions to describe the categories of risks factors and cautions against including generic risk factors that apply to any issuer or any offering. Further, the SEC staff has often commented that any language in a risk factor that mitigates the risk it covers should be removed. The SEC staff also often asks registrants to separate different risks into multiple risk factors instead of bundling them into one.

[3] Special Corporate Governance Rules

p. 4-83

p. 4-84

Once companies become public in the United States, they also become subject to various substantive corporate governance requirements. These include the Exchange Act's requirement to maintain an adequate system of internal controls and certain other requirements imposed by the Sarbanes-Oxley Act with respect to corporate governance, management accountability and auditor independence, among others. The Dodd-Frank Act also imposes a number of substantive requirements on reporting companies, especially with respect to executive compensation and compensation committees, although foreign issuers are generally excluded from these requirements. Separately, NYSE and Nasdaq rules impose certain corporate governance requirements on listed companies. A more detailed discussion of these requirements is included in Chapter 5.

[4] Mine Safety Disclosure Requirements

Section 1503 of the Dodd-Frank Act [290] requires every reporting company that is an operator, [291] or has a subsidiary [292] that is an operator, of coal or other mines in the United States to make certain health- and safety-related disclosures in periodic reports and, for domestic companies covered by the rule, in current reports on Form 8-K. [293] These provisions thus apply to foreign issuers that operate or have subsidiaries that operate mines in the United States. The required disclosures include information about certain orders, violations and citations regarding mine safety and health standards under the Mine Act, proposed assessments from the U.S. Labor Department's Mine Safety and Health Administration ("MSHA") under the Mine Act, mining-related fatalities and pending legal actions before MSHA. The SEC's form requirements implementing § 1503 clarify that the disclosure must be provided for each mine and that no aggregation is permitted, and they confirm that all orders, violations or citations received

p. 4-84

p. 4-85

during a period must be disclosed, even if they have subsequently been dismissed, reduced or settled or are contested by the company. [294]

Most of the disclosures must be included as an exhibit to the annual report on Form 10-K, Form 20-F or Form 40-F and to quarterly reports on Form 10-Q. [295] Some disclosures of U.S. issuers must also be made in current reports on Form 8-K within four business days of triggering events, while the Form 8-K requirements do not apply to foreign issuers. [296] In the Mine Safety Adopting Release, the SEC noted that it was "mindful of concerns that the disclosure requirement should be as equal as possible in order to avoid disadvantaging U.S. issuers in comparison to foreign issuers," but the final rule does not require foreign issuers to disclose mine safety information in current reports on Form 6-K that correspond to domestic issuers' requirements for disclosures on Form 8-K. No particular format is required for the disclosures, although the SEC encourages presentation in tabular format. EXtensible Business Reporting Language ("XBRL") format reporting of the disclosures is not currently required. [297]

Unlike the disclosures relating to conflict minerals, mine safety disclosures are automatically incorporated by reference in registration statements on Form S-3 (or F-3) under the Securities Act, but such information is not required in a long-form registration statement on Form S-1 (or F-1). [298]

[5] Oil and Gas Disclosure Requirements

p. 4-85
p. 4-86

Major revisions to the SEC's rules governing disclosures about oil and gas activities took effect for Securities Act registration statements filed on or after January 1, 2010 and annual reports on Forms 10-K or 20-F for fiscal years ending on or after December 31, 2009. [299] The previously applicable special oil and gas disclosure rules for foreign issuers were eliminated, so foreign issuers are now subject to the same disclosure regime as U.S. domestic issuers (though this change does not affect Canadian issuers that file with the SEC pursuant to the Multi-Jurisdictional Disclosure System). [300] The revised rules, together with the oil- and gas-related disclosure requirements previously contained in Industry Guide 2, are now codified in new Subpart 1200 of Regulation S-K. [301]

In adopting the revised rules, the SEC recognized that its prior rules, adopted more than 25 years earlier, had not kept pace with subsequent significant developments in the oil and gas industry. These changes included major advances in the technology used to assess oil and gas reserves, substantially increased volatility in oil and gas prices, the rapidly growing importance of non-traditional sources of oil and gas and the increasingly geographic diversification of the industry (including significant growth both in the number of major non-U.S. oil and gas companies that file reports with the SEC and in the percentage of U.S. and non-U.S. oil and gas companies' reserves that are located outside the United States). [302]

The revised rules changed the pricing methodology used to determine the economic producibility of reserves. The price that is required to be used now is a 12-month average price, calculated based on the first day of each month, whereas a single-day period-end price was previously required. [303] This change addressed criticism that the single-day period-end price is not the preferable price to establish economic producibility of reserves since it is particularly subject to volatility and seasonality. Thus, it is expected that a 12-month average price will result in improved reserves estimates while maintaining comparability. Although the SEC acknowledged that historical prices are less useful than expected future prices in determining the fair value of a company's reserves, it did not permit

p. 4-86
p. 4-87

use of expected future prices as a pricing methodology. The SEC believes reserves estimates are intended to permit comparison of reserves and not the fair value of reserves. [304] In addition, using future prices could require subjective judgments and result in diminished comparability due to differing assumptions. [305] Regardless of the pricing methodology used, price volatility leads to uncertainty and unintended consequences for disclosure and financial statements. This affects not only the value of the reserves but also the existence of economically producible reserves. The revised rules permit, but do not require, companies to provide a sensitivity analysis table to address this issue. [306]

Other changes will also affect determination of reserves. The revised rules permit the determination of reserves to be based on new technologies (other than just actual production or flow tests), so long as such technologies are empirically demonstrated to be reliable indicators of reserves volumes. [307] The revised rules also permit the calculation of reserves estimates using both deterministic and probabilistic methods, as well as the inclusion of analogous reservoirs in reserves calculations. [308]

Prior to the revised rules, disclosure of any reserves estimates other than proven reserves was prohibited. The revised rules permit (but do not require) the disclosure of probable and possible reserves. [309] Under the old rules, oil and gas

p. 4-87
p. 4-88

companies widely disclosed amounts of probable and possible reserves by means other than through filings with the SEC, including through press releases and on their Internet websites. The revised rules recognized this market practice and the fact that investors seem to find this information helpful in assessing a company's reserves position. Many commenters opposed this disclosure and raised the issue of potential liability to the companies that may arise from including such information in SEC filings. [310] Underwriters will also be exposed to heightened liability if a company includes, or incorporates by reference, probable or possible reserves information in Securities Act filings. While liability issues might not be dispositive in the context of necessary or useful communications with investors and the market, in this case issuers have successfully followed the widely established market practice of disseminating this information outside SEC filings.

The revised rules introduced new definitions that are consistent with those used in the Petroleum Resources Management System ("PRMS") developed by the Society of Petroleum Engineers ("SPE") and other major industry organizations. [311] The definition of undeveloped proved reserves changes the "certainty" standard for non-adjacent undeveloped reserves to a "reasonable certainty" standard. The term "reasonable certainty" follows the PRMS definition and provides that for probabilistic methods reasonable certainty requires at least a 90% probability that quantities recovered will equal or exceed the estimate. [312] The definition also contains an "elaboration," which is consistent with the staff's prior position, to the effect that reasonable certainty embodies the concept that estimated ultimate recovery is much more likely to increase or remain constant than to decrease over time. [313] Moreover, in connection with the SEC's abandonment

p. 4-88

p. 4-89

of its long-standing prohibition on disclosure of probable and possible reserves in SEC filings, the terms probable and possible reserves are now defined, consistent with the PRMS definitions.

The revised pricing methodology also applies to the accounting for oil and gas reserves by companies that follow the successful efforts method, as Accounting Standards Codification 932, Extractive Activities—Oil and Gas, as amended, refers to Regulation S-K definitions. This change allows consistency between the new reserves disclosure requirements and the U.S. GAAP accounting presentation of reserves. The SEC clarified that the pricing change should be applied prospectively only and does not require retroactive application. [314]

In response to the SEC's revised disclosure rules about oil and gas activities, in January 2010 FASB issued Accounting Standards Update No. 2010-03, Oil and Gas Reserve Estimation and Disclosures ("ASU 2010-03") to align its requirements for estimation and disclosure of oil and gas reserves under U.S. GAAP with the new SEC rules. ASU 2010-03 became effective for annual reporting periods ending on or after December 31, 2009.

The SEC acknowledged in the Oil and Gas Release the importance of providing consistency of standards and stated that it is communicating with the FASB and the IASB on these matters. [315] However, uncertainties exist in connection with IFRS. The IASB published a discussion paper on extractive activities in April 2010, [316] but it effectively discontinued this project in December 2012, in favor of a broader research project on intangible assets. A new discussion paper is expected to be published. [317]

Under the revised SEC rules, resources such as bitumen from oil sands and oil and gas from coal and shale are required to be disclosed as oil and gas activities instead of mining activities. [318] The SEC indicated that accounting changes as a result of non-traditional resources being accounted for under oil and gas accounting rules and not mining industry rules should be applied prospectively only and do not require retroactive application.

Finally, new Subpart 1200 of Regulation S-K imposed several new disclosure requirements relating to reserves, including principally the following:

p. 4-89

p. 4-90

- more detailed geographic breakdowns of reserves information; [319]
- technologies used in estimation of reserves; [320]
- registrants' internal controls over the reserves estimation process; [321]

- the qualifications of the technical person at each registrant who is primarily responsible for reserves estimation; [322] and
- the filing of third-party reports comprising reserves audits or process reviews, if the issuer represents that a third party prepared or audited the reserves estimates or conducted a process review. [323]

The filed report can be a summary rather than the full report, and it must (in the case of a report on a reserves audit or third-party preparation of a reserves estimate) contain specified information. [324] In addition, where a report is included in or incorporated into a Securities Act registration statement, the third party must file a consent and is an "expert" for Securities Act purposes. [325]

[6] 2010 Interpretive Release on Disclosure of Climate Change Matters

On February 2, 2010, the SEC issued an interpretive release to provide guidance on existing SEC disclosure requirements as they apply to climate change. [326] In issuing the Climate Change Release, the SEC stated that its objective is to provide clarity on disclosure relating to climate change, including in an issuer's risk factors, business description, legal proceedings and MD&A. The SEC emphasized that the Climate Change Release does not impose any new legal requirements or modify existing ones. [327] In particular, the Climate Change

p. 4-90

p. 4-91

Release does not, in and of itself, require an issuer to disclose its carbon footprint or the steps it is taking to reduce emissions. Although the Climate Change Release states that it is not intended to impose new disclosure requirements, the contemplated analyses appear in some cases to go beyond existing norms. For example, the Climate Change Release calls for extensive assessment of the prospects for and possible impacts of potential future climate change requirements, whether resulting from U.S. legislation or regulation or international accords. The SEC also emphasizes that, as this is a rapidly developing area, issuers should regularly assess their disclosure obligations. [328]

After generally summarizing the disclosure requirements of Regulation S-K and Regulation S-K of potential relevance for environmental matters, the Climate Change Release highlights four topics as examples in which climate change may trigger disclosure requirements. The Climate Change Release notes that while disclosure obligations of foreign issuers are governed by Form 20-F and not Regulation S-K, most of the disclosure requirements applicable to domestic issuers under Regulation S-K have parallels under Form 20-F. [329] In particular, the Climate Change Release highlights Item 3.D (material risks), Item 4.B.8 (material effects of government regulation), Item 4.D (environmental issues that may affect company utilization of its assets), Item 5 (MD&A) [330] and Item 8.A.7 (legal proceedings) as those under Form 20-F that might require disclosure concerning climate change matters material to an issuer's business. [331]

[a] Impact of Legislation and Regulation

The Climate Change Release notes that the financial impacts of legislation and regulation regarding climate change may implicate the following disclosure obligations, among others [332]:

p. 4-91

p. 4-92

- Risk factor disclosure. According to the Climate Change Release, a company should consider the specific risks faced by the company or its industry sector and "avoid generic risk factor disclosure that could apply to any company." [333]
- MD&A disclosure. The Climate Change Release sets out a two-step analysis to the effect that a known uncertainty, such as pending climate change legislation or regulation, requires disclosure unless management determines either that the pending legislation or regulation is not reasonably likely to be enacted or that, if enacted, it would not be reasonably likely to have a material effect on the issuer, its financial condition or results of operations. [334]

The Climate Change Release also references various possible consequences of pending legislation and regulation that issuers should assess. [335]

[b] Impact of International Accords

The Climate Change Release states that an issuer should consider, and disclose when material, the risks or effects on its business of international accords and treaties relating to climate change (*e.g.*, the Paris Agreement, the Kyoto Protocol, the European Union Emission Trading Scheme and other international activities) just as it should do for U.S. legislation and regulation. [336]

[c] Indirect Consequences of Regulation or Business Trends

The Climate Change Release notes that indirect consequences or risks relating to climate change may need to be disclosed as risk factors, in MD&A or, if significant enough, in the business description. As examples, the Climate Change Release highlights the following possible indirect consequences or opportunities to be considered:

p. 4-92

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p. 4-93

- decreased demand for goods that produce significant greenhouse gas emissions;
- increased demand for goods that result in lower emissions than competing products;
- increased competition to develop innovative new products;
- increased demand for generation and transmission of energy from alternative energy sources;
- decreased demand for services related to carbon-based energy sources, such as drilling services or equipment maintenance services; and
- reputational damage related to the public's perception of any publicly available data relating to an issuer's greenhouse gas emissions. [337]

[d] Physical Impacts of Climate Change

The Climate Change Release states that issuers whose businesses may be vulnerable to severe weather or climate events should consider disclosure of material risks or consequences. Examples include property damage and operational disruptions to facilities in coastal areas; indirect effects from the impact of severe weather on suppliers or customers; for insurance companies, increased claims and liabilities; decreased agricultural production; and increased insurance costs or decrease in the availability of coverage. [338]

[7] Disclosure of Preliminary Merger Negotiations

There is some uncertainty as to the circumstances in which companies must disclose the existence of preliminary merger negotiations. In particular, companies question whether they must make such disclosure when they are filing registration statements or annual reports or at other times. In its release on MD&A disclosure, the SEC noted that its forms for periodic reporting under the Exchange Act generally do not require *pro forma* financial information in connection with material mergers and acquisitions or require disclosure of such transactions, until definitive agreement is reached or upon completion. [339]

p. 4-93

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p. 4-94

When a company registers securities under the Securities Act, however, the SEC requires disclosure in the registration statement of probable material acquisitions and dispositions of businesses, including in certain cases the financial statements of each business to be acquired as well as certain *pro forma* financial information. [340] When the proceeds from the sale of the securities being registered are to be used to finance an acquisition of a business, the registration statement must also disclose the intended use of proceeds. Companies are, however, permitted to omit from registration statements disclosure of the identity of the parties and the nature of the business sought, if the acquisition is immaterial or not yet probable and the board of directors determines that including such disclosure would threaten completion of the acquisition. Nevertheless, if financial statements are required to be included under the relevant rules, a more detailed description of the business to be acquired must be included. [341]

When disclosure is not otherwise required by these filing requirements, and has not otherwise been made, the MD&A in a registration statement or an annual report need not contain a discussion of the impact of preliminary merger negotiations if, in the issuer's view, inclusion of such information would threaten completion of the transaction. When disclosure is otherwise required or has otherwise been made by or on behalf of the issuer, the negotiations become subject to the same disclosure standards in the MD&A as any other known trend, commitment, event or uncertainty. [342]

[8] Guide 3 Disclosure Requirements for Bank Holding Companies

SEC Industry Guide 3 provides guidelines for statistical disclosures by foreign banks and bank holding companies in SEC filings. [343] It is intended to elicit information concerning the risks and uncertainties in banking operations to enable prospective investors to assess the issuer's financial condition and to differentiate among issuers in terms of income sources and risk exposure. Guide 3

p. 4-94

p. 4-95

requires detailed disclosures concerning a foreign bank's assets, liabilities and equity accounts, interest rates and interest spreads, investment portfolio, loan portfolio, loan maturities, loan sensitivity to changes in interest rates, problem loans, loan concentrations, loan loss experience, other earning assets, deposits and return on equity and assets.

Because an issuer is required to disclose in a filing not only all required information concerning its operations and financial condition but also all material information necessary to make what is disclosed not misleading, disclosure may in certain circumstances have to go beyond the requirements of Guide 3. Moreover, the SEC has historically permitted some deviation from the specific requirements of the Guide if more meaningful disclosure with respect to a particular issue would thereby be provided. The disclosure requirements of Guide 3 are applicable to foreign companies to the extent the requested information is available. If the information is unavailable and cannot be compiled without unwarranted or undue burden or expense, this situation should be brought to the attention of the SEC staff at an early stage in the process of preparing for registration. If possible, reasonably comparable data should be furnished instead. In addition, while the SEC staff may allow an initial filing by a foreign issuer to be made without full compliance with Guide 3, the staff may condition such relief on more complete compliance in connection with filings for subsequent periods.

[9] Beneficial Ownership of Shares by, and Compensation of, Directors and Officers

A U.S. issuer is required to include in a registration statement or an annual report (or in a proxy statement if the Part III information of Form 10-K is incorporated by reference therefrom) a tabular disclosure of beneficial ownership of each class of equity securities of the issuer or its parents or subsidiaries by each of the directors (including director nominees) and named executive officers [344] and all directors and executive officers as a group. [345] A foreign issuer is subject to a similar requirement to disclose in a registration statement or an annual report information as to share ownership in the company by the directors and members

p. 4-95

p. 4-96

of the administrative, supervisory or management bodies and options granted to them on the foreign issuer's shares. [346] This information must be provided on an individual basis [347] and include disclosure of the number of shares, percentage of shares of such class outstanding, any special voting rights and, with respect to options, the exercise and purchase prices, together with the expiration date(s) of the options. The term "beneficial ownership" for this purpose is defined in Rule 13d-3 under the Exchange Act for U.S. issuers and in General Instruction E of Form 20-F for foreign private issuers.

A U.S. issuer is also required to provide in a registration statement or an annual report (or in a proxy statement as described above) information about the individual compensation of each of its named executive officers and directors. [348] In contrast, foreign issuers may provide information concerning the remuneration of directors and members of its administrative, supervisory or management bodies in an aggregate amount in an SEC filing, unless the issuer is required to provide individual disclosure in its home jurisdiction or has otherwise made such data public. [349] A discussion of certain disclosure requirements related to shareholders that beneficially own 5% or more of an issuer's shares or control an issuer is included in § 6.03[2].

[10] Interested Party Transactions

p. 4-96

p. 4-97

A U.S. issuer is required to describe in a registration statement any transaction between the issuer, on the one hand, and its management or any holder of more than 5% of the issuer's voting securities, on the other hand, involving an amount in excess of $120,000. [350] Foreign companies are also required to provide disclosure regarding interested party transactions, but only those that are material to the company or the interested party (or that are unusual), except that loans by the company to or for the benefit of an interested party must be disclosed regardless of amount. [351] If more detailed information is required to be disclosed by the foreign company's home jurisdiction or a market in which its securities are listed or traded or otherwise made publicly available, it should be disclosed pursuant to Item 404 of Regulation S-K. [352]

In the SEC's 2002 MD&A Statement calling for better-quality disclosure in several areas of the MD&A, the SEC also called for better-quality disclosure regarding related-party and similar transactions, noting that additional disclosure may be required when there are transactions involving parties, whether or not classified as related parties under applicable accounting regulations, that have relationships that enable them to negotiate terms of material transactions that might not be available on an arm's-length basis from clearly independent third parties. [353] Examples of such parties could include entities established by former senior management or by persons who have some other current or former relationship with the issuer.

The SEC has suggested that issuers consider including disclosure regarding all material transactions with such parties, together with a discussion of any terms that differ from those that would be available on an arm's-length basis. In describing these relationships, the SEC cautioned issuers to include information regarding the business purpose, the persons involved, how transaction prices were determined, how the transaction was evaluated for fairness (if such evaluation is stated to have been made) and any ongoing contractual or other commitments resulting from the arrangement.

[11] Derivatives Disclosure

p. 4-97

p. 4-98

In 1997, the SEC adopted amendments to a number of rules and forms that imposed significant disclosure requirements on both domestic and foreign issuers with respect to derivatives and other financial instruments. [354] The amendments came in response to the substantial growth in the use of derivative instruments as a tool for managing market risk and the perceived deficiencies in companies' disclosure about their exposures to such risks, as well as the significant and well publicized losses experienced in recent years by some companies in market risk-sensitive instruments due to changes in, among other things, interest rates, foreign currency exchange rates and commodity prices.

The disclosure required under the 1997 rules is both specific and extensive. First, enhanced descriptions must be supplied in the footnotes to the financial statements with respect to accounting policies for derivative instruments. [355] Seven specified items must be considered, and must be addressed in the footnotes to the extent material. [356] Second, disclosure outside the financial statements must be made of both qualitative and quantitative information about derivative and other financial instruments. With respect to quantitative information about market risk associated with such instruments, registrants are generally required to present information as of the end of the latest fiscal year and to elect one of three alternatives: (i) tabular presentation of fair value information and contract terms relevant to determining future cash flows, categorized by expected maturity dates, (ii) sensitivity analysis expressing the potential loss in future earnings, fair values or cash flows from selected hypothetical changes in market rates and prices, or (iii) value-at-risk disclosures expressing such potential losses over a selected period of time with a selected likelihood of occurrence. [357] In preparing this quantitative information, registrants must group separately those

p. 4-98
p. 4-99

instruments entered into for trading purposes and those entered into for other purposes and must, within each such group, present separate quantitative information for each market risk exposure category (*i.e.*, interest rate risk, foreign currency exchange rate risk, commodity price risk, etc.). [358] Different disclosure alternatives may be used for each of the separate disclosures. With respect to qualitative information, the requirements include a narrative discussion of a registrant's primary market risk exposures and how the registrant manages those exposures, as well as any changes in either of these areas relative to the most recent prior reporting period and what is known or expected in future periods. [359]

These derivatives disclosure provisions apply to a greater or lesser extent to all foreign registrants. Under Item 18 of Form 20-F, foreign issuers are required to provide all information required by Regulation S-K, including the footnote disclosure regarding derivatives accounting policies required by Rule 4-08 of Regulation S-K. Item 11 of Form 20-F, meanwhile, requires disclosure by all foreign issuers of the quantitative and qualitative information about market risk described above. As a practical matter, a foreign company whose portfolio includes significant derivative instruments and other financial instruments will almost certainly require sophisticated internal staff or sophisticated assistance from third parties in order to comply with these disclosure requirements. In addition to the cost of such assistance, the time that may be required to produce the necessary disclosure will need to be considered in planning any U.S.-registered offering. [360]

[12] Disclosure Regarding ADR Fees

Under Item 12D.3 of Form 20-F, an issuer is required to disclose in its annual report the fees and charges holders of ADRs may have to pay. The issuer

p. 4-99
p. 4-100

must also disclose (i) any fees or charges for "general depositary services, particularly those charged on an annual basis" and (ii) whether the depositary has the right to collect fees and other charges by offsetting them against dividends or against deposited securities. [361] Item 12D.4 of Form 20-F also requires disclosure in registration statements and annual reports about payments from the depositary to the issuer. [362]

[13] Global Security Risk Disclosure; OFAC Sanctions; Section 13(r) (Iran)

In 2004, the SEC's Division of Corporation Finance established the Office of Global Security Risk. [363] The stated objectives of the Office of Global Security Risk are to (i) identify companies whose activities raise concern about global security risks that are material to investors, (ii) obtain appropriate disclosure where merited and (iii) share information as necessary and appropriate with other key government agencies responsible for tracking terrorist financing. The Office of Global Security Risk is charged with focusing on "asymmetric risk" by assisting SEC review staff in considering whether a U.S. or foreign company has operations or other exposure in areas of the world that may subject the company and its investors to material risk, trends or uncertainties. This consideration would include whether a company has operations in a country or area of activity where political, economic or other risks exist that are material, or whether the company faces public or government opposition, boycotts, litigation or similar circumstances that are reasonably likely to have a material adverse impact on its financial condition or results of operations. [364] The Office of Global Security Risk is required to provide quarterly reports on its activities to Congress. [365]

In June 2007, the SEC established a website in which it listed reporting companies that, based on disclosure in their annual reports, engaged in business

p. 4-100

p. 4-101

in Cuba, Iran, North Korea, Sudan and Syria. The website also included links to the relevant sections of the companies' annual reports. [366]

Substantial criticism followed that the website did not fulfill its purpose of informing investors as to companies supporting the specified countries. In particular, it was suggested that some of the companies listed had disclosures to the effect that they were engaged in "negligible" activities or had even stopped their activities. The disclosures by the SEC on the website were characterized as "unfair and perhaps counterproductive." [367] The SEC took the website down in July 2007 and issued a concept release seeking comments as to whether and how the SEC should provide easier access to companies' disclosures concerning their business in or with countries designated as state sponsors of terrorism. [368] No further action on this subject followed the concept release. The staff continues to make comments seeking disclosure or additional details regarding issuers' activities that may implicate global security risk issues.

The SEC indicated in May 2001 that the staff would attempt to review all registration statements of foreign issuers engaged in material business activities in or with countries, governments or persons subject to sanctions administered by the U.S. Treasury Department's Office of Foreign Assets Control (the "OFAC Sanctions"). Under the OFAC Sanctions, dealings by U.S. persons (and, in some cases, the non-U.S. subsidiaries of U.S. persons) with such countries, governments and persons are restricted. [369]

Foreign issuers must apply traditional materiality standards when determining whether disclosure of operations or relationships with countries, governments or entities subject to OFAC Sanctions is necessary. If such disclosure is made, the SEC can be expected to review subject registration statements and request detailed explanations of relevant transactions. [370]

On August 10, 2012, President Obama signed the Iran Threat Reduction and Syria Human Rights Act of 2012 ("ITRA") into law. [371] Section 219 of ITRA added § 13(r) to the Exchange Act, under which any issuer of securities that is required to file quarterly or annual reports under § 13(a) of the Exchange Act

p. 4-101

p. 4-102

must make specific disclosure in its public filings if it or an affiliate [372] has knowingly engaged in certain activities listed in § 13(r). [373] Disclosure must include: (i) the nature and extent of the activity; (ii) the gross revenues and net profits attributable to the activity; and (iii) whether the issuer or affiliate intends to continue the activity. The issuer is also obligated to file a separate notification of the disclosures to the SEC concurrently with the report. [374] As a result, while it is not per se illegal for non-U.S. companies listed in the United States to engage in business with U.S.-sanctioned parties linked to Iran, failure to make the disclosures required by § 13(r) will now constitute a violation of U.S. securities law and may result in civil and criminal penalties. [375]

[14] Interactive Data

In January 2009, the SEC adopted rules (the "XBRL Rules") requiring issuers reporting under U.S. GAAP or IFRS as issued by the IASB to provide financial statements to the SEC in XBRL. [376] The XBRL Rules currently apply only to foreign issuers that prepare their financial statements in accordance with U.S. GAAP or IFRS as issued by the IASB. Interactive data files will be filed as exhibits that supplement, but do not replace, the financial statements otherwise required to be filed. XBRL is an interactive data format that makes a company's financial statements machine-readable so they can be analyzed and compared

p. 4-102

p. 4-103

using other software applications. Interactive data filing is designed to improve the usefulness of financial information submitted to the SEC by making it possible to download financial data directly into spreadsheets and other applications. Although many foreign countries have voluntary or pilot XBRL programs, the SEC is among the first to make XBRL filing mandatory. [377] Foreign issuers that file financial statements in accordance with IFRS as issued by the IASB were not required to file XBRL interactive data until the SEC publishes a taxonomy for IFRS on its website, which it did on March 1, 2017. They will now be required to file XBRL interactive data beginning with fiscal periods ending on or after December 15, 2017. [378]

Under the XBRL Rules, an electronic filer is required to submit an interactive data file exhibit with annual reports on Form 20-F and reports on Form 6-K that include updated or revised financial statements. [379] Electronic filers will also be required to submit interactive data files as exhibits to their Securities Act registration statements that include financial statements that are not incorporated by reference. [380] In such cases, the interactive data exhibit will not be required until a price or price range has been determined and will be required for later amendments only if the financial statements have changed. Registration statements for an IPO will not be required to include an interactive data file. Similarly, issuers will not be required to include an interactive data file when using Forms 10, 20-F or 40-F to register under the Exchange Act.

Issuers have incurred additional expenses in connection with filings of interactive data, and the time necessary to prepare interactive data files has put additional time pressure on at least some issuers, who have effectively been required to finalize their filings up to several days before what would otherwise have been the case, in order to accommodate the preparation of interactive data

p. 4-103

p. 4-104

files. It is also not clear whether the utility of interactive data files to investors or regulators has justified burdens to date.

[15] Cybersecurity Disclosure

On October 13, 2011, the SEC's Division of Corporation Finance issued disclosure guidance on cybersecurity. [381] Although this guidance is not a rule or regulation, it provides the Division's view on adequate disclosure relating to cybersecurity risks and cyber incidents in light of recent highly publicized cyber-attacks on companies. The guidance uses the materiality standard to determine whether any cybersecurity disclosure is required. [382] For example, the guidance explains that cybersecurity risks should be disclosed as a risk factor if such risk is one of the "most significant factors that make an investment in the company speculative or risky." The guidance also suggests that a company should disclose cybersecurity risks or cyber incidents in the MD&A section, if such risks or incidents are reasonably likely to have a material impact on the company's financial results and operations. Other specific areas covered by the guidance include description of business, legal proceedings, financial statement disclosure, and disclosure controls and procedures. Lastly, companies are cautioned against providing generic "boilerplate" disclosure related to cybersecurity and are encouraged to provide meaningful disclosure that specifically applies to a particular company or industry.

Footnotes

283 SEC Release No. 33-7497 (Jan. 28, 1998).

284 SEC Release No. 33-7497 (Jan. 28, 1998), 63 Fed. Reg. 6370, 6370 (Feb. 6, 1998).

285 SEC Release No. 33-7497 (Jan. 28, 1998), 63 Fed. Reg. 6370, 6371 (Feb. 6, 1998).

286 SEC Release No. 33-7497 (Jan. 28, 1998), 63 Fed. Reg. 6370, 6371 (Feb. 6, 1998).

287 *See* Rules 13a-20 and 15d-20 under the Exchange Act and SEC Release No. 33-8732A (Aug. 29, 2006) (requiring the use of plain English in executive and director compensation, related-person transaction, beneficial ownership and corporate governance disclosures); *see also* Rule 14a-16(g) under the Exchange

Act, SEC Release No. 34-55146 (Jan. 22, 2007) and SEC Release No. 34-56135 (July 26, 2007) (requiring the use of plain English in the notice of Internet availability of proxy materials).

288 Form 20-F, Item 3.D.

289 SEC, Division of Corporation Finance, CF Disclosure Guidance: Topic No. 2 (Oct. 13, 2011). *See* § 4.07[15].

290 15 U.S.C. 78m-2. While § 1503 is not a part of and does not add provisions to the Exchange Act, it provides that a violation of § 1503 or any rules therein still be treated in the same manner as violations of the Exchange Act or rules thereunder.

291 The term "operator" has the meaning given to the term in § 3 of the Federal Mine Safety and Health Act of 1977, Pub. L. No. 91-173, 83 Stat. 742 (1969), as amended by Pub. L. No. 95-164, 91 Stat. 1290 (1977) (the "Mine Act"). *See* § 1503(e)(3) of the Dodd-Frank Act; 15 U.S.C. § 78m-2(e)(3).

292 The statute does not define the term "subsidiary," which would mean that the applicable definition would be the one in Item 1-02(x) of Regulation S-K.

293 Only mines subject to the Mine Act are covered. *See* § 1503(e)(2) of the Dodd-Frank Act; 15 U.S.C. § 78m-2(e)(2).

294 Mine Safety Adopting Release, 76 Fed. Reg. 81,762, 81,765, 81,768 (Dec. 28, 2011). Under the final rule, a company may, however, provide additional information to give context. For example, a company could indicate that orders, violations or citations received during the year were subsequently dismissed, reduced or otherwise resolved. Mine Safety Adopting Release, 76 Fed. Reg. 81,762, 81,768 (Dec. 28, 2011).

295 *See* § 1503(a) of the Dodd-Frank Act. Initially, many companies had made such disclosures in the report itself, but the final rule requires that the disclosures be made in an exhibit. Under the final rule, the body of the report includes a brief disclosure and refers to the exhibit with a cross reference. *See* Mine Safety Adopting Release, 76 Fed. Reg. 81,762, 81,766 (Dec. 28, 2011). Of course, issuers should consider whether material information in the exhibits should be covered in other areas of the annual or quarterly report, *e.g.*, Risk Factors, MD&A, Description of Business or Legal Proceedings.

296 Mine Safety Adopting Release, 76 Fed. Reg. 81,762, 81,775 (Dec. 28, 2011). Triggering events for an 8-K filing for a U.S. issuer include (i) an imminent danger order under the Mine Act, (ii) written notice from the MSHA of a pattern of violations of mandatory health or safety standards that are of such nature as could have significantly and substantially contributed to the cause and effect of coal or other mine health or safety hazards under the Mine Act and (iii) written notice from the MSHA of the potential to have a pattern of such violations. The SEC confirmed in the final rule that the untimely filing of required mine safety disclosures on Form 8-K will not result in loss of Form S-3 eligibility. *See* Mine Safety Adopting Release, 76 Fed. Reg. 81,762, 81,776 (Dec. 28, 2011). Items reported on Form 8-Ks must be repeated in a company's next Form 10-Q or 10-K. *See* § 3.02[1][b] for a discussion of the eligibility criteria for an issuer to use Form F-3.

297 *See* Mine Safety Adopting Release, 76 Fed. Reg. 81,762, 81,767 (Dec. 28, 2011).

298 Mine Safety Adopting Release, 76 Fed. Reg. 81,767 (Dec. 28, 2011). *See* § 4.08 for a discussion of conflict minerals.

299 SEC Release No. 33-8995 (Dec. 31, 2008) ("the Oil and Gas Release"); *see also* SEC Release No. 33-8935 (June 26, 2008) (the "Oil and Gas Proposing Release"); SEC Release No. 33-8870 (Dec. 12, 2007) (Concept Release).

300 *See* Chapter 13 for discussion of the Multi-Jurisdictional Disclosure System.

301 *See* Items 1201 to 1208 of Regulation S-K under the Securities Act. The definitions adopted under the Oil and Gas Release are codified in Rule 4-10(a) of Regulation S-K.

302 *See* Oil and Gas Release, 74 Fed. Reg. 2157 (Jan. 14, 2009).

303 Rules 4-10(a)(22) and 4-10(c)(8) of Regulation S-K. In the Oil and Gas Proposing Release, the SEC proposed changing the disclosure rules to a 12-month average price, while maintaining the use of a single-day period-end price in the accounting rules.

304 *See* Oil and Gas Release, 74 Fed. Reg. 2157, 2160–61 (Jan. 14, 2009).

305 The Oil and Gas Release also notes that natural gas is sold through longer-term contracts in many situations and parts of the world where observable market inputs are not widely available. In such situations, comparability among different companies would differ depending on their assumptions, as those assumptions would be inherent in estimating future prices. In these situations, comparability between reserve estimates would be reduced if future prices were used. *See* Oil and Gas Release, 74 Fed. Reg. 2157, 2162 (Jan. 14, 2009).

306 Oil and Gas Release, 74 Fed. Reg. 2157, 2173–74 (Jan. 14, 2009). The SEC also reminded companies in the adopting release that Item 303 of Regulation S-K under the Securities Act for domestic companies (the "MD&A" section) and Item 5 of Form 20-F for foreign companies (the "Operating and Financial Review and Prospects" section) require discussion of known trends and uncertainties, which may include changes in prices and costs. In addition, companies should also consider whether to address price volatility risks in the form of risk factors. To determine the scope of the necessary disclosure, the standard a company should apply is whether the information it provides contains an untrue statement of a material fact or omits to state a material fact necessary to make what is disclosed not misleading. *See* §§ 11 and 12(a)(2) of the Securities Act and Rules 10b-5 and 12b-20 under the Exchange Act.

307 In adopting this standard, the SEC did not adopt provisions from the Oil and Gas Proposing Release that would have required the technology used to (i) be "widely accepted" as that standard would have excluded technologies developed internally that are proven to be reliable or (ii) have been proven empirically to lead to correct conclusions in 90% or more of its applications as such standard would have been difficult to verify and maintain. *See* Oil and Gas Release, 74 Fed. Reg. 2157, 2166 (Jan. 14, 2009).

308 Oil and Gas Release, 74 Fed. Reg. 2157, 2168 (Jan. 14, 2009).

309 *See* Instruction 2 to paragraph (a)(2) of Item 1202 of Regulation S-K under the Securities Act. "Probable reserves" are additional reserves that are less certain to be recovered than proved reserves but are as likely as not to be recovered. *See* Oil and Gas Release, 74 Fed. Reg. 2157, 2167 (Jan. 14, 2009). "Possible reserves" include additional reserves that are less certain to be recovered than probable reserves. *See* Oil and Gas Release, 74 Fed. Reg. 2157, 2167 (Jan. 14, 2009). Nevertheless, disclosures of estimates of oil and gas resources other than reserves are still prohibited in any document publicly filed with the SEC unless the information is required to be disclosed by foreign or state law. Companies may still make this information available outside public filings, and they may still disclose this information publicly in filings related to acquisitions, mergers and other consolidations if the target in such transaction previously made those estimates available to the acquiror. Oil and Gas Release, 74 Fed. Reg. 2157, 2173 (Jan. 14, 2009); *see* Item 102 of Regulation S-K.

310 *See* Oil and Gas Release, 74 Fed. Reg. 2157, 2172–73 (Jan. 14, 2009).

311 PRMS was developed in 2007 by SPE in collaboration with the World Petroleum Council, the American Association of Petroleum Geologists, and the Society of Petroleum Evaluation Engineers. *See* SPE, Petroleum Resources Management System (Mar. 2007); *see also* Oil and Gas Release, 74 Fed. Reg. 2157, 2160, n.15 (Jan. 14, 2009).

312 Oil and Gas Release, 74 Fed. Reg. 2157, 2164 (Jan. 14, 2009).

313 *See* Oil and Gas Release, 74 Fed. Reg. 2157, 2164 (Jan. 14, 2009). In the Oil and Gas Proposing Release, the SEC proposed defining "reasonable certainty" as "much more likely to be achieved than not" but adopted the PRMS standard of "high degree of confidence that the quantities will be recovered." *See* Oil and Gas Release, 74 Fed. Reg. 2157, 2164 (Jan. 14, 2009). The SEC believes these two standards have the same meaning.

314 Oil and Gas Release, 74 Fed. Reg. 2157, 2164 (Jan. 14, 2009).

315 *See* Oil and Gas Release, 74 Fed. Reg. 2157, 2179–80, 2187 (Jan. 14, 2009).

316 For more information, *see* International Accounting Standards Board, DISCUSSION PAPER: EXTRACTIVE ACTIVITIES (Apr. 2010).

317 Deloitte, Extractive activities – Comprehensive project (IASPlus), http://www.iasplus.com/en/projects/completed/assets/extractives.

318 These activities are now included in the definition of "oil and gas producing activities." *See* Oil and Gas Release, 74 Fed. Reg. 2157, 2163 (Jan. 14, 2009); *see also* Rule 4-10(a)(16) of Regulation S-K for the amended definition of "oil and gas producing activities."

319 *See* Oil and Gas Release, 74 Fed. Reg. 2157, 2170–71 (Jan. 14, 2009).

320 Item 1202(a)(6) of Regulation S-K under the Securities Act. Such disclosure is only required when the company has not previously disclosed reserves estimates in a filing with the SEC or is disclosing material additions to its reserves estimates.

321 Item 1202(a)(7) of Regulation S-K under the Securities Act.

322 Item 1202(a)(7) of Regulation S-K under the Securities Act.

323 Item 1202(a)(8) of Regulation S-K under the Securities Act.

324 *See* Oil and Gas Release, 74 Fed. Reg. 2157, 2175–76 (Jan. 14, 2009).

325 *See* § 11.03[1][c] for a discussion of "expertized" portions of disclosure documents and § 11 liability standards with respect to such disclosures.

326 SEC Release No. 34-61469 (Feb. 2, 2010), 75 Fed. Reg. 6290, 6295 (Feb. 8, 2010) (the "Climate Change Release").

327 The Climate Change Release notes that Rule 408 under the Securities Act and Rule 12b-20 under the Exchange Act require a registrant to disclose, in addition to the information expressly required by SEC regulation, "such further material information, if any, as may be necessary to make the required statements, in light of the circumstances under which they are made, not misleading." *See* Rule 408 under the Securities Act and Rule 12b-20 under the Exchange Act.

328 Climate Change Release, 75 Fed. Reg. 6290, 6296 (Feb. 8, 2010).

329 Climate Change Release, 75 Fed. Reg. 6290, 6295 (Feb. 8, 2010).

330 The SEC has indicated that although the wording in Item 5 of Form 20-F and Item 303 of Regulation S-K under the Securities Act (the item requiring MD&A disclosure for U.S. domestic companies) is not identical, the SEC interprets Item 5 as requiring the same disclosure as Item 303. *See* SEC Release No. 34-62932, 75 Fed. Reg. 59,866, 59,875 n.65 (Sept. 28, 2010).

331 Climate Change Release, 75 Fed. Reg. 6290, 6295 (Feb. 8, 2010).

332 The Climate Change Release also cites disclosure obligations under Item 101 of Regulation S-K under the Securities Act on disclosure of material estimated capital expenditures for environmental control facilities. Form 20-F does not include a specific Item requiring this precise disclosure, but, as noted above in Note 327, disclosure of material information is required if its omission would render what is disclosed misleading.

333 Climate Change Release, 75 Fed. Reg. 6290, 6296 (Feb. 8, 2010).

334 Climate Change Release, 75 Fed. Reg. 6290, 6296 (Feb. 8, 2010).

335 These factors include: (i) costs to purchase, or profits from sales of, allowances or credits under a "cap and trade" system, (ii) costs required to improve facilities and equipment to reduce emissions in order to comply with regulatory limits or to mitigate the financial consequences of a "cap and trade" regime, (iii) changes to profit or loss arising from increased or decreased demand for goods and services produced by the registrant arising directly from legislation or regulation, and indirectly from changes in costs of goods sold, and (iv) favorable consequences, including new business opportunities and potential sale of allowances or offset credits. Climate Change Release, 75 Fed. Reg. 6290, 6296 (Feb. 8, 2010).

336 Climate Change Release, 75 Fed. Reg. 6290, 6296 (Feb. 8, 2010).

337 Climate Change Release, 75 Fed. Reg. 6290, 6296 (Feb. 8, 2010).

338 Climate Change Release, 75 Fed. Reg. 6290, 6296–97 (Feb. 8, 2010).

339 U.S. companies that are subject to the reporting requirements of the Exchange Act must file certain

information within four business days after any acquisition or disposition of a significant amount of assets. Foreign companies that are subject to the reporting requirements of the Exchange Act also may be required to furnish such information to the SEC in a report on Form 6-K promptly after the information is otherwise made public. *See* the discussion of periodic reports in § 4.02[3][c]; *cf.* SEC Release No. 33-8400 (Mar. 16, 2004) (adopting rules to expand the events triggering Form 8-K filing requirements applicable to U.S. issuers, including the entry into a definitive material agreement, and shortening the filing deadline generally to four business days after a disclosable event).

340 *See* § 4.05[5][a].

341 1989 MD&A Release, § III.F.4, 54 Fed. Reg. 22,427, 22,435–36 (May 24, 1989).

342 1989 MD&A Release, § III.F.4, 54 Fed. Reg. 22,427, 22,436 (May 24, 1989); *see also Basic Inc. v. Levinson*, 485 U.S. 224 (1988). For a general discussion of the disclosure obligations of an SEC-reporting company under the U.S. securities laws, *see* § 4.02[3][a].

343 As discussed in § 3.05[2], securities issued or guaranteed by U.S. banks or U.S. branches of foreign banks are exempt from registration under § 3(a)(2) of the Securities Act. Thus, this guide applies only to obligations that must be registered, which are typically obligations of the holding company or a nonbank subsidiary or securities issued by a foreign bank (but not its U.S. branch). *But see* § 3.05[2] for a discussion of the Comptroller's securities offering disclosure rules for national banks and federal branches and agencies of foreign banks.

344 Item 402(a)(3) of Regulation S-K defines "named executive officers" as (1) all individuals serving as the registrant's principal executive officer or acting in a similar capacity during the last completed fiscal year, regardless of compensation level; (2) all individuals serving as the registrant's principal financial officer or acting in a similar capacity during the last completed fiscal year, regardless of compensation level; (3) the registrant's three most highly compensated executive officers other than the persons covered by clauses (1) and (2) who were serving as executive officers at the end of the last completed fiscal year; and (4) up to two additional individuals for whom disclosure would have been provided pursuant to clause (3) but for the fact that the individual was not serving as an executive officer of the registrant at the end of the last completed fiscal year.

345 Item 403(b) of Regulation S-K under the Securities Act.

346 Form 20-F, Item 6.E. General Instruction F of Form 20-F notes that for purposes of determining who to include among the group of persons covered by the term "administrative, supervisory or management bodies," an issuer should look to the meaning given to that phrase by such issuer's host country.

347 If any of the directors or members of the administrative, supervisory or management bodies beneficially own less than 1% of the class of shares and the individual ownership of such person has not been previously disclosed publicly, instead of disclosing the individual share ownership for that person, the foreign issuer may include an asterisk and an explanatory footnote that the person beneficially owns less than 1%.

348 Item 402 of Regulation S-K under the Securities Act; *see supra* Note 345.

349 Form 20-F, Item 6.B. Foreign issuers are required to file an employment or compensatory plan with management or directors (or portion of such plan) only when the foreign issuer either is required to publicly file the plan (or portion of it) in its home country or has otherwise publicly disclosed the plan. *See* Form 20-F, Instruction 4(c)(v) as to Exhibits; SEC Release No. 33-8732A (Aug. 29, 2006).

The adequacy of disclosure concerning director and officer compensation and related-party transactions was highlighted in the SEC's cease-and-desist order relating to the Walt Disney Company. The SEC found that, between 1999 and 2001, Disney failed to disclose relationships between the company and its directors that were required to be disclosed in its proxy statements and annual reports filed with the SEC. *See* Press Release, SEC, SEC Charges the Walt Disney Company for Failing to Disclose Relationships Between Disney and Its Directors; Disney Consents to a Cease-and-Desist Order (Dec. 20, 2004). In September 2004, the General Electric Corporation consented to the entry of an order that it cease and desist from violating the proxy solicitation and periodic reporting provisions of the federal securities laws. The SEC found that GE's 1997 to 2002 proxy statements and annual reports failed to fully and accurately disclose substantial retirement benefits provided to GE's former chief executive officer and chairman. *See* Press Release, SEC, General Electric Settles SEC Action for Disclosure Failures in Connection with Its Former CEO's Benefits Under His Employment and Retirement Agreement (Sept. 23, 2004). As indicated by these proceedings and the 2006 rule changes relating to executive compensation disclosure, the adequacy of director and officer compensation is a key regulatory focus of the SEC, and foreign issuers should take special care to ensure that the disclosure requirements concerning director and officer remuneration in Form 20-F are met.

350 Item 404(a) of Regulation S-K under the Securities Act.

351 Form 20-F, Item 7.B; *see also* § 402 of the Sarbanes-Oxley Act (prohibiting both U.S. and foreign issuers from directly or indirectly extending, maintaining, renewing or arranging for an extension of credit in the form of a personal loan to or for any executive officer or director of a subject issuer, as discussed in greater detail in § 5.04[2]).

352 Instruction 2 to Item 404 of Regulation S-K under the Securities Act; *see also* SEC Release No. 33-8732A (Aug. 29, 2006).

353 SEC Release No. 33-8056 (Jan. 22, 2002), 67 Fed. Reg. 3746, 3751 (Jan. 25, 2002).

354 SEC Release No. 33-7386 (Jan. 31, 1997) (the "Derivatives Disclosure Release"). Additional interpretive guidance is provided by the SEC staff's Questions and Answers about the New "Market Risk" Disclosure Rules (July 31, 1997). Rules adopted by the SEC to implement § 401(a) of the Sarbanes-Oxley Act further enhanced derivatives and financial instrument disclosure by requiring off-balance sheet arrangements to be disclosed in periodic reports and registration statements of subject issuers. *See* § 4.06[5][a].

355 Rule 4-08 of Regulation S-K ; ASC 815.

356 Such items include the various methods used to account for derivatives, the types of derivatives accounted for under each method and the criteria required to be met for each such accounting method to be used. When assessing materiality for this purpose, the SEC expects registrants to consider the financial statement effects of all derivatives, including those not recognized in the statement of financial position, and the relative effects of using the accounting method selected as compared to the other methods available. *See* Derivatives Disclosure Release, 62 Fed. Reg. 6044, 6047 (Feb. 10, 1997).

357 Form 20-F, Item 11(a). According to published highlights of a meeting of the AICPA SEC Regulations Committee's International Practices Task Force, the SEC staff has noted that when financial statements are updated in order to comply with the age of financial statements requirements as set forth in Item 8 of Form 20-F applicable to registration statements, an issuer must also update other "financial" information including its Qualitative and Quantitative Disclosure of Market Risk. *See supra* Note 106.

358 Derivatives Disclosure Release, 62 Fed. Reg. 6044, 6048 (Feb. 10, 1997).

359 Derivatives Disclosure Release, 62 Fed. Reg. 6044, 6051 (Feb. 10, 1997); Form 20-F, Item 11(b). Item 11 expressly provides that forward-looking disclosures made pursuant to its requirements are within the statutory safe harbors provided by § 27A of the Securities Act and § 21E of the Exchange Act. *See* §§ 4.06[5][c] and 11.03[5]. Moreover, the item makes clear that the safe harbors are, in this connection, available to all types of issuers and transactions (even though the safe harbors are generally not available to, for example, first-time registrants or in the case of an IPO), and state that the "meaningful cautionary statements" requirement of the safe harbors, which has proved difficult to apply in other contexts, will be deemed to be satisfied in the case of quantitative disclosures under Item 11(a) so long as the registrant satisfies the requirements of those Items.

360 In addition to complying with the derivative disclosures discussed in the text, a foreign issuer will have to take into account, in connection with its U.S. GAAP reconciliation (where such reconciliation is required), the accounting standard for derivatives, ASC 815.

361 *See* 2008 Form 20-F Reporting Enhancement Release, 73 Fed. Reg. 58,300, 58,311–13 (Oct. 6, 2008).

362 Payments from the depositary to the issuer, often but not always formulated as reimbursements of the

issuer's expenses, have been a common practice for many years, and, in our experience, they appear to have increased in recent years, at least for some issuers.

363 *See* H.R. Rep. No. 108-221, at 151 (2003) (directing the SEC to establish the Office of Global Security Risk).

364 *See* William H. Donaldson, Chairman, SEC, Testimony Before the Subcommittee on Commerce of the U.S. House of Representatives Committee on Energy and Commerce, Testimony Concerning Fiscal 2005 Appropriations Request for the U.S. Securities and Exchange Commission (Mar. 31, 2004).

365 H.R. Rep. No. 108-221, at 151 (2003).

366 *See* Press Release, SEC, SEC Adds Software Tool for Investors Seeking Information on Companies' Activities Known to Sponsor Terrorism (June 25, 2007).

367 *See* Letter from Barney Frank, Chairman, House Committee on Financial Services, to Christopher Cox, Chairman, SEC, Regarding SEC List of Terrorist-Financing States (June 12, 2007); Adam Sterling and Todd M. Malan, *The SEC's Flawed Terror List*, WALL ST. J., July 5, 2007, at A15; Jeremy Grant, *Outrage over SEC Terrorism 'Blacklist,'* FINANCIAL TIMES, June 28, 2007, at 1.

368 SEC Release No. 33-8860 (Nov. 16, 2007).

369 *See* § 9.08[1].

370 *See* § 9.08 for a detailed discussion of the OFAC Sanctions and other sanctions.

371 Iran Threat Reduction and Syria Human Rights Act of 2012, Pub. L. No. 112-158, 126 Stat. 1214 (2012) (§ 219 codified at 15 U.S.C. § 78m(r)).

372 On December 4, 2012, the SEC staff published an interpretation stating that the term "affiliate," for purposes of disclosure made pursuant to Exchange Act § 13(r), is used as defined in Exchange Act Rule 12b-2. *See* SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Exchange Act Forms, Question 147.03 (Dec. 4, 2012). *See also* Rule 12b-2 under the Exchange Act.

373 These activities include: (1) sanctionable activities under the 1996 Iran Sanctions Act (as amended), including provisions relating to the Iranian oil and gas industry, financial services, weapons of mass destruction ("WMD") and other activities; (2) sanctionable activities under the provisions of the Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010 and the Iranian Financial Sanctions Regulations relating to activities by foreign financial institutions; (3) sanctionable activities relating to goods, services or technologies likely to be used for human rights abuses; (4) any transactions or dealings with Specially Designated Nationals ("SDNs"), regardless of nationality, designated for their support of WMD proliferation or terrorist activity (*i.e.*, SDNs designated as "[SDGT]" (Specially Designated Global Terrorist) or "[WMD]"); or (5) any transaction or dealing with the "Government of Iran" as defined in OFAC Sanctions regulations, including the Iranian government, entities it owns or controls directly or indirectly, persons who are, or there is reasonable cause to believe are, acting on behalf of the foregoing, and any SDNs designated as "[IRAN]."

374 The SEC has created a new EDGAR form type, "IRANNOTICE," for filing such notification.

375 15 U.S.C. § 78ff(a). Any person who willfully violates the Exchange Act can be fined up to $5 million and/or imprisoned for up to 20 years. If such person is an entity, the fine may be up to $25 million.

376 *See* SEC Release No. 33-9002 (Jan. 30, 2009) (the "XBRL Release"). The SEC has created a website to provide detailed information about XBRL.

377 The XBRL Release lists Australia, Belgium, Canada, China, Denmark, France, Germany, Ireland, Israel, Japan, Korea, Luxembourg, the Netherlands, New Zealand, Norway, Singapore, Spain, Sweden, Thailand and the United Kingdom as countries with such voluntary or pilot programs.

378 *See* SEC, SEC Posts Notice of Availability of IFRS Taxonomy (Mar. 1, 2017), available at https://www.sec.gov/news/pressrelease/2017-58.html ; *The Center for Audit Quality* (avail. Apr. 8, 2011). A "taxonomy" is an electronic glossary that allows issuers to "tag" information in their financial statements so the information converts into various interactive formats (charts, excel tables, *etc.*). *See* XBRL Glossary.

379 For a foreign issuer, this would apply when it files a Form 6-K with interim financial statements incorporated by reference into a Securities Act registration statement to meet the nine-month updating requirement of Item 8.A.5 of Form 20-F, but would not apply when a foreign issuer files a Form 6-K with interim financial statements that are not otherwise required to be filed. *See* Form 6-K, General Instruction C.6. For U.S. public companies, filings are required with annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K.

380 Where the financial statements are incorporated by reference, the related interactive data file will be filed as an exhibit to the report containing the incorporated financial statements. XBRL Release, 74 Fed. Reg. 6776, 6780 n.74 (Feb. 10, 2009).

381 SEC, Division of Corporation Finance, CF Disclosure Guidance: Topic No. 2 (Oct. 13, 2011).

382 The guidance notes that "material information regarding cybersecurity risks and cyber incidents is required to be disclosed when necessary in order to make other required disclosures, in light of the circumstances under which they are made, not misleading."

U.S. Regulation of the International Securities and Derivatives Markets, § 4.08, SPECIAL DISCLOSURES ON CONFLICT MINERALS AND RESOURCE EXTRACTION PAYMENTS

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 4.08 (11th and 12th Editions 2014-2017)
11th and 12th Editions

[1] Conflict Minerals

Section 1502 of the Dodd-Frank Act, requiring disclosures regarding "conflict minerals," was intended by Congress to further the humanitarian goal of ending the extremely violent conflict in the Democratic Republic of the Congo (the "DRC"), particularly sexual and gender-based violence, which has been partially financed by the exploitation and trade of conflict minerals originating in specified "covered countries." [383] Section 1502 directed the SEC to adopt new

p. 4-105

disclosure requirements under the securities laws to further this objective. In 2012, to implement this mandate, the SEC adopted Rule 13p-1 under the Exchange Act and Form SD. [384] These require disclosures by any reporting company [385] that manufactures or contracts to manufacture products for which conflict minerals are necessary to those products' functionality or production. Reporting foreign issuers, smaller reporting companies and voluntary filers are all subject to the rule; registered investment companies are not. [386] Suppliers (whether or not reporting companies) are also affected, as a reporting company needs extensive information from its suppliers to be able to prepare the required disclosure. [387] The SEC noted, when it adopted the rule, that "Congress chose to use the securities laws' disclosure requirements to bring greater public awareness of the source of the issuers' conflict minerals and to promote the exercise of due diligence on conflict mineral supply chains." [388]

"Conflict minerals" are defined in the rule as cassiterite, columbite-tantalite (coltan), gold and wolframite, and three derivatives of these minerals: tin, tantalum and tungsten (the "3Ts"). [389] These minerals and their derivatives are widely used in various types of products, including electronics, lighting, electrical and heating applications, and jewelry.

p. 4-105

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p. 4-106

Disclosures concerning conflict minerals are filed on Form SD and are subject to the liability provisions of § 18 of the Exchange Act, [390] in addition to the general antifraud provisions of § 10(b) of the Exchange Act and Rule 10b-5 thereunder. [391] Form SD is not deemed incorporated by reference into any Securities Act filing, however, unless the company specifically incorporates it by reference. The conflict minerals disclosure must be filed annually on Form SD no later than May 31 (or, if May 31 is not a business day, on the next business day), [392] covering products manufactured in the prior calendar year by the issuer and its consolidated subsidiaries. If a subsidiary of the issuer also has reporting obligations under the Exchange Act, the issuer may file a single Form SD covering it and its consolidated subsidiaries. Disclosures must also be posted on the company's website and maintained there for at least one year. Notably, the Conflict Minerals FAQs clarified that failure to timely file a Form SD would not affect an issuer's eligibility to use Form F-3. [393]

An issuer that obtains control over a company that manufactures or contracts for the manufacturing of products with necessary conflict minerals, where the acquired company previously was not obligated to file a Form SD with respect to its conflict minerals, may delay reporting on the acquired company's products until the end of the first reporting calendar year that begins no sooner than eight months after the effective date of the acquisition. [394]

The conflict minerals rule adopted by the SEC in 2012 was almost immediately challenged in federal court by industry groups, which argued that the rule should be modified or set aside in whole or in part. [395] After extensive litigation, in April 2014 the petitioners prevailed on appeal in only one of their arguments, contending that the Dodd-Frank Act and the rule violate the First Amendment to the extent that they may require an issuer to report to the SEC and state on its website that any of its products have "not been found to be ‘DRC conflict free.’" [396] As a result of that decision, which was reaffirmed in August 2015, [397] and as discussed more fully below, the SEC provided guidance that an issuer

p. 4-106

p. 4-107

covered by the rule is still required to file its Form SD by the applicable deadline in accordance with the rule in all respects, except that the filer is permitted not to identify any of its products with the descriptors "DRC Conflict Free," "DRC conflict undeterminable" or "not found to be ‘DRC conflict free.’" [398]

[a] Three-Step Process for Determining Scope of Disclosure

A reporting company subject to the conflict minerals disclosure requirements must inquire into the provenance of any conflict minerals necessary to the functionality or production of any product manufactured or contracted to manufacture by the company and its consolidated subsidiaries and disclose the results of that inquiry. This inquiry involves a three-step process: [399]

- *Step One* — The company must determine whether it manufactures or contracts to manufacture any products for which conflict minerals are necessary to the functionality or production of those products. If not, the company is not required to file Form SD or to make any disclosures. If so, it must proceed to Step Two.
- *Step Two* — The company must conduct a "reasonable country of origin inquiry" to determine whether its necessary conflict minerals originated in the covered countries or came from recycled or scrap sources. [400] If the company determines that (i) its necessary conflict minerals did not originate in a covered country or it has no reason to believe otherwise or (ii) its necessary conflict minerals came from recycled or scrap sources or it reasonably believes that to be the case, it must disclose its determination and briefly describe the reasonable country of origin inquiry and the results of the inquiry. The disclosure must be provided on Form SD and on the company's website. If the company determines or has reason to believe that any of its necessary conflict minerals originated in a covered country and are not from recycled or scrap sources, it must proceed to Step Three.
- *Step Three* — The company must conduct due diligence on the source and chain of custody of the conflict minerals. The due diligence must conform to a nationally or internationally recognized due diligence framework, if one is available. If the company's due diligence determines that a product does not

p. 4-107

p. 4-108

  contain necessary conflict minerals that directly or indirectly finance or benefit armed groups in a covered country, that product is considered "DRC conflict free." [401] The company must also prepare a detailed "Conflict Minerals Report," file it as an exhibit to Form SD and post it on the company's website. In certain circumstances described below, the company may also be required to obtain an independent private sector audit ("IPSA") of its Conflict Minerals Report. [402]

[b] Conflict Minerals Report

The Conflict Minerals Report, if required, must include a detailed description of the company's due diligence on the source and chain of custody of its conflict minerals (including the IPSA, if required), a statement that the company has obtained the IPSA if one is required, the name of the relevant auditor and the audit report, a description [403] of the products manufactured or contracted to be manufactured by the company that have not been found to be "DRC conflict free," the facilities used to process the conflict minerals used in those products, the country of origin of those minerals and the company's efforts to determine the mine or location of origin with the greatest possible specificity. [404] The company's due diligence measures do not need to be carried out constantly throughout the year; the measures can also begin before or extend beyond the calendar year covered by the Form SD. [405] If the company's due diligence process is relatively consistent throughout the supply chain, the description of the due diligence can be general, but if there are significantly different processes for various aspects of the supply chain (*e.g.*, for different minerals or products), those differences should be described. [406]

p. 4-108

p. 4-109

The conflict minerals rule as originally adopted required certain descriptors to be used in a company's Conflict Minerals Report. [407] As noted above, the D.C. Circuit Court of Appeals decided in 2014 that the conflict minerals rule, and the underlying provision of the Dodd-Frank Act, violate the First Amendment to the extent that they require an issuer to report to the SEC and state on its website that any of its products have "not been found to be ‘DRC conflict free.’" [408] Following the decision, the director of the SEC's Division of Corporation Finance released a statement addressing the effect on the rule of the appeals court's decision. [409] Since the remainder of the rule was upheld and the appeals court had no First Amendment objection to any other aspects of the rule, the statement indicated that the Division expected that issuers required to file a Form SD under the rule would still do so on or before the due date of June 2, 2014, subject to the following guidance:

1. An issuer is not required to identify any of its products with the descriptors "DRC conflict free," "DRC conflict undeterminable" or "not found to be ‘DRC conflict free,’" but may voluntarily elect to do so.
2. An issuer should make all other disclosures called for in the rule, including a description of its reasonable country of origin inquiry and, if required to attach a Conflict Minerals Report, a description of the due diligence it undertook.
3. For any products that an issuer finds to be "DRC conflict undeterminable" or "not found to be ‘DRC conflict free’" in accordance with the rule and Form SD, while disclosures using these terms are not required, the issuer must still disclose the facilities used to produce the

p. 4-109

p. 4-110

conflict minerals, the country of origin of the minerals and the efforts to determine the mine or location of origin.
4. An IPSA is no longer required unless an issuer voluntarily elects to describe any of its products as "DRC conflict free" in its Conflict Minerals Report.

On May 2, 2014, the SEC issued a partial stay of the rule consistent with this guidance. [410] It has not taken any further action to modify the rule in response to the Court of Appeals decision.

A product is "DRC conflict free" if it does not contain conflict minerals that directly or indirectly finance or benefit armed groups in the covered countries. [411] Under the rule as originally written, after the transition period (now applicable only to smaller reporting companies), [412] if, after conducting due diligence, a company was unable to determine that (i) its conflict minerals did not originate in the covered countries, (ii) its conflict minerals that originated in the covered countries did not directly or indirectly finance or benefit armed groups, or (iii) its conflict minerals came from recycled or scrap sources, those products making use of any such minerals were required to be described as "not having been found to be ‘DRC conflict free,’" and the company had to provide the IPSA with respect to the related minerals in the Conflict Minerals Report. [413] The Conflict Minerals FAQs clarified that products that contain multiple conflict minerals from different sources must be described as "not having been found to be ‘DRC conflict free’" if even one of those minerals did finance or benefit armed

p. 4-110

groups in the covered countries. Similarly, if the company was unable to determine the source of even one of those minerals, it could not describe the product as "DRC conflict free." [414] However, neither the descriptor nor an IPSA are currently required pursuant to the 2014 SEC guidance.

[c] Key Definitions and Guidance

[i] *Definition of "Manufacture" and "Contract to Manufacture"*

The final rule does not define either "manufacture" or "contract to manufacture," but the SEC provided guidance for both terms in the Conflict Minerals Adopting Release.

A company that only services, maintains or repairs a product is not "manufacturing" the product. A company that assembles a product is "manufacturing" the product, however, even if it does not manufacture any of the components. Under the final rule, a mining company is not deemed to manufacture unless it also conducts manufacturing activities. [415] The Conflict Minerals FAQs clarified that "[a]n issuer that only engages in those activities customarily associated with mining, including gold mining of lower grade ore, is not considered to be manufacturing those minerals." [416]

If a company does not actually manufacture the product, it still may be considered to "contract to manufacture" it, and be subject to the rule. Whether a company "contracts to manufacture" depends on the degree of influence the company exercises over the materials, parts, ingredients or components included in the product, based on the individual facts and circumstances surrounding the company's business and industry. The term includes contracting to manufacture components of a product, and it could apply even if an issuer does not have "substantial" influence or control over the manufacturing of a product. A company is not "contracting to manufacture" if it only (1) specifies or negotiates contractual terms with a manufacturer that does not directly relate to the manufacturing of the product, such as training, technical support, price, insurance, indemnity, intellectual property rights or dispute resolution (unless it exercises a degree of influence over the manufacturing of the product that is practically equivalent to doing so); (2) affixes its brand, marks, logo or label to a generic product manufactured by a third party; [417] or (3) services, maintains or repairs a product manufactured

p. 4-111

p. 4-112

by a third party. [418] In practice, the determination of whether a company is "contracting to manufacture" for purposes of the rule is a matter of significant judgment regarding the specific facts and circumstances.

[ii] *Definition of "Necessary"*

The SEC did not define "necessary to the functionality" or "necessary to the production" of a product, indicating that both depend on the company's particular facts and circumstances, but again provided guidance. For a conflict mineral to be considered "necessary," it must be contained in the product and have been intentionally added to the product or a product component rather than being a naturally occurring byproduct. [419] There is no *de minimis* exception; even minute or trace amounts of a conflict mineral in a product or product component could trigger disclosure obligations. [420]

In order to determine whether a conflict mineral is "necessary to the functionality" of a product, a company should consider whether the conflict mineral is necessary to the product's generally expected function, use or purpose. Where a product has multiple functions, a conflict mineral need only be necessary for one function to be considered necessary to the product as a whole. If the conflict mineral is incorporated for purposes of ornamentation, decoration or embellishment, the company should consider whether the primary purpose of the product is ornamentation or decoration. [421] The Conflict Minerals FAQs specifically clarified that the packaging and container for a product are not considered to be part of the product, even if the packaging or container is necessary to preserve the usability of the product up to and following the product's purchase; packaging and containers sold independently of the product are considered products in their own right. [422]

The following are not considered "necessary to the production" of a product: (1) a conflict mineral used as a catalyst or in a similar manner but that is not contained in the product, even in trace amounts; (2) a conflict mineral in a physical tool, machine or other equipment used to manufacture the product; [423] and (3) a conflict mineral included in materials, prototypes and other demonstration

p. 4-112

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p. 4-113

devices. [424] The SEC also provided guidance in its Conflict Minerals FAQs that services are not products, and equipment that a company may manufacture or contract to manufacture to allow it to provide a service is not itself a product for purposes of the rule. [425]

[d] Reasonable Country of Origin Inquiry

A company that reaches Step Two in the disclosure process must conduct a reasonable country of origin inquiry, which must be reasonably designed to determine whether the company's conflict minerals originated in a covered country or came from recycled or scrap sources, and which must be performed in good faith. The SEC did not specify what steps are necessary to meet that standard, stating in the Conflict Minerals Adopting Release that it is a facts-and-circumstances determination based on a company's size, products, relationships with suppliers and other factors, as well as the available resources, which will evolve over time. The SEC noted that a "reasonableness standard" is not absolute—certainty is not required, and there is no need for disclosure indicating that the determination is uncertain (although companies may wish to provide it). [426] Many companies preparing their first Form SD in 2014 used the more detailed due diligence procedures described below at § 4.08[1][e] as their Reasonable Country of Origin Inquiry, rather than having two separate sets of procedures, but the SEC Division of Corporation Finance staff later noted that companies should take care to distinguish between the two processes in their Conflict Minerals Reports. [427]

The Conflict Minerals Adopting Release states that a company may rely on supplier and smelter representations regarding the origination of the conflict minerals if the company has reason to believe the representations are true given the facts and circumstances, taking into account any applicable warning signs or other circumstances indicating that the conflict minerals may have originated in the covered countries or did not come from recycled or scrap sources. For example, a company would have reason to believe a smelter representation was true if the processing facility received a "conflict-free" designation by a recognized industry group that requires an IPSA of the smelter, or if the facility itself obtained an IPSA that is made publicly available. A company need not receive representations from all of its suppliers, however, so long as it designs the inquiry reasonably, performs the inquiry in good faith and does not ignore

p. 4-113

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p. 4-114

warning signs that some of its conflict minerals may have originated in the covered countries. [428]

[e] Nationally or Internationally Recognized Due Diligence Framework

A company that reaches Step Three in the disclosure process must conduct due diligence on the source and chain of custody of its necessary conflict minerals. The due diligence must conform to a nationally or internationally recognized due diligence framework, if one is available. [429] Currently, the only such framework in place is the OECD's "Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas." [430]

The OECD guidance contains supplements with specific guidance on implementation of the OECD due diligence framework for the supply chains of tin, tantalum, tungsten and gold. [431] It should be noted that the OECD framework generally aims "to help companies respect human rights and avoid contributing to conflict through their sourcing decisions," [432] and includes steps to prevent or mitigate the risk that they may be contributing to conflict; § 1502 of the Dodd-Frank Act and the final rule have the same overall goal, but take a disclosure-based approach and do not explicitly require a company to avoid using conflict minerals.

The OECD's Due Diligence Guidance consists of the following five steps:

1. *Establish strong company management systems*
    - Adopt and commit to a supply chain policy for minerals originating from conflict-affected and high-risk areas.
    - Structure internal management systems to support supply chain due diligence.

p. 4-114
p. 4-115

    - Establish a system of controls and transparency over the mineral supply chain.
    - Strengthen company engagement with suppliers.
    - Establish a company level grievance mechanism.
2. *Identify and assess risks* [433] *in the supply chain*

    For upstream companies:
    - Identify the scope of the risk assessment of the mineral supply chain.
    - Map the factual circumstances of the company's supply chain(s), underway and planned.
    - Assess risks in the supply chain.

    For downstream companies:
    - Identify, to the best of their efforts, the smelters/refiners in their supply chain.
    - Identify the scope of the risk assessment of the mineral supply chain.
    - Assess whether the smelters/refiners have carried out all elements of due diligence for responsible supply chains of minerals from conflict-affected and high-risk areas.
    - Where necessary, carry out, including through participation in industry-driven programs, joint spot checks at the mineral smelter/refiner's own facilities.
3. *Design and implement a strategy to respond to identified risks*
    - Report findings to designated senior management.
    - Devise and adopt a risk management plan.
    - Implement the risk management plan, monitor and track performance of risk mitigation, report back to designated senior

p. 4-115
p. 4-116

      management and consider suspending or discontinuing engagement with a supplier after failed attempts at mitigation.
    - Undertake additional fact and risk assessments for risks requiring mitigation or after a change of circumstances.
4. *Carry out an independent third-party audit of smelter/refiner's due diligence practices*
    - Plan an independent third-party audit of the smelter/refiner's due diligence for responsible supply chains of minerals from conflict-affected and high-risk areas.
    - Implement the audit in accordance with set out audit scope, criteria, principles and activities.
5. *Report annually on the supply chain due diligence*
    - Annually report or integrate, where practicable, into annual sustainability or corporate

responsibility reports additional information on due diligence for responsible supply chains of minerals from conflict-affected and high-risk areas.

[f] Determination Whether Conflict Minerals "Directly or Indirectly Finance or Benefit Armed Groups"

The SEC has provided only limited guidance regarding how a company should determine whether its conflict minerals directly or indirectly finance or benefit armed groups in the covered countries. The SEC did not clarify what would constitute, for example, an "indirect benefit" to an armed group. Form SD defines the term "armed group" as "an armed group that is identified as a perpetrator of serious human rights abuses in annual Country Reports on Human Rights Practices under §§ 116(d) and 502B(b) of the Foreign Assistance Act of 1961" [434] relating to the covered countries. The SEC noted in the Conflict Minerals Adopting Release that authority to identify those perpetrators is assigned to the U.S. Department of State, and that the SEC lacks "the authority and expertise to provide further guidance or qualify the State Department's conclusions in this area." [435]

p. 4-116

p. 4-117

The SEC suggests in the Conflict Minerals Adopting Release that the due diligence framework used would provide guidance to a company in determining whether its conflict minerals directly or indirectly finance or benefit armed groups in the covered countries. [436] The State Department guidance for commercial entities seeking to exercise due diligence on conflict minerals used in their products and on their suppliers [437] also provides guidance to companies in this determination, although the Conflict Minerals Adopting Release notes that it does not have a direct impact on the rule and a company need not rely solely on it in making the determination. [438]

One specific clarification the Conflict Minerals Adopting Release provides is that products are considered "DRC conflict free" if the conflict minerals contained in those products did not directly or indirectly finance or benefit armed groups in the covered countries at the time they were purchased and transported through the supply chain from the mine to the company even if at some later time an element of that supply chain becomes controlled by an armed group (and even if the money the company paid to purchase the conflict minerals is seized by the armed group and thus in fact benefits the armed group). [439]

[g] Independent Private Sector Audit

The IPSA, if required, must comply with standards established by the Comptroller General of the Government Accountability Office ("GAO"). The SEC indicated that the GAO does not intend to establish new auditing standards for the audit; auditors may use the provisions for either Attestation Engagements or Performance Audits in the generally accepted government auditing standards established by the GAO ("GAGAS," referred to as the Yellow Book). [440]

[i] *Audit Objective*

p. 4-117

p. 4-118

The objective of the audit is to express an opinion or conclusion as to (i) whether the design of the company's due diligence measures as set forth in, and with respect to the period covered by, the Conflict Minerals Report is in conformity with, in all material respects, the criteria set forth in the nationally or internationally recognized due diligence framework used by the company, and (ii) whether the company's description of the due diligence measures in the Conflict Minerals Report is consistent with the due diligence process the company undertook. [441] The SEC has confirmed that the IPSA need not cover any matter beyond that objective, such as the company's reasonable country of origin inquiry. [442]

[ii] *Effect on Auditor Independence*

The Conflict Minerals Adopting Release states that it would not be inconsistent with the auditor independence requirements in Rule 2-01 under Regulation S-K if the independent public accountant also performs the IPSA of the Conflict Minerals Report, but that the engagement to perform the Conflict Minerals Report audit would be considered a "non-audit service" subject to the pre-approval requirements of Rule 2-01(c)(7) under Regulation S-K. [443]

[iii] *Audit Certification*

The statutory provision required the company to provide an "audit certification." The SEC's rule provided that this need not be signed by an officer of the company. Instead, the certification takes the form of a statement in the Conflict Minerals Report that the company obtained an IPSA. [444]

[h] Conflict Minerals from Recycled or Scrap Sources

Conflict minerals from recycled or scrap sources are considered DRC conflict free and do not require the company to prepare a Conflict Minerals Report. [445] However, if as a result of its reasonable country of origin inquiry the

p. 4-118

p. 4-119

company has reason to believe its conflict minerals may not have been from recycled or scrap sources, it must exercise due diligence on the source and chain of custody of the minerals using a nationally or internationally recognized due diligence framework specifically for conflict minerals from recycled or scrap sources, where available. [446] Currently, the only such standard is the OECD standard for recycled gold. [447] There is no such due diligence framework for the 3Ts at this time. Where there is no such framework, the company must describe its due diligence measures in the Conflict Minerals Report, but need not obtain an IPSA regarding those recycled conflict minerals. [448]

The final rule tracks the OECD definition of "recycled metals"—minerals from recycled metals, including reclaimed end-user or post-consumer products and scrap process metals created during product manufacturing, but not minerals that are partially processed or unprocessed, or a byproduct from another ore. [449]

[i] Other Supply Chain Tracking and Reporting Initiatives

A number of other initiatives are focused on facilitating supply chain tracking and reporting. For example:

- In 2010, the Electronic Industry Citizenship Coalition ("EICC") and the Global e-Sustainability Initiative ("GeSI") launched the Conflict-Free Smelter ("CFS") Program, which identifies and validates conflict-free smelters and refiners. [450]
- The Public-Private Alliance for Responsible Minerals Trade ("PPA") established by the U.S. State Department and the U.S. Agency for International Development is working to establish a verifiable traceability scheme for the covered countries for conflict-free minerals. [451]

p. 4-119

p. 4-120

- The International Conference on the Great Lakes Region of central Africa ("ICGLR"), comprised of 12 countries in that region, has established standards for traceability and certification of conflict minerals compliant with the OECD due diligence guidelines. Beginning in December 2012, the government and companies in each member country have had to comply with the standards upon export of the minerals, which is evidenced by a certificate that minerals are "conflict free." Any imports of the minerals from another member country must also be accompanied by such a certificate. [452] The DRC passed legislation in February 2012 requiring adherence to the ICGLR standards.

[j] International Context of Rule

Other jurisdictions and states have passed or are considering legislation or regulation relating to conflict minerals. In 2014, the European Commission proposed an integrated EU approach to stop profits from conflict minerals being used to fund armed conflicts. [453] The proposals included a regulation to increase transparency of the supply practices of importers, smelters and refiners in order to facilitate the responsible sourcing of tin, tantalum, tungsten and gold and encourage legitimate trade (the "Regulation"). The Regulation included a voluntary self-certification system for EU companies that chose to be "responsible importers." Under the proposed regulation, EU importers would need to exercise due diligence and provide audit assurances and disclosure information. The EU would also publish an annual list of EU and global "responsible smelters and refiners." In June 2016, the Council, European Parliament and European Commission reached an informal agreement on the text of the proposed Regulation. [454] However, the text goes beyond the Commission's "self-certification" approach, calling for mandatory due diligence checks, conducted according to OECD due diligence guidelines, for importers of tin, tungsten, tantalum and gold

p. 4-120

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p. 4-121

and their ores from certain areas, as well as smelters and refiners. Large EU firms that make or sell goods containing these minerals in their supply chain will also be encouraged to report on their sourcing practices based on a new set of performance indicators developed by the Commission. Final approval of the text of the Regulation is expected to occur in the first quarter of 2017.

[2] Resource Extraction Payments

On June 27, 2016, the SEC adopted a revised final rule, which, as discussed below, has now been disapproved by Congress, on specialized disclosure relating to payments to governments by companies engaged in resource extraction pursuant to § 1504 of the Dodd-Frank Act. [455] The SEC had initially approved a rule on disclosure of resource extraction payments in August 2012 (the "2012 Rule"), but that version of the rule was vacated by the U.S. District Court for the District of Columbia in July 2013. [456] The revised final rule under the Exchange Act (Rule 13q-1) and revised Form SD would have required disclosures by any company that was a "resource extraction issuer," defined as an issuer that is required to file an annual report with the SEC pursuant to § 13 or § 15(d) of the Exchange Act and that engages in the commercial development of oil, natural gas or minerals. [457] Reporting foreign issuers (including government-owned entities) [458] and smaller reporting companies would have been subject to the rule, while registered investment companies would not have been. [459]

As a result of action recently taken by the new U.S. Congress under the Congressional Review Act (the "CRA"), the revised rule adopted by the SEC on

p. 4-121

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p. 4-122

June 27, 2016 ceased to have effect as of February 3, 2017. [460] The mandate to the SEC under Dodd-Frank Act § 1504 to adopt a rule on the disclosure of resource extraction payments is still law, however, with a new deadline for the SEC to adopt a final rule by February 2018. [461] Any new rule would have to meet both the detailed prescriptions of § 1504 of the Dodd-Frank Act [462] and the prohibition under the CRA on reissuing a rule after disapproval. This could be difficult, and, separately, the Financial Services Chair of the U.S. House of Representatives has already proposed to repeal § 1504 itself. [463]

In the remainder of this section we discuss (a) how Dodd-Frank Act § 1504 relates to measures taken elsewhere in the world to enhance disclosure relating to resource extraction payments and (b) the legal challenges the SEC faced in adopting its rule. However, because the rule has ceased to have effect, and may not be reissued in the same form, we do not discuss it in any detail.

[a] International Context

The SEC summarized the congressional intention of Dodd-Frank Act § 1504 as being to support global efforts to improve transparency in extractive industries, to help combat corruption and to empower citizens of resourcerich countries to hold their governments accountable. [464]

Section 1504 of the Dodd-Frank Act is broadly derived from the Extractive Industries Transparency Initiative ("EITI"), a global initiative of a voluntary coalition of companies, governments, investor groups and non-governmental organizations that seeks to promote accountability for payments made by resource extraction companies to foreign governments by increasing transparency around these payments. "EITI compliant" countries undergo a reconciliation process in which company payments are matched with government revenues

p. 4-122

p. 4-123

by an independent administrator. [465] The United States completed the process of becoming an EITI candidate country on March 19, 2014 and published its first report, covering calendar year 2013, on December 15, 2015. [466] In order to become fully EITI compliant, the United States must undergo a formal evaluation process conducted by an external, independent validator procured by the EITI International Secretariat. The validation process is scheduled to begin on April 1, 2018 and will assess the United States' progress in complying with the EITI requirements. [467]

The rule as adopted explicitly linked the disclosures it would have required to broader international efforts to better track and disclose resource extraction payments, including but not limited to the work of the EITI, directing that "[t]o the extent practicable, the rules … shall support the commitment of the Federal Government to international transparency promotion efforts relating to the commercial development of oil, natural gas, or minerals." [468]

The European Union has adopted two directives providing for disclosures similar to those under the now vacated Rule 13q-1. [469] Those rules apply to companies in the European Economic Area that are "large undertakings" or "public-interest entities" active in the extractive or logging industries, as well as companies in those industries that are admitted to trading on a European Union regulated market.

Canada has also adopted a federal resource extraction disclosure law, the Extractive Sector Transparency Measures Act ("ESTMA"), which came into force in 2015. [470] These rules apply to entities that engage in commercial development of oil, gas or minerals and are listed on a stock exchange in Canada, as well as entities that have a place of business in Canada, do business in Canada or have assets in Canada and meet certain other criteria. [471]

p. 4-123

p. 4-124

Stock exchanges, such as the London Stock Exchange's Alternative Investment Market [472] and the Hong Kong Stock Exchange, [473] also have rules related to resource extraction payment disclosures for companies listed on those exchanges.

[b] Legal Challenge

As noted above, the mandate for the SEC to adopt a new resource extraction payments disclosure rule under § 1504 of the Dodd-Frank Act is still in effect, and the SEC is now required to issue a new rule by February 2018. [474] Even if § 1504 is not repealed, it is unlikely the SEC under the administration of President Trump will move quickly to propose a new rule unless compelled by a court to do so, as it was in 2015 after the 2012 Rule was vacated and the SEC was sued to implement the statutory mandate. The future of the rule remains unclear, but we provide a summary of the historical legal challenges to it below.

The U.S. Chamber of Commerce and three industry groups (the American Petroleum Institute ("API"), the Independent Petroleum Association of America and the National Foreign Trade Council) [475] challenged the 2012 Rule on October 10, 2012 [476] primarily based on the claims, among others, that (i) the required disclosures of sensitive, confidential information violated rights under the First Amendment to the U.S. Constitution protecting a person's rights against compelled speech and (ii) the SEC failed to adequately perform the cost-benefit analysis required by the Administrative Procedure Act. [477] In connection with the lawsuit, the plaintiffs also filed with the SEC a motion for a stay of the effectiveness of the 2012 Rule and the related amendments to Form SD pending final

p. 4-124

p. 4-125

resolution of their legal challenges. [478] The SEC denied the stay on November 8, 2012, and the rule and amendments to Form SD became effective on November 13, 2012. [479]

In a decision issued on July 2, 2013, the U.S. District Court for the District of Columbia granted the plaintiffs' motion for summary judgment; the court also issued a separate order vacating the 2012 Rule and remanding the matter to the SEC for further proceedings consistent with the court's Memorandum Opinion. [480] This delayed the implementation of the rule, which would otherwise have required disclosures beginning in 2014. The court found that (1) the SEC wrongly concluded that the statute requires reports of resource extraction payments to be publicly available (citing the statutory language requiring the SEC to make public only "a compilation of the information required to be submitted" to the SEC "to the extent practicable") [481] and (2) the SEC's failure to provide an exemption for payments in countries that prohibit disclosure was arbitrary and capricious. [482]

In September 2014, when the SEC had still not made a new rule proposal following the 2013 court decision vacating the initial version of the rule, Oxfam brought an action in federal court to compel the agency to adopt a rule as required by the Dodd-Frank Act. In September 2015, the court held that the SEC had unlawfully withheld action by not promulgating a final rule. [483]

The SEC adopted a revised final rule on June 27, 2016. The revised final rule was consistent with the 2012 Rule on the two issues that the District Court found problematic with the 2012 Rule: it required the disclosure to be publicly filed and provided no exemption for payments in countries that prohibit disclosure. In 2013, the District Court expressly reserved the constitutional argument that the disclosure of resource extraction payments is a prohibited instance of compelled speech.

Footnotes

383 The "covered countries" are the DRC and the "adjoining countries," which currently consist of Angola, Burundi, Central African Republic, the Republic of the Congo, Rwanda, South Sudan, Tanzania, Uganda and Zambia. On January 31, 2017, acting SEC Chairman Piwowar directed the SEC staff to reconsider its guidance (discussed below) under the conflict minerals rule and whether any additional relief might be appropriate, stating that the disclosure requirements have resulted in a de facto boycott of minerals from parts of Africa and that it is unclear whether the costs associated with the rule have resulted in any of the desired benefits. The SEC is soliciting comments from interested parties on all aspects of the rule and guidance. *See* Michael S. Piwowar, Acting Chairman SEC, Reconsideration of Conflict Minerals Rule Implementation (Jan. 31, 2017).

384 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,352–53 (Sept. 12, 2012).

385 A foreign issuer that has a class of securities exempt from Exchange Act registration pursuant to Rule 12g3-2(b) under the Exchange Act is not required to provide conflict minerals disclosure under the rules as it does not file reports with the SEC under § 13(a) or § 15(d) of the Exchange Act. Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,286 (Sept. 12, 2012).

386 The SEC Division of Corporation Finance has published two sets of guidance setting forth the SEC staff's interpretation of certain provisions of § 13(p) of the Exchange Act, Rule 13p-1 under the Exchange Act and Form SD. SEC, Division of Corporation Finance, Dodd-Frank Wall Street Reform and Consumer Protection Act, Frequently Asked Questions, Conflict Minerals (Apr. 7, 2014 and May 30, 2013) ("SEC CM FAQs"), which we refer to together as the "Conflict Minerals FAQs." *See* SEC CM FAQs 1 and 3.

387 The Conflict Minerals Adopting Release estimated the total number of affected suppliers at approximately 278,000. *See* Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,352–53 (Sept. 12, 2012). A 2015 report by the U.S. Government Accountability Office noted that many company representatives cited difficulties in obtaining information from suppliers as a reason they were unable to determine the country of origin of conflict minerals. *See* UNITED STATES GOVERNMENT ACCOUNTABILITY OFFICE, SEC CONFLICT

MINERALS RULE: INITIAL DISCLOSURES INDICATE MOST COMPANIES WERE UNABLE TO DETERMINE THE SOURCE OF THEIR CONFLICT MINERALS, 14 (Aug. 2015), http://www.gao.gov/assets/680/672051.pdf.

388 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,275 (Sept. 12, 2012).

389 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,285 (Sept. 12, 2012).

390 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,280 (Sept. 12, 2012). *See* § 11.05[1][c] for a discussion of § 18 of the Exchange Act and liability thereunder.

391 *See* § 11.04[2] for a discussion of § 10(b) of the Exchange Act and Rule 10b-5 thereunder.

392 General Instruction B of Form SD.

393 SEC CM FAQ 12. *See* § 3.02[1][b] for a discussion of the eligibility criteria for an issuer to use Form F-3.

394 The Conflict Minerals FAQs also confirmed that a similar delay in reporting would be available to an issuer conducting an IPO, where such issuer need only start reporting for the first calendar year that begins no sooner than eight months after the effective date of the IPO registration statement. *See* SEC CM FAQ 11.

395 *See* § 4.08[1][b] for more information on the legal challenge to the conflict minerals rule.

396 *National Association of Manufacturers v. SEC*, 748 F.3d 359, 373 (D.C. Cir. 2014).

397 *See National Association of Manufacturers*, No. 13-5252 (D.C. Cir. 2015), rehearing *National Asssociation of Manufacturers v. SEC*, 748 F.3d 359 (D.C. Cir. 2014).

398 *In the Matter of Exchange Act Rule 13p-1 and Form SD: Order Issuing Stay*, SEC Release No. 34-72079 (May 2, 2014); Keith F. Higgins, Director, SEC, Division of Corporation Finance, Statement on the Effect of the Recent Court of Appeals Decision on the Conflict Minerals Rule (Apr. 29, 2014).

399 *See* Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,279–80 (Sept. 12, 2012) for a more detailed discussion of each of the three steps.

400 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,280 (Sept. 12, 2012).

401 Following the 2014 D.C. Court of Appeals decision and subsequent SEC guidance, an issuer is not required to use the descriptor "DRC conflict free" in its Form SD. *See* § 4.08[1][b] for further discussion of the D.C. Court of Appeals decision and the related SEC guidance.

402 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,281–82, 56,299 (Sept. 12, 2012).

403 The SEC noted in the Conflict Minerals Adopting Release that an issuer may describe its products based on its own facts and circumstances because the issuer is in the best position to know its products and to describe them in terms commonly understood within its industry. Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,323 (Sept. 12, 2012). The Conflict Minerals FAQs clarify that an issuer is not required to describe its products using model numbers. *See* SEC CM FAQ 9.

404 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,320–21 (Sept. 12, 2012).

405 *See* SEC CM FAQ 20.

406 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,326 (Sept. 12, 2012). The Conflict Minerals Report need not include a full description of the design of the issuer's due diligence; however, the due diligence measures actually undertaken must be described in sufficient detail to allow the auditor preparing an IPSA to form an opinion about whether the description is consistent with the issuer's actual process. *See* SEC CM FAQ 21.

407 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,276 (Sept. 12, 2012).

408 On August 18, 2015, the same panel of the D.C. Circuit Court of Appeals reaffirmed its original 2014 judgment despite an intervening *en banc* decision of the full D.C. Circuit Court of Appeals in another case that upheld certain Department of Agriculture requirements for labeling meat products and took a different view of the applicable standard of review for government-compelled commercial speech. *See National Association of Manufacturers. v. SEC*, No. 13-5252 (D.C. Cir. 2015), rehearing *National Association of Manufacturers v. SEC*, 748 F.3d 359 (D.C. Cir. 2014); *American Meat Institute. v. U.S. Dep't of Agriculture*, 760 F.3d 18 (D.C. Cir. 2014), rehearing *en banc American Meat Institute. v. U.S. Dep't of Agriculture*, 746

F.3d 1065 (D.C. Cir. 2014). On March 4, 2016, the Department of Justice notified the Speaker of the House that it would not appeal the decision. *See* Letter from Loretta Lynch, Attorney General to Hon. Paul Ryan, Speaker, U.S. House of Representatives (Mar. 4, 2016), https://www.justice.gov/oip/foia-library/osg-530d-letters/3-4-2016.pdf/download. The district court is now expected to take action in accordance with the appeals court's ruling, and whether and when the SEC may come out with updated guidance is uncertain.

409 Keith F. Higgins, Director, SEC, Division of Corporation Finance, Statement on the Effect of the Recent Court of Appeals Decision on the Conflict Minerals Rule (Apr. 29, 2014).

410 *In the Matter of Exchange Act Rule 13p-1 and Form SD: Order Issuing Stay*, SEC Release No. 34-72079 (May 2, 2014).

411 § 13(p)(1)(D) of the Exchange Act.

412 While the initial two-year transition period has now passed for other filers, under the rule as originally written, smaller reporting companies (for which the transition period is four years) may still designate products "DRC conflict undeterminable" if, after conducting due diligence, the company is unable to determine that (i) its conflict minerals did not originate in the covered countries, (ii) its conflict minerals that originated in the covered countries did not directly or indirectly finance or benefit armed groups, or (iii) its conflict minerals came from recycled or scrap sources. Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,322–23, 56,344–45 (Sept. 12, 2012). If a company designates some of its products as "DRC conflict undeterminable," it is also not required to obtain an IPSA regarding the related minerals, but it must include in the Conflict Minerals Report a description of the steps it has taken or will take, if any, since the end of the period covered in its most recent prior Conflict Minerals Report to mitigate the risk that those minerals benefit armed groups, including any steps to improve its due diligence. However, neither the descriptor nor an IPSA are currently required pursuant to the 2014 SEC guidance.

For the definition of a "smaller reporting company" (generally, a company with a public float of at least $75 million), *see* Rule 12b-2 under the Exchange Act.

413 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,345 (Sept. 12, 2012).

414 *See* SEC CM FAQ 16.

415 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,290 (Sept. 12, 2012).

416 SEC CM FAQ 2. The specific mining company activities cited to exemplify those customarily associated with mining, and therefore not "manufacturing" for purposes of the rule, include transporting, processing, smelting and refining ores.

417 This point was emphasized in the Conflict Minerals FAQs. *See* SEC CM FAQ 4.

418 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,290–92 (Sept. 12, 2012).

419 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,296–97 (Sept. 12, 2012).

420 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,298 (Sept. 12, 2012).

421 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,297 (Sept. 12, 2012).

422 *See* SEC CM FAQ 6.

423 Even if tools, machines or other equipment were manufactured by an issuer to manufacture its products and subsequently sold by the issuer, the Conflict Minerals FAQs clarified that "the staff will not view their later entry into the stream of commerce as transforming them into products of that issuer." *See* SEC CM FAQ 8.

424 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,297–98 (Sept. 12, 2012).

425 *See* SEC CM FAQ 7.

426 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,314 (Sept. 12, 2012).

427 *See*, *e.g.*, Yin Wilczek, SEC Official Offers Three Pointers on Issuers' Conflict Mineral Disclosures, BLOOMBERG BNA, Sept. 19, 2014, *available at* http://www.bna.com/sec-official-offers-n17179895108.

428 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,312 (Sept. 12, 2012). The due diligence

guidance developed by the Organisation for Economic Co-operation and Development ("OECD") provides examples of red flags that should trigger increased diligence. *See* OECD DUE DILIGENCE GUIDANCE FOR RESPONSIBLE SUPPLY CHAINS OF MINERALS FROM CONFLICT-AFFECTED AND HIGH-RISK AREAS at 33–34, 79–80, 87–88 (3d ed. 2016) (the "OECD Due Diligence Guidance").

429 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,281, 56,326 (Sept. 12, 2012). Form SD and the Conflict Minerals Adopting Release provide guidance on how a company should conduct due diligence if there is no framework in place for a conflict mineral. *See* Item 1.01(c)(1)(v) of Form SD; Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,282 (Sept. 12, 2012).

430 *See* OECD Due Diligence Guidance.

431 OECD Due Diligence Guidance at 31, 61.

432 OECD Due Diligence Guidance at 3.

433 Although the OECD due diligence guidance defines "risks" generally to include any potential adverse impacts to the company or others in connection with its operations (including the supply chain), the guidance is focused on the risks that a company may be contributing to conflict, and a "high-risk area" (as opposed to a "conflict-affected area") may include areas of political instability or repression, institutional weakness, insecurity, collapse of civil infrastructure and widespread violence. *See*, *e.g.*, OECD Due Diligence Guidance at 13.

434 *See* Item 1.01(d)(2) of Form SD. *See also* § 1502(e)(3) of the Dodd-Frank Act, which has a similar, but not identical definition; Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,324 (Sept. 12, 2012).

435 *See* Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,324 (Sept. 12, 2012). *See also* Department of Commerce Reporting Requirements Under Section 1502(d)(3)(C) of the Dodd-Frank Act, World-Wide Conflict Mineral Processing Facilities (stating that Department of Commerce is unable to distinguish which facilities finance conflict in the covered countries).

436 For example, the OECD due diligence guidance notes that it is intended "to help companies respect human rights and avoid contributing to conflict through their sourcing decisions." OECD Due Diligence Guidance at 12. Accordingly, the due diligence framework is designed to allow companies to identify and prevent or mitigate "adverse impacts" associated with those decisions, which include financing or otherwise contributing to conflict.

437 U.S. Department of State, Bureau of Economic, Energy, and Business Affairs, Statement Concerning Implementation of Section 1502 of the Dodd-Frank Legislation Concerning Conflict Minerals Due Diligence (July 15, 2011).

438 *See* Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,323–24 (Sept. 12, 2012).

439 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,324 (Sept. 12, 2012).

440 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,328 (Sept. 12, 2012). An auditor that is not a certified public accountant may perform an IPSA if the audit meets the applicable requirements under the Performance Audit provisions in the Yellow Book. SEC CM FAQ 13.

441 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,329 (Sept. 12, 2012).

442 *See* SEC CM FAQs 17 and 18.

443 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,328–29 (Sept. 12, 2012). *See* § 5.03[1][b] for a discussion of Rule 2-01(c)(7) under Regulation S-K.

444 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,320 (Sept. 12, 2012).

445 If the company determines that the conflict minerals in some of its products come from recycled or scrap sources, but is also required to prepare a Conflict Minerals Report as to the conflict minerals in some of its other products, the report (and any required IPSA) need not include disclosures about the recycled or scrap sources. *See* SEC CM FAQ 19.

446 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,332 (Sept. 12, 2012).

447 *See* Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,332–33 (Sept. 12, 2012).

448 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,322 n.561 (Sept. 12, 2012).

449 *See* OECD Due Diligence Guidance at 12 n.1.

450 The CFS Program requires smelters and refiners to undergo a third-party audit to ensure that they have procured only from global conflict-free sources. To date, the CFS Program has identified 46 compliant tantalum smelters, 90 compliant gold smelters, 66 compliant tin smelters, and 39 compliant tungsten smelters. *See* CONFLICT-FREE SMELTER (CFS) PROGRAM: CONFLICT-FREE SMELTERS AND REFINERS, http://www.conflictfreesourcing.org/conflict-free-smelter-refiner-lists/ (last visited Dec. 28, 2016). The EICC operates a validated audit process ("VAP") program. A typical VAP audit includes a thorough document review, interviews with management and employees and a visual site survey. *See* EICC: VALIDATED AUDIT PROCESS, http://www.eiccoalition.org/standards/validated-audit-process (last visited Dec. 28, 2016).

451 *See*, *e.g.*, Fact Sheet, U.S. Department of State, Public-Private Alliance for Responsible Minerals Trade (Nov. 15, 2011); PUBLIC-PRIVATE ALLIANCE FOR RESPONSIBLE MINERALS TRADE (PPA), OVERVIEW (2015), and PUBLIC-PRIVATE ALLIANCE FOR RESPONSIBLE MINERALS TRADE, PARTICIPATION AND GOVERNANCE PROTOCOLS (Jan. 30, 2013).

452 *See*, *e.g.*, *ICGLR Regional Initiative against the Illegal Exploitation of Natural Resources (RINR)*, and ICGLR Regional Certification Mechanism (RCM)—Certification Manual. The ICGLR countries are Angola, Burundi, Central African Republic, Republic of Congo, the DRC, Kenya, Rwanda, South Sudan, Sudan, Tanzania, Uganda, and Zambia (which includes all covered countries).

453 European Commission, Proposal for a Regulation of the European Parliament and of the Council setting up a Union system for supply chain due diligence self-certification of responsible importers of tin, tantalum and tungsten, their ores, and gold originating in conflict-affected and high-risk areas (Mar. 5, 2014), http://trade.ec.europa.eu/doclib/docs/2014/march/tradoc_152227.pdf.

454 Press Release, European Parliament, Conflict minerals: MEPs secure mandatory due diligence for importers (June 16, 2016), http://www.europarl.europa.eu/pdfs/news/expert/infopress/20160615IPR32320/20160615IPR32320_en.pdf.

455 *See* Resource Extraction Payments Adopting Release, 81 Fed. Reg. 49,359 (July 27, 2016).

456 *American Petroleum Institute v. SEC*, 953 F. Supp. 2d 5 (D.D.C. 2013). The U.S. Chamber of Commerce and three industry groups (the American Petroleum Institute ("API"), the Independent Petroleum Association of America and the National Foreign Trade Council) challenged the 2012 Rule. *See* § 4.08[2][b].

457 Resource Extraction Payments Adopting Release, 81 Fed. Reg. 49,359 (July 27, 2016); § 13(q)(1)(D) of the Exchange Act. Although the SEC has not explicitly defined the phrase "oil, natural gas or minerals," it is generally understood that the phrase as used in the U.S. securities laws includes coal, as well as gold and other metals. *See*, *e.g.*, *Penturelli v. Spector, Cohen, Gadon & Rosen*, 779 F.2d 160, 166 (3d Cir. 1985) (holding that fractional undivided interests in coal are encompassed by "fractional undivided interest in oil, gas, or other mineral rights" in the definition of "security" in § 2(a)(1) of the Securities Act); and SEC Industry Guide 7, which contemplates the inclusion of coal, among other things, in the term "mineral deposit."

458 Resource Extraction Payments Adopting Release, 81 Fed. Reg. 49,359, 49,400 (July 27, 2016).

459 Resource Extraction Payments Adopting Release, 77 Fed. Reg. 56,365, 56,390 n.390 (Sept. 12, 2012).

460 The recent adoption of the final rule made it available for disapproval by the new Congress under the CRA, and, now that Congress has disapproved it, the rule is treated as if it had never taken effect. *See* H.R.J. Res. 41, 115th Cong. (2017), Pub. L. No. 115-4 (2017).

461 5 U.S.C. § 803.

462 § 1504 of the Dodd-Frank Act added § 13(q) to the Exchange Act, which directs the SEC to issue rules requiring resource extraction companies to include in an annual report information relating to any payment made by the company, a subsidiary of the company, or an entity under the control of the company, to a foreign government or the federal government for the purpose of the commercial development of oil, natural

gas, or minerals. Section 13(q) requires a resource extraction company to provide information about the type and total amount of such payments made for each project related to the commercial development of oil, natural gas, or minerals, and the type and total amount of payments made to each government.

463 *See* H.R. 5983, 114th Cong. (2016).

464 Resource Extraction Adopting Release, 81 Fed. Reg. 49,359, 49,361 (July 27, 2016).

465 *See* The EITI Standard (Feb. 23, 2016). *See also* The International Bank for Reconstruction and Development/The World Bank, IMPLEMENTING THE EXTRACTIVE INDUSTRIES TRANSPARENCY INITIATIVE: APPLYING EARLY LESSONS FROM THE FIELD (2008).

466 *See* the United States Extractive Industries Transparency Initiative, 2015 Executive Summary, *available at* https://useiti.doi.gov/downloads/USEITI_executive-summary_2015-12-22.pdf.

467 *See* EITI Standard, Part I, Chapter 3 (Feb. 23, 2016) for full EITI Requirements and *United States of America*, EITI.ORG, https://eiti.org/united-states-america (last visited Dec. 28, 2016).

468 Resource Extraction Adoption Release, 81 Fed. Reg. 49,359, 49,361 (July 27, 2016).

469 Council Directive 2013/34, 2013 O.J. (L 182) 19–76 (EU) (the "EU Accounting Directive"); Council Directive 2013/50, 2013 O.J. (L 294) 13–27 (EU) (the "EU Transparency Directive" and, together with the EU Accounting Directive, the "EU Directives").

470 S.C. 2014, c. 39, s. 376 (Can.).

471 The rules apply if, during at least one of the previous two financial years, relevant companies have met at least two of the following criteria: (i) have at least C$20 million in assets, (ii) have generated at least C$40 million in revenue, or (iii) employ an average of at least 250 employees.

472 *See* Note for Mining and Oil and Gas Companies – June 2009, *available at* http://www.londonstockexchange.com/companies-and-advisors/aim/advisers/rules/guidance-note.pdf.

473 *See* the Main Board Listing Rules (Chapter 10.05(6)(c)) and the Growth Enterprise Market (GEM) Board Listing Rules (Chapter 18A.05(6)(c)) of the HKSE, *available at* https://www.hkex.com.hk/eng/rulesreg/listrules/mbrules/documents/chapter_18.pdf and https://www.hkex.com.hk/eng/rulesreg/listrules/gemrules/documents/chapter_18a.pdf, respectively.

474 H.R.J. Res. 41, 115th Cong. (2017), Pub. L. No. 115-4 (2017).

475 The API represents over 500 companies involved in all aspects of the U.S. and international oil and gas industry, including exploration, production, refining, marketing, distribution and marine activities. The Independent Petroleum Association of America and the National Foreign Trade Council are trade associations that represent thousands of oil, natural gas, mining and service companies.

476 Complaint, *American Petroleum Institute v. SEC*, No. 12-1668 (D.D.C. filed Oct. 10, 2012). On the same day that they filed their complaint in the U.S. District Court for the District of Columbia, these groups also filed a Petition for Review in the U.S. Court of Appeals for the District of Columbia Circuit; the appeals court dismissed the petition for lack of jurisdiction. *American Petroleum Institute v. SEC*, 714 F.3d 1329 (D.C. Cir. 2013).

477 5 U.S.C. §§ 551-559.

478 Motion for Stay of Rule 13q-1 and Related Amendments to New Form SD by Am. Petroleum Inst., Chamber of Commerce of the U.S., Indep. Petroleum Ass'n of Am., and Nat'l Foreign Trade Council (Oct. 25, 2012).

479 SEC Release No. 34-68197 (Nov. 8, 2012) (Order denying stay).

480 *American Petroleum Institute v. SEC*, 953 F. Supp. 2d 5 (D.D.C. 2013).

481 *American Petroleum Institute v. SEC*, 953 F. Supp. 2d 5, 17–20 (D.D.C. 2013).

482 *American Petroleum Institute v. SEC*, 953 F. Supp. 2d 5, 20–23 (D.D.C. 2013).

483 *See Oxfam America, Inc., v. SEC*, 126 F. Supp. 3d 168 (D. Mass. 2015).

U.S. Regulation of the International Securities and Derivatives Markets, § 4.09, DISCLOSURE OF NON-GAAP FINANCIAL MEASURES

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 4.09 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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Rules adopted by the SEC to implement § 401(b) of the Sarbanes-Oxley Act amended Form 20-F to impose more stringent conditions on SEC filings containing non-GAAP financial measures (a term used by the SEC to identify the

p. 4-126

"*pro forma*" information targeted by § 401(b) of the Sarbanes-Oxley Act). These rules are contained in Item 10(e) of Regulation S-K [484] and Regulation G. [485]

[1] Definitions

"Non-GAAP financial measures" are defined as numerical measures of an issuer's historical or future financial performance, financial position or cash flows that (i) exclude amounts, or are subject to adjustments that have the effect of excluding amounts, that are included in the most directly comparable measure calculated and presented in accordance with GAAP in the statement of income, balance sheet or statement of cash flows (or equivalent statements) of the issuer or (ii) include amounts, or are subject to adjustments that have the effect of including amounts, that are excluded from the most directly comparable measure so calculated and presented. [486] Financial measures that an issuer is required to disclose under GAAP, SEC rules or a system of regulation of a government or governmental agency or self-regulatory organization that is applicable to the issuer are, however, exempt. [487] The SEC has indicated that measures of capital or reserves calculated for regulatory purposes would fall within this exclusion. [488]

p. 4-126

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p. 4-127

For purposes of the rules, "GAAP" refers to generally accepted accounting principles in the United States, except that (i) in the case of foreign issuers whose primary financial statements are prepared in accordance with non-U.S. GAAP, the term GAAP refers to the principles under which those primary financial statements are prepared and (ii) in the case of foreign issuers that include a non-GAAP financial measure derived from or based on a measure calculated in accordance with U.S. GAAP, GAAP refers to U.S. GAAP for purposes of the application of these rules to the disclosure of that measure. [489]

The SEC has stated that the term "non-GAAP financial measure" is intended to include all measures that have the effect of depicting either a measure of performance that is different from that presented in the financial statements (such as income or loss before taxes or net income or loss as calculated in accordance with GAAP) or a measure of liquidity that is different from cash flow or cash flow from operations calculated in accordance with GAAP. [490] The SEC has provided further guidance as to what items are intended to be excluded from the definition of "non-GAAP financial measure." For example, "non-GAAP financial measure" would not include:

- ratios or measures calculated using only (i) financial measures calculated in accordance with GAAP and (ii) operating measures or other measures that are not non-GAAP financial measures; or
- operating and other statistical measures (such as unit sales, "same store sales," numbers of employees, numbers of subscribers or numbers of advertisers). [491]

In addition, measures of profit or loss and total assets for each segment required to be disclosed in accordance with GAAP are not non-GAAP financial measures. [492]

p. 4-127

p. 4-128

The SEC has confirmed that, notwithstanding the use of the term "*pro forma*" financial information in § 401(b) of the Sarbanes-Oxley Act, *pro forma* financial information presented pursuant to Article 11 of Regulation S-K (*e.g.*, required disclosures relating to certain acquisitions or divestitures) is not subject to these rules.

[2] Requirements under Item 10(e) of Regulation S-K

Under the rule, all subject filings that include a non-GAAP financial measure must also include:

- a presentation, with equal or greater prominence, of the most directly comparable financial measure or measures calculated and presented in accordance with GAAP; [493]
- a reconciliation (by schedule or other clearly understandable method), which must quantify the differences between the non-GAAP financial measure disclosed and the most directly comparable financial measure or measures calculated and presented in accordance with GAAP; [494]
- a statement disclosing the reasons why the registrant's management believes that presentation of the non-GAAP financial measure provides useful

p. 4-128

p. 4-129

information to investors regarding the registrant's financial condition and results of operations; [495] and

- to the extent material, a statement disclosing the additional purposes, if any, for which the registrant's management uses the non-GAAP financial measure that are not disclosed under the preceding bullet point. [496]

p. 4-129

p. 4-130

In addition, subject to a limited exception for foreign issuers discussed below, filings may not:

- exclude charges or liabilities that required, or will require, cash settlement, or would have required cash settlement absent an ability to settle in another manner, from non-GAAP *liquidity* measures, other than EBIT (earnings before interest and taxes) and EBITDA (earnings before interest, taxes, depreciation and amortization); [497]
- present non-GAAP financial measures on the face of the registrant's financial statements prepared in accordance with GAAP or in the accompanying notes;
- present non-GAAP financial measures on the face of any *pro forma* financial information required to be disclosed by Article 11 of Regulation S-K ;
- use titles or descriptions of non-GAAP financial measures that are the same as, or confusingly similar to, titles or descriptions used for GAAP financial measures; [498] or

p. 4-130

p. 4-131

- adjust a non-GAAP *performance* measure to eliminate or smooth items identified as nonrecurring, infrequent or unusual, when the nature of the charge or gain is such that it is reasonably likely to recur within two years or where there was a similar charge or gain within the prior two years. [499]

With respect to the last prohibition, C&DIs state that it is based on the *description* of the item being adjusted, rather than its nature. In other words, the rule does not prohibit adjustment for recurring items. It prohibits characterizing an item as nonrecurring, infrequent or unusual unless it, in fact, meets the specified criteria. This guidance marked a significant change as compared to the SEC's previous guidance in this area, which has been eliminated, under which the SEC had articulated burdens and conditions that, together with staff practices under the guidance, led companies to avoid using non-GAAP performance measures in SEC filings, unless the adjustments were for nonrecurring items only. Instead, the Non-GAAP Measures C&DIs emphasize clear disclosure and explanation surrounding the use of non-GAAP financial measures in accordance with Item 10(e). [500]

These prohibitions will not, however, apply to a non-GAAP financial measure included in a filing of a foreign issuer, provided that the non-GAAP financial measure:

- relates to the GAAP used in the issuer's primary financial statements included in its filings with the SEC;

p. 4-131

p. 4-132

- is required or expressly permitted by the standard-setter that is responsible for establishing the GAAP used in such financial statements; and
- is included in the annual report prepared by the issuer for use in its home jurisdiction or for distribution to its securityholders. [501]

The prohibitions in Item 10(e) of Regulation S-K do not apply to non-GAAP financial measures contained in disclosures subject to the SEC's rules regarding communications in connection with business combinations. [502]

[3] Requirements under Regulation G

Unlike Item 10(e) of Regulation S-K, Regulation G extends beyond SEC filings to all public disclosures of non-GAAP financial measures by issuers. Regulation G thus joins the general antifraud provisions of the federal securities laws and Regulation FD in covering an issuer's public statements generally and not only statements in SEC filings. [503]

p. 4-132

p. 4-133

Under Regulation G, whenever an issuer required to file reports under the Exchange Act publicly discloses (other than disclosure subject to Regulation M-A) material information that includes a non-GAAP financial measure, it must accompany that disclosure with:

- a presentation of the most directly comparable financial measure calculated and presented in accordance with generally accepted accounting principles, [504] and
- a quantitative reconciliation of the differences between the non-GAAP financial measure and the most directly comparable financial measure or measures calculated and presented in accordance with generally accepted accounting principles. [505]

Regulation G permits the public presentation of non-GAAP financial measures orally, telephonically, by webcast or broadcast or by similar means without requiring the additional disclosure, provided that the most directly comparable financial measure using generally accepted accounting principles and the required reconciliation are provided on the issuer's website at the same time, and the location of the website is also included in the public presentation. [506]

p. 4-133

p. 4-134

Regulation G contains an antifraud provision prohibiting the publication of any non-GAAP financial measure that, taken together with the information accompanying that measure and any other accompanying discussion, contains an untrue statement of a material fact or omits to state a material fact necessary in order to make the presentation of the non-GAAP financial measure, in light of the circumstances under which it is presented, not misleading. [507] However, noncompliance with Regulation G does not in itself affect any person's liability in a private cause of action under the antifraud provisions of § 10(b) of the Exchange Act or Rule 10b-5 thereunder. An issuer that fails to comply with Regulation G could be subject to an SEC enforcement action under Regulation G and, if warranted by the facts and circumstances, an enforcement action pursuant to § 10(b) and Rule 10b-5. [508]

Regulation G does not apply to non-GAAP financial measures contained in disclosures specifically subject to the SEC's rules regarding communications in connection with business combinations, [509] although related communications not specifically captured by the business combination communications rules, and related Securities Act registration and proxy or tender offer statements, are subject to Regulation G. Regulation G does not apply to the disclosure of non-GAAP financial measures by foreign issuers if the following conditions are satisfied:

- the securities of the issuer are listed or quoted on a securities exchange or inter-dealer quotation system outside the United States;
- the non-GAAP financial measure is not derived from or based on a measure calculated and presented in accordance with U.S. generally accepted accounting principles; [510] and
- the disclosure is made by or on behalf of the issuer outside the United States, or is included in a written communication that is released by or on behalf of the issuer outside the United States. [511]

p. 4-134

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p. 4-135

Provided that these conditions are satisfied, the exemption is available notwithstanding the existence of one or more of the following circumstances:

- a written communication is released in the United States as well as outside the United States, so long as the communication is released in the United States contemporaneously with or after the release outside the United States and is not otherwise targeted at persons located in the United States;
- U.S. journalists have access to the information;
- the information appears on one or more websites maintained by the issuer, so long as the websites, taken together, are not available exclusively to, or targeted at, persons located in the United States; or
- following the disclosure or release of the information outside the United States, the information is included in a submission by the issuer to the SEC made under cover of a Form 6-K. [512]

Footnotes

484 Item 10(e) of Regulation S-K applies to all filings with the SEC. Additionally, Item 10(e)(1)(i) of Regulation S-K applies to financial information furnished under Item 2.02 of Form 8-K. However, Item 10(e) of Regulation S-K does not apply to filings made by investment companies registered under § 8 of the Investment Company Act, which are exempt from § 401 of the Sarbanes-Oxley Act, and eligible Canadian companies under the U.S.-Canadian multijurisdictional disclosure system discussed in Chapter 13.

485 Simultaneously with its adoption of Item 10(e) of Regulation S-K, which governs non-GAAP financial measures in SEC filings, the SEC adopted Regulation G, which governs the public disclosure of non-GAAP financial measures. *See* § 4.09[3]. Under Regulation G, companies are prohibited from disseminating false or misleading non-GAAP financial measures or presenting non-GAAP financial measures in a manner that is misleading or obscures the company's GAAP results.

486 Item 10(e)(2) of Regulation S-K under the Securities Act and Form 20-F, General Instruction C(e).

487 Item 10(e)(5) of Regulation S-K under the Securities Act and Form 20-F, General Instruction C(e).

488 SEC Release No. 33-8176 (Jan. 22, 2003), 68 Fed. Reg. 4820, 4822 (Jan. 30, 2003) (the "Non-GAAP Measures Release"). The SEC has been quite strict in applying this exception. For example, even though U.S. federal banking regulations have increasingly treated common equity and tangible common equity ("TCE") measures as significant, financial institutions have been forced to treat TCE measures as non-GAAP measures. In any event, these financial measures remain subject to § 10(b) of the Exchange Act, Rule 10b-5 thereunder and the SEC's existing guidance on non-GAAP financial measures. *See*, *e.g.*, *In the Matter of Trump Hotels & Casino Resorts, Inc.*, SEC Release No. 34-45287 (Jan. 16, 2002); Cautionary Advice Regarding the Use of "Pro Forma" Financial Information in Earnings Releases, SEC Release No.

33-8039 (Dec. 4, 2001); SEC Accounting Series Release No. 142, SEC Release No. 33-5377 (Mar. 15, 1973). The SEC also has brought enforcement actions under Regulation G. *See SEC v. SafeNet, Inc.*, SEC Litigation Release No. 21290 (Nov. 12, 2009) (The SEC alleged that the defendant violated Regulation G reporting obligations by improperly excluding certain ordinary expenses as non-recurring charges. SafeNet later settled these charges.).

489 Item 10(e)(3) of Regulation S-K under the Securities Act and Form 20-F, General Instruction C(e).

490 Non-GAAP Measures Release, 68 Fed. Reg. 4820, 4822 (Jan. 30, 2003).

491 Item 10(e)(4) of Regulation S-K under the Securities Act; Form 20-F, General Instruction C(e); Non-GAAP Measures Release, 68 Fed. Reg. 4820, 4822 (Jan. 30, 2003).

492 Non-GAAP Measures Release, 68 Fed. Reg. 4820, 4822 (Jan. 30, 2003). To not be a non-GAAP financial measure, the segment information must be presented in conformity with ASC 280. *See* SEC, Division of Corporation Finance, Compliance & Disclosure Interpretations, Non-GAAP Financial Measures ("Non-GAAP Measures C&DIs"), Question 104.01. A segment measure that is adjusted to include amounts excluded from, or exclude amounts included in, the segment measure calculated and presented in accordance with ASC 280 would be a non-GAAP measure. *See* Non-GAAP Measures C&DIs, Question 104.03. If a company includes in its MD&A a discussion of segment profitability that is consistent with ASC 280, which requires that a footnote to the company's consolidated financial statements provide a reconciliation, the company also should include in the segment discussion in the MD&A a complete discussion of the reconciling items that apply to the particular segment being discussed. *See* Non-GAAP Measures C&DIs, Question 104.02. Similar principles would apply to the use of measures in respect of segment disclosure for foreign issuers that prepare their financial statements in accordance with IFRS as issued by the IASB, except that for such issuers, such segment measures would be required to be calculated and presented in accordance with IFRS 8, *Operating Segments*, to be non-GAAP measures.

493 In May 2016, the SEC's Division of Corporation Finance released new and updated Compliance & Disclosure Interpretations ("C&DIs") on the use of non-GAAP financial measures that signaled the SEC's tightening policy. One new C&DI provides an illustrative list of disclosure practices the SEC staff believes improperly make non-GAAP financial measures more prominent than the most directly comparable GAAP measures. For example, the staff would consider a non-GAAP financial measure to be more prominent if it is disclosed or discussed before the most directly comparable GAAP measure. *See* Non-GAAP Measure C&DIs, Question 102.10.

494 The rules provide an exception from the quantitative reconciliation requirement with respect to forward-looking non-GAAP financial measures in situations where a quantitative reconciliation is not available without unreasonable effort. *See* Item 10(e)(1)(i)(B) of Regulation S-K under the Securities Act; Form 20-F, General Instruction C(e). Where this exception applies, the SEC expects the issuer to (i) disclose the fact that the most directly comparable GAAP measure is unavailable, (ii) provide reconciling information that is available without unreasonable effort and (iii) identify information that is unavailable and disclose its probable significance, in a location of equal or greater prominence compared to the forward-looking non-GAAP financial measures in question. Non-GAAP Measures Release, 68 Fed. Reg. 4820, 4823 (Jan. 30, 2003); Non-GAAP Measure C&DIs, Question 102.10.

495 The SEC has indicated that use by, or usefulness to, analysts cannot be the sole support for presenting a non-GAAP financial measure. Rather, the justification for use of the measure must be substantive, although it can be a justification that causes a measure to be used by or useful to analysts. Significantly, the SEC made clear in the adopting release for the rules that the required statement of the utility of the information to investors (i) should not be boilerplate, (ii) must in certain instances discuss why investors would find the non-GAAP financial measure valuable in the context in which it is presented, given the excluded items, and (iii) is intended to "be clear and understandable [and]… specific to the non-GAAP financial measure used, the registrant, the nature of the registrant's business and industry and the manner in which management assesses the non-GAAP financial measure and applies it to management decisions." Non-GAAP Measures Release, 68 Fed. Reg. 4820, 4825 (Jan. 30, 2003). The Non-GAAP Measures C&DIs made clear that a

company is not required to use a non-GAAP financial measure in managing its business or for other purposes as a condition to being able to disclose it. *See* Non-GAAP Measures C&DIs, Question 102.04.

The SEC routinely asks questions on registration statements and periodic reports regarding the explanation given as to why a proposed non-GAAP metric provides useful information to investors, particularly with respect to more unusual or unconventional measures, and at times has pressured issuers to remove references to certain non-GAAP measures. In particular, the new C&DIs introduced in May 2016 emphasize that the SEC staff may view certain types of non-GAAP financial measures as inherently misleading and therefore prohibited from use regardless of their purported usefulness. *See* Non-GAAP Measures C&DIs, Questions 100.01 through 100.04. Under this guidance, non-GAAP performance measures that exclude "normal, recurring, cash operating expenses necessary to conduct the company's business" could be considered inherently misleading. Non-GAAP Measures C&DI, Question 100.01. Although it predates the new C&DIs, Groupon Inc.'s use of a non-GAAP financial measure called adjusted consolidated segment operating income, or adjusted CSOI, in its initial Form S-1 filing for its IPO, is often cited as an example of a non-GAAP performance measure that would be considered misleading under this guidance. The metric presented consolidated segment operating income before subtracting subscriber acquisition costs and certain other non-cash charges. Groupon described the measure as its "operating profitability before marketing costs incurred for long-term growth." Groupon, Inc., Form S-1 (June 2, 2011). According to published reports, after questions and pressure from the SEC staff during the comment process, Groupon removed adjusted COSI from its offering documents. Shayndi Rice and Lynn Cowan, *Groupon Bows to Pressure*, WALL ST. J., Aug. 11, 2011. Furthermore, a new C&DI indicates that a non-GAAP revenue measure that backs out the effect of GAAP revenue recognition and measurement principles applicable to a company's business could be inherently misleading. Specifically, a non-GAAP financial measure that adds back revenue that would have been deferred and recognized ratably under GAAP is considered misleading under this guidance. Similar non-GAAP adjustments to other line items may also be misleading. Non-GAAP Measures C&DIs, Question 100.04.

496 In the case of filings other than annual reports on Form 20-F, the rules do not require a registrant to include information regarding the purpose for which the non-GAAP financial measure is used and the reasons why that financial measure is believed to be useful to investors, so long as (i) that information was included in the registrant's most recent annual report on Form 20-F or a more recent filing and (ii) that information is updated to the extent necessary to meet the applicable requirements at the time of the current filing. The SEC has confirmed that the reference to filings does not include reports on Form 6-K, which are "furnished" to the SEC, except insofar as they are incorporated by reference into a Securities Act registration statement or prospectus or an Exchange Act report filed with the SEC. Non-GAAP Measures Release, 68 Fed. Reg. 4820, 4824 n.39 (Jan. 30, 2003). The SEC has also confirmed that the reference to filings does not include free writing prospectuses, unless the free writing prospectus is included in or incorporated by reference into a registration statement or Exchange Act filing. *See* Non-GAAP Measures C&DIs, Question 102.08.

497 The SEC has stated that, with respect to EBIT and EBITDA, (i) the term "earnings" is intended to mean net income as presented in the statement of operations under GAAP and that, if an issuer is able to justify its use as a performance measure, EBIT or EBITDA should be reconciled to net income and not operating income and (ii) measures that are calculated differently may not be characterized as EBIT or EBITDA and their titles should be distinguished, for example, as "Adjusted EBITDA." *See* Non-GAAP Measures C&DIs, Questions 103.01 and 103.02.

Presentation of "adjusted EBITDA" may nevertheless violate Item 10(e) and therefore continue to be prohibited in filings made with the SEC if adjustments that effect prohibited exclusions are made. The SEC does, however, recognize that credit agreements often require issuers to include an "adjusted EBITDA" measure in periodic reports and, accordingly, has indicated that disclosure of such a measure would be permissible to the extent (i) the credit agreement is a material agreement, (ii) the covenant requiring presentation of the measure is a material term of the credit agreement and (iii) information elicited by the covenant is material to an investor's understanding of the issuer's financial condition and/or liquidity. If this is the case, the SEC has further stated that disclosure regarding the covenant may be misleading absent a discussion of the (i) materiality of the credit agreement and covenant, (ii) amount or limit required for compliance with the covenant and (iii) actual or reasonably likely effects of compliance or non-compliance with the covenant on the issuer's financial condition and liquidity. *See* Non-GAAP Measures C&DIs, Question 102.09.

498 Item 10(e)(1)(ii) of Regulation S-K under the Securities Act; Form 20-F, General Instruction C(e). Notably, although the presentation of per share non-GAAP financial measures in SEC filings is not explicitly prohibited by the rules, the SEC has stated that per share measures that are prohibited specifically under GAAP or SEC rules continue to be prohibited in materials filed with or furnished to the SEC. Non-GAAP Measures Release, 68 Fed. Reg. 4820, 4820 n.11 (Jan. 30, 2003). As an example, the SEC has cited SFAS No. 95, Statement of Cash Flows, paragraph 33 of which provides that "[f]inancial statements shall not report an amount of cash flow per share. Neither cash flow nor any component of it is an alternative to net income as an indicator of an enterprise's performance, as reporting per share amounts might imply." While not expressly cited in the Non-GAAP Measures Release, the SEC's Accounting Series Release No. 142 states that the presentation of cash flow per share "run[s] a high risk of materially misleading investors." SEC Release No. 33-5377 (Mar. 15, 1973), 38 Fed. Reg. 9158, 9159 (Apr. 11, 1973). The SEC does recognize, however, that certain non-GAAP per share measures may be meaningful to investors from an "operating viewpoint," in which case the SEC views accompanying disclosure explaining how such measures are used by management and in what way they provide meaningful information as being critical, together with a reconciliation of the per share measure to the GAAP financial measure of earnings per share. However, non-GAAP liquidity measures, such as cash flow or free cash flow, should not be presented on a per share basis and the SEC staff will focus on the substance of the non-GAAP financial measure in determining whether the measure is a performance or liquidity measure regardless of management's characterization. *See* Non-GAAP Measures C&DIs, Question 102.05. The SEC staff also makes it clear that EBIT or EBITDA cannot be presented on a per share basis, because these measures can be used as a liquidity measure. Non-GAAP Measures C&DIs, Question 103.02.

499 Item 10(e)(1)(ii) of Regulation S-K under the Securities Act.

500 *See* Non-GAAP Measures C&DIs, Question 102.03.

501 Note to paragraph (e) of Item 10 of Regulation S-K under the Securities Act; Form 20-F, General Instruction C(e). The Non-GAAP Measures C&DIs provide more detail on the "expressly permitted" standard. *See* Non-GAAP Measures C&DIs, Question 106.01. In particular, express permission can be demonstrated by the explicit acceptance of the presentation of the non-GAAP financial measure by the securities regulator in the company's home country jurisdiction or market. "Explicit acceptance" includes: (i) the published views of the regulator or members of its staff, or (ii) a letter from the regulator or its staff to the issuer indicating the acceptance of the presentation, which would be provided to the SEC staff on request. This guidance on the definition of "expressly permitted" should make it easier for a foreign issuer to establish that it may use in SEC filings the same measures it presents in home-country filings. However, as the effort to harmonize the rules governing non-GAAP financial measures across different jurisdictions gains support, it would be rare for a non-GAAP financial measure to be prohibited under Item 10(e) of Regulation S-K under the Securities Act but expressly permitted in another local jurisdiction. For example, a Statement on Non-GAAP Financial Measures published by the Board of the International Organization of Securities Commissions (IOSCO) in 2016 and Guidelines on Alternative Performance Measures published by the European Securities and Markets Authority (ESMA) in June 2015 (effective in July 2016) both present guidelines that are largely consistent with Regulation G, Item 10(e) of Regulation S-K and the Non-GAAP Measures C&DIs.

502 Item 10(e)(6) of Regulation S-K under the Securities Act; Form 20-F, General Instruction C(e). This exemption does not extend beyond disclosures contained in communications subject to Rule 425 under the Securities Act or Rules 14a-12, 14d-2(b)(2) and 14d-9(a)(2) under the Exchange Act. If the same non-GAAP financial measure included in a communication under one of those rules is also disclosed in a Securities Act registration statement, proxy statement or tender offer statement, it would not be exempt from Regulation G or Item 10(e) of Regulation S-K in the Securities Act filing. *See* Non-GAAP Measures C&DIs, Question 101.01.

503 The general antifraud provisions, embodied in § 10(b) of the Exchange Act and Rule 10b-5 thereunder, as well as § 17 of the Securities Act, apply to all entities and not just those registered with the SEC, and can also apply to private fraudulent statements as discussed in § 11.04. Regulation FD is discussed in § 4.10[6]. Although Regulation FD by its terms does not apply to foreign issuers, many foreign issuers comply with it or follow its precepts.

504 As general guidance with respect to this requirement, the SEC has stated that "(1) non-GAAP financial measures that measure cash or 'funds' generated from operations (liquidity) should be balanced with disclosure of amounts from the statement of cash flows … and (2) non-GAAP financial measures that depict performance should be balanced with net income, or income from continuing operations, taken from the statement of operations." Non-GAAP Measures Release, 68 Fed. Reg. 4820, 4823 n.26 (Jan. 30, 2003). The SEC has clarified that, (i) with respect to the use of EBITDA as a performance measure, it would require a reconciliation to net income (as opposed to operating income) and (ii) only non-GAAP measures derived from GAAP net income may properly be characterized as EBITDA or EBIT. *See* Non-GAAP Financial Measure C&DIs, Questions 103.01 and 103.02.

505 Rule 100(a) of Regulation G. The required reconciliation must be quantitative for historical non-GAAP financial measures and quantitative, to the extent available without unreasonable efforts, for forward-looking information. Rule 100(a)(2) of Regulation G. With respect to forward-looking non-GAAP financial measures that are not available without unreasonable effort, the SEC expects issuers to (i) disclose the fact that the most directly comparable measure using generally accepted accounting principles is unavailable, (ii) provide reconciling information that is available without unreasonable effort and (iii) identify information that is unavailable and disclose its probable significance. Non-GAAP Measures Release, 68 Fed. Reg. 4820, 4823 (Jan. 30, 2003).

506 Note 1 to Rule 100 of Regulation G. The SEC encourages issuers to provide website access to this information for at least a 12-month period and has suggested that this information may appear on the website or page that the issuer normally uses for its investor relations function. Non-GAAP Measures Release, 68 Fed. Reg. 4820, 4823 n.28 (Jan. 30, 2003).

507 Rule 100(b) of Regulation G. Significantly, the SEC has indicated that a change in the methodology for calculating or presenting a non-GAAP financial measure from one period to another, without a complete description of the change in methodology, can violate this antifraud provision. Non-GAAP Measures C&DIs, Question 100.02; *see also* Non-GAAP Measures Release, 68 Fed. Reg. 4820, 4823 n.23 (Jan. 30, 2003).

508 Non-GAAP Measures Release, 68 Fed. Reg. 4820, 4823 (Jan. 30, 2003).

509 *See* Rule 425 under the Securities Act (regulating communications in connection with a business combination in which stock consideration is being registered under the Securities Act) and Rule 14a-12 under the Exchange Act (regulating solicitations before the furnishing of a proxy statement).

510 By its terms, therefore, this exemption is not available to a foreign issuer that reports under U.S. generally accepted accounting principles and discloses non-GAAP financial measures derived from U.S. generally accepted accounting principles.

511 Rule 100(c) of Regulation G. However, to the extent such disclosure is subsequently incorporated by reference into a Securities Act registration statement, it would need to comply with Item 10(e) of Regulation S-K under the Securities Act. *See* Non-GAAP Financial Measure C&DIs, Question 106.03. Conversely, where a foreign issuer wishes to incorporate by reference into a Securities Act registration statement a portion of an earnings release that does not contain non-GAAP measures, it may do so either by (i) furnishing the entire earnings release on Form 6-K and indicating in the Form 6-K which portion of the release is incorporated by reference or (ii) furnishing two Form 6-K reports, with one containing the full earnings release and another the portions that will be incorporated by reference (which the SEC has indicated may provide more clarity to investors). *See* Non-GAAP Financial Measure C&DIs, Question 106.02. Even when the conditions for exemption from Regulation G are satisfied, foreign issuers often voluntarily comply with the requirements of Regulation G as a matter of good corporate governance practice.

512 Note 2 to Rule 100 of Regulation G.

U.S. Regulation of the International Securities and Derivatives Markets, § 4.10, COMMUNICATIONS WITH INVESTORS AND FINANCIAL ANALYSTS

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 4.10 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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Securities analysts play a key role in securities markets, and publicly held companies as a matter of market practice regularly brief them to help them understand company results and business trends. Foreign issuers, like U.S. issuers, are expected to meet regularly, through telephone conference or otherwise, with securities analysts once they are SEC reporting companies. There have been some unfortunate instances, however, in which analysts have received nonpublic information and passed the information on to their clients, who have acted on it before the information was disclosed to the general public. In the wake of these cases, as well as Enron and the unanticipated and significant decline in the financial position of other public companies, the role of the securities analyst was scrutinized by Congress, the SEC, state regulators and various self-regulatory

p. 4-136

organizations. [513] The result was a heightened campaign against selective disclosure, facilitated by the SEC's adoption of Regulation FD (Fair Disclosure) in 2000, discussed in detail below. [514] For several years prior to 2009, the SEC brought few cases for violations of Regulation FD, but since September 2009 there has been a marked increase in the number of Regulation FD enforcement actions by the SEC. This increase in enforcement action serves as a reminder that ongoing vigilance in this area is certainly warranted.

The U.S. rules governing disclosure to analysts by issuers originally emerged from case law construing a basic antifraud rule, Rule 10b-5 under the Exchange Act. The rules provided by this case law were not straightforward, at times ambiguous and, in any event, have not been applied, with one known exception, [515] to communications between issuers and analysts. This situation led the SEC to adopt a new disclosure regime, Regulation FD, to prevent material nonpublic information from being given selectively to market professionals (broker-dealers, investment advisers and managers, and investment companies), who could use such information to their own or their clients' advantage. Regulation FD applies to communications on behalf of the issuer with market professionals and with securityholders who may foreseeably trade on the basis of the disclosed information.

Although Regulation FD does not apply to foreign issuers, [516] they too should avoid selective disclosure of material nonpublic information both as a matter of best practice and to avoid potential liability. Ill-considered disclosure

p. 4-136

p. 4-137

can lead to liability both for the company and for its management personally under Rule 10b-5, raise potential issues regarding correcting or updating information and have adverse market consequences. For all of these reasons, rigorous monitoring of company communications with analysts is highly advisable.

[1] General Disclosure Requirements and Rule 10b-5 Liability

The U.S. Supreme Court has established that tipping or trading on the basis of material nonpublic information will not result in a violation of Rule 10b-5 unless there is a breach of a fiduciary duty or other relationship of trust and confidence, or a misappropriation of information received in violation of such a relationship. [517] This has led to three general principles with respect to the disclosure of corporate information to securities analysts and the public. First, Rule 10b-5 by itself does not normally require management to disclose material nonpublic information regarding the company to the investment community, unless there is otherwise a duty to disclose (for example, filing an annual report on Form 20-F, or disclosure in connection with an offering of securities). [518] Subject to certain

p. 4-137

p. 4-138

exceptions discussed below, the timing of such disclosure is ordinarily left to the business judgment of management. Second, if a company does disclose corporate information (whether voluntarily or otherwise), Rule 10b-5 requires that those disclosures neither contain misleading statements of material information nor omit material facts necessary to make the statements made not misleading. [519] Third, when divulging material nonpublic information, company officials may not disclose it selectively— *e.g.*, exclusively to securities analysts—but rather must make the information available to the general public, [520] if those officials could be found to have gained a personal benefit from the selective disclosure. Selective disclosure can lead to liability for the company and for company officials themselves for insider trading by persons receiving the disclosure.

Although Rule 10b-5 might not require dissemination of material information, the NYSE and the Nasdaq require listed companies to disclose material

p. 4-138

p. 4-139

information promptly to the public through any Regulation FD-compliant method of disclosure, [521] except under certain limited circumstances. [522] In addition, listed companies are required to notify the NYSE or Nasdaq of the release of any such information prior to its release to the public. [523] NYSE and Nasdaq rules, however, do not have the force of law and cannot be the basis for an implied private right of action. The Second Circuit held in *State Teachers Retirement Board v. Fluor Corp.* that no private right of action exists for a violation of the NYSE LISTED COMPANY MANUAL'S disclosure rules. [524] The court reasoned

p. 4-139

p. 4-140

that, given the extensive regulation in this area by Congress and the SEC, "a federal claim for violation of the [NYSE's LISTED] COMPANY MANUAL rules regarding disclosure of corporate news cannot be inferred." [525]

Finally, when preparing disclosure responsive to the SEC's Exchange Act reporting requirements, companies should be mindful of Rule 12b-20, which requires inclusion of any information beyond what is expressly required "as may be necessary to make the required statements, in the light of the circumstances under which they are made, not misleading." The SEC has brought enforcement actions for violating Rule 12b-20 even in the context of Form 6-K filings, where there are no express disclosure requirements. [526]

[2] The Nature of “Material” Information

Because the U.S. securities laws, including Rule 10b-5 under the Exchange Act, generally impose liability only when the information disclosed or omitted is "material," it is important, but also exceedingly difficult in many cases, to distinguish "material" from "immaterial" facts. [527] Courts have formulated a number of tests in recent years attempting to define the types of information that would be material for purposes of Rule 10b-5. The Supreme Court held in *Basic Inc. v. Levinson* that information is material if it "would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available." [528] The Second Circuit has enunciated a more specific standard, holding before *Basic Inc. v. Levinson* that a fact is to be considered material if it is "reasonably certain to have a substantial effect on the market price of the security" [529] and holding subsequently that a fact is to be considered material "if there is a substantial likelihood that a reasonable person would consider it important in deciding whether to buy or sell shares." [530] The SEC has consistently stated that materiality is not solely a quantitative determination and that qualitative materiality judgments must be made based on "all the facts and circumstances." [531] The SEC, in Staff Accounting Bulletin No. 99, discussed the necessity and difficulty of making these determinations and provided some examples. [532]

While these judicial standards are imprecise, certain types of information would almost always be considered material. The most obvious example would be earnings reports or earnings projections (whether favorable or unfavorable) because these data usually have an immediate, and often dramatic, impact on a company's stock price. [533] The following list of potentially material information illustrates by way of example other types of facts that may be so important to investment decisions that their selective disclosure to analysts could lead to Rule 10b-5 liability:

- a decrease or increase in dividend rate or a proposed stock split;
- a significant acquisition or disposition of assets or businesses, including pursuant to a joint venture or merger;
- significant labor problems;

p. 4-141

p. 4-142

- the discovery or development of a significant new product;
- the acquisition or loss of an important contract or major change in backlog or other significant development involving customers or suppliers;
- the proposed sale of a significant amount of additional securities or the incurrence of significant new indebtedness or a default under existing indebtedness;
- a change in control or significant change in management;
- a tender offer for another company's shares;
- significant litigation; and
- another event requiring the filing of a current report under the Exchange Act. [534]

Courts, however, have found certain types of statements not to be material as a matter of law. For example, they have held that statements such as "our company is poised to carry the growth and success of the past year well into the future" to be soft, puffing statements that are not material for purposes of Rule 10b-5. [535] Similarly, the Supreme Court has held that a statement of belief and opinion is not subject to Securities Act liability unless (i) the statement was subjectively disbelieved by the defendant at the time it was expressed, (ii) the statement was accompanied by "embedded statements of fact" that are untrue or (iii) the statement omitted material facts concerning the defendant's inquiry or knowledge about the statement if "those facts conflict with what a reasonable investor would take from the statement itself." [536] Courts have also held that an omission is not material where the information omitted is already in the public domain. [537] In adopting Regulation FD, the SEC made clear that an analyst's ability to piece together immaterial information into a mosaic of information

p. 4-142

p. 4-143

that, taken together, is material would not result in a violation of Regulation FD (or, presumably, Rule 10b-5). [538]

Nevertheless, in light of the broad range of information that has been found to be material, [539] management should be cautious when concluding that any factual information is not material and therefore may be selectively disclosed to analysts. Management should do so only when it is confident the information in question is entirely consistent with information that already is publicly available so that the additional disclosure will have no impact on the market price of the company's securities.

[3] Liability for Misleading Statements and Omissions of Material Fact

Rule 10b-5 liability can arise if a communication made to analysts or to the general public contains a misleading material statement or omits a material fact necessary to make the statements made not misleading. [540] Two SEC administrative rulings, *In re Carnation Company* [541] and *In re E.ON AG*, [542] demonstrate the extent to which liability can attach under these circumstances.

In *In re Carnation Company*, a corporate official publicly stated that no company news or corporate developments could account for recent stock activity and that, to the best of his knowledge, the company was not engaged in any acquisition negotiations. The official, however, was unaware that negotiations were actually taking place regarding the acquisition of Carnation by Nestle. The SEC ruled that, despite the official's ignorance of company developments, such comments violated the Rule 10b-5 prohibition against material misstatements. Because an official cannot be expected to know everything that happens in a corporation, officials communicating with analysts or the public should consult with senior executives prior to making a statement about matters of which they are not certain.

In re E.ON AG involved management denials of merger discussions that were in fact occurring. The merger discussions involved two German companies, and the denials were not, according to *E.ON AG*, a violation of German law.

p. 4-143
p. 4-144

While one of the parties was listed on the NYSE, only a small percentage of its shares was held by U.S. investors. Moreover, both companies were persuaded that a no-comment policy would be construed by the German press as a confirmation that talks were going on and that premature disclosure would have jeopardized the ultimate merger. Nevertheless, the SEC ruled that the statements denying the merger discussions were false and a violation of Rule 10b-5. E.ON subsequently adopted a no-comment policy, as have most other German companies publicly traded in the United States.

[4] Duty to Correct or Update Previous Communications

A duty to correct previous communications arises when the issuer of the statement discovers that the statement was inaccurate or misleading when made. [543] Even if a company's statements are accurate when made, a duty to update explicit or implicit forward-looking statements may arise if circumstances change and such statements become inaccurate or misleading. [544] Currently, the circuits are split on whether a duty to update exists. The First, Second and Third Circuits have recognized a duty to update but generally have construed it narrowly (including rejecting its applicability to routine earnings guidance in the Third Circuit and the Southern District of New York), while the Seventh Circuit has held that there is no duty to update forward-looking statements. Other circuits either appear to have approved a duty to update in dicta [545] or have not yet decided whether a duty to update exists. [546]

p. 4-144
p. 4-145

Courts have considered a variety of factors in determining whether a company has a duty to update. Some courts have emphasized that "optimistic, vague projections of future success which prove to be ill-founded are not, without more, sufficiently material to incur Rule 10b-5 liability." [547] Other courts have concluded that a duty to update forward-looking disclosure requires an implicit factual representation that remained "alive" in the minds of investors as a continuing representation. [548] In *McCarthy v. C-COR Electronics, Inc.*, the court suggested certain elements that could be considered in determining whether or not a duty to update exists. [549] For example, the specificity of the predictions was one factor that could weigh in favor of a duty to update. Predictions of corporate success more distant in the future were also believed to be "necessarily less reliable." [550] Finally, the court suggested that courts should also consider the "degree to which the prediction ... is inherently [more] difficult or unreliable." [551]

In *Backman v. Polaroid Corp.*, the company released a quarterly report that allegedly misrepresented the prospects for the sales and profitability of a new camera. [552] The plaintiffs argued that although the company had instructed its manufacturers to significantly reduce production, the report expressed the company's continued optimism regarding the product. The First Circuit stated that if a disclosure is misleading when made, the company is under a duty to correct the statement promptly. The court also recognized that "in special circumstances, a statement, correct at the time, may have a forward intent and connotation upon which parties may be expected to rely." [553] In such circumstances, "further disclosure" could be necessary to avoid misleading the investing public. [554]

In *In re Time Warner Inc. Securities Litigation*, corporate officials had previously disclosed that the company was seeking foreign strategic alliances, and plaintiffs alleged that management had a duty to update such disclosure when

p. 4-145

p. 4-146

problems arose concerning negotiations within the proposed alliance. [555] The Second Circuit held that, pursuant to Rule 10b-5, companies have a duty to update prior statements not only if intervening events completely negate such earlier remarks, but also if such events render previously disclosed information materially misleading. [556] However, the court refused to hold the company liable under the facts of this case, emphasizing that company statements were not definitive predictions that such deals would be struck, but rather merely expressed management hopes that negotiations would be successful. For this reason, the court found that the attributed public statements lacked the sort of definitive projections that might require later correction. [557]

The Third Circuit's decision in *Weiner v. Quaker Oats Co.* indicates how courts may analyze differently the broad range of forward-looking statements companies make. [558] On the one hand, the court held that a failure to update a statement could be actionable when the statement related to a specific targeted debt-to-equity ratio guideline that ceased to apply because of a subsequent acquisition. [559] On the other hand, the court refused to find actionable a failure to update an earnings projection rendered inaccurate by that same acquisition,

p. 4-146

p. 4-147

because the projection was presented more vaguely as "earnings growth of at least 7 percent over time." [560]

The Seventh Circuit is the only circuit that has affirmatively taken the position that there is no duty to update. In *Stransky v. Cummins Engine Co.*, the company issued optimistic statements in press releases about its redesigned engines. [561] The engines were later discovered to have design problems that led to higher-than-anticipated warranty costs. The court held that there was no duty to update forward-looking statements that become untrue due to subsequent events. [562]

Regulation FD's prohibition on selective disclosure resulted in the public issuance of earnings guidance becoming more prevalent, making the question whether there is a duty to update earnings guidance more important. [563] The Third Circuit is the only circuit that has both recognized the duty to update and expressly addressed whether it applies to ordinary earnings guidance. In *In re Burlington Coat Factory Securities Litigation*, the Third Circuit declined to impose a duty to update an ordinary earnings projection, noting that "disclosure of a specific earnings forecast does not contain the implication that the forecast will continue to hold good even as circumstances change." [564] This holding arguably is inconsistent with other cases in the Third Circuit, and in other circuits that recognize a duty to update, because it appears to create a per se exception for earnings guidance, whereas the other cases generally exclude only statements that are too vague or optimistic to be treated as ongoing factual representations. [565] Nevertheless, the Third Circuit reaffirmed this decision in *In re Advanta Corp. Securities Litigation*, holding that Advanta had no duty to update a statement made by one of its investor relations officers in a Dow Jones article that "[o]ver the next six months Advanta will experience a large increase in revenues as it converts more than $5 billion in accounts that are now at teaser rates of about 7% to its normal interest rate of about 17%" when Advanta later decided to reprice the accounts at 13% or 14%. [566]

A case decided in the Southern District of New York in 2003 (subsequently affirmed by the Second Circuit in an unreported decision) indicates that the Second Circuit may strike a similar balance between the duty to update and routine earnings guidance. In *In re Duane Reade Inc. Securities Litigation*, the court held that Duane Reade did not have a duty to update quarterly sales projections for its non-prescription products before releasing quarterly results of the products' sales performance that did not meet the projections. [567] The district court held that the non-prescription sales projections were immaterial and therefore not subject to a duty to update. [568] Moreover, quoting the Seventh Circuit's decision in *Stransky*, the court stated that a "'company has no duty to update forward-looking statements merely because changing circumstances have proven them wrong.'" [569] The district court, however, did not attempt to harmonize its holding with the Second Circuit's decision in *In re Time*

Warner Inc. Securities Litigation, which suggested in dicta that a duty to update "definite" projections or opinions may arise if intervening events have rendered them misleading. [570] Nor did the district court address Second Circuit precedent, albeit dated, finding earnings projections material. [571] Nevertheless, the Second Circuit has now affirmed the district court decision in *Duane Reade*, although in a nonprecedential, unpublished summary order, and we believe other courts are likely to follow the Third Circuit trend and reject a duty to update routine earnings guidance.

p. 4-148

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p. 4-149

In sum, the case law demonstrates that outside the Seventh Circuit, forward-looking statements may be subject to a duty to update. Generally, this duty applies unless the statements in question are vague or in the nature of puffing, or, as concluded in *Burlington*, *Advanta* and *Duane Reade*, involve routine earnings guidance or similar estimates of future results.

[5] Correcting or Confirming Market Rumors

As described above, under Rule 10b-5 companies generally do not have an obligation to disclose material nonpublic information to either analysts or the public at large. In *State Teachers Retirement Board v. Fluor Corp.*, the Second Circuit held that corporate officials have no duty to correct or verify rumors in the marketplace unless such rumors can be attributed to the company. [572] The test for attribution in the context of market rumors mirrors the test described below in the section on analysts' reports (for example, whether the company has "sufficiently entangled itself" with the disclosure of information giving rise to the rumor). In *Fluor*, the company had been awarded a major contract, and before it publicly released information regarding this contract, its share price and volatility began to increase dramatically. The court held that the company could not be held liable for its decision not to confirm these contract rumors because there had been no evidence linking corporate employees to such rumors and because company officials had refused to respond to inquiries by analysts. [573]

[6] Regulation FD

p. 4-149

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p. 4-150

In August 2000, the SEC adopted rules [574] that prohibit U.S. issuers from selectively disclosing material nonpublic information to market professionals and to securityholders under circumstances in which it is reasonably foreseeable that the holders will trade on the basis of the information. Regulation FD (Fair Disclosure) requires that whenever an issuer intentionally discloses material nonpublic information, it must do so through a general public disclosure, and that whenever an issuer learns that it has made a non-intentional selective disclosure, it must make public disclosure of that information promptly. All U.S. issuers filing periodic reports with the SEC under the Exchange Act are subject to the regulation. Although Regulation FD does not apply to foreign issuers, [575] foreign issuers should continue to avoid selective disclosure of material nonpublic information out of concern for potential liability under Rule 10b-5 and should look to Regulation FD for guidance as a matter of best practice. In fact, many foreign issuers have elected to comply with Regulation FD. [576]

The following are the key provisions of Regulation FD:

- The regulation applies to communications with market professionals (broker-dealers, investment advisers and managers, and investment companies), and with securityholders that will reasonably foreseeably trade on the basis of the disclosed information. [577] It focuses on what the SEC believes to be the core problem—selective disclosure to those who will foreseeably trade on that

  p. 4-150

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  p. 4-151

  information or prompt others to do so. [578] The regulation therefore does not apply to communications with, among others, media representatives, advisers in a relationship of trust or confidence with the issuer (such as legal advisers and investment bankers), employees [579] or government officials. [580]

- The regulation applies to communications by senior officials, officers, employees or agents of the issuer who regularly communicate with market professionals or securityholders. [581]
- The regulation applies to selective disclosures of "material" nonpublic information. [582] "Materiality" is not further defined in Regulation FD and is thus left to the guidance provided by case law and the SEC. [583]

p. 4-151

p. 4-152

- Whenever an issuer makes an "intentional" disclosure of material nonpublic information, simultaneous public disclosure is required. [584] Whenever an issuer learns that it has made a non-intentional selective disclosure, it must make public disclosure of that information "promptly" (in any event, generally within 24 hours).
- Violations of Regulation FD are subject to SEC enforcement actions, but cannot give rise to Rule 10b-5 liability or private causes of action. They also do not result in a loss of short-form registration eligibility or of the Rule 144 resale safe harbor for an issuer's securities.

Public disclosure for purposes of Regulation FD can be made by filing or furnishing a Form 8-K [585] or by disseminating the information through a method or combination of methods that is "reasonably designed to provide broad, non-exclusionary distribution of the information to the public." The most common method is by press release. [586] Posting information to a company website or through social media also may be a sufficient method of public disclosure,

p. 4-152

p. 4-153

depending on the facts and circumstances. [587] If an issuer wishes to make public disclosure of material nonpublic information by means of a conference call, adequate notice must be given, including the date, time, subject matter and dial-in information for the call. [588] Disclosure at a shareholders' meeting, even one that is open to the public, is not sufficient if the meeting is not webcast or broadcast by electronic means, and the mere presence of the press at an otherwise nonpublic meeting does not render the meeting public. [589]

Soon after the adoption of Regulation FD, the Director of the SEC's Division of Enforcement indicated that the SEC would look for egregious violations involving the intentional or reckless disclosure of unquestionably material information, such as those involving earnings, as well as cases against people deliberately attempting to take advantage of the system either by speaking in code or by stepping over the line again and again and therefore diminishing the credibility of any claim that disclosures were non-intentional, noting in particular that "walking the Street up or down is almost certainly prohibited and can no longer be done privately." [590] In 2002, the SEC released its first three enforcement actions [591]

p. 4-153

p. 4-154

and a Section 21(a) investigation report [592] under Regulation FD, and since then has engaged in further enforcement actions from time to time. [593] Since September 2009, the SEC has exhibited a renewed emphasis on enforcement actions. [594]

p. 4-154

p. 4-155

Issuers should take care to monitor their disclosures in all circumstances and use particular care when disseminating information in semi-public or private forums, such as invitation-only conferences, private offering road shows, one-on-one meetings with investors or analysts and even conference calls or webcasts where inadequate or no notice of the event has been given to the public. Moreover, if an issuer believes that analysts require supplemental information about earnings releases or other releases about important business information, that information is probably material and should not be selectively disclosed. The enforcement actions also confirm that the SEC will look to market reaction as an indicator of the materiality of selective disclosure. One significant similarity among the enforcement actions is that visible and in some instances dramatic stock trading price and volume shifts occurred in the aftermath of the selective disclosures, and the

SEC has stated that a very significant market reaction to selectively disclosed information requires public disclosure of that information.

These proceedings are also noteworthy because of their varying penalties. Each of Raytheon and Secure submitted an offer of settlement in anticipation of an enforcement proceeding and agreed to a cease-and-desist order barring it from future violations of Regulation FD and § 13(a) of the Exchange Act. Siebel did

p. 4-155

p. 4-156

the same in the 2002 action and also agreed to pay a fine of $250,000 as part of its settlement. Both Schering-Plough and Richard Kogan, its CEO, also agreed to cease-and-desist orders and to pay fines of $1 million and $50,000, respectively. Office Depot, its CEO and former CFO similarly agreed to cease-and-desist orders; the company also agreed to pay a fine of $1 million, and each executive agreed to a fine of $50,000. Flowserve and its CEO agreed to cease-and-desist orders and fines of $350,000 and $50,000, respectively, and Flowserve's Director of Investor Relations agreed to a cease-and-desist order. Senetek agreed to a cease-and-desist order without admitting or denying the SEC's findings, and, according to the order, the SEC took no action against any individual at Senetek and imposed no monetary penalty because of remedial acts promptly taken by Senetek and the cooperation it provided to the staff. [595] The SEC elected not to bring an enforcement action against Motorola or its senior officials because those officials sought in-house counsel's advice, which, although erroneous, was given in good faith. The SEC cautioned, however, that reliance on counsel may not provide a successful defense in future cases, especially in light of the § 21(a) report issued in connection with the Motorola proceeding, and that the availability of this defense will depend on the facts and circumstances of each case. [596]

p. 4-156

p. 4-157

Then-SEC Commissioner Campos dissented as to the lack of a penalty in the Raytheon and Secure proceedings, while then-SEC Commissioners Glassman and Atkins dissented as to the imposition of the $250,000 penalty against Siebel, and then-Commissioner Atkins dissented as to the imposition of the $1 million penalty against Schering-Plough. Although the SEC does not explain the different approaches, one factor that may have contributed to the penalty in the 2002 Siebel case is that the information selectively disclosed by Siebel's CEO was diametrically opposed to the company's recent public disclosure. This contrasts with the Raytheon case, where the information selectively disclosed was broadly consistent with publicly available information, including Raytheon's results from the previous year. In the Secure case, there were extenuating circumstances, such as the need for a third party's consent before the material nonpublic information could be disclosed to the public. In addition, Secure's management, at least with respect to the initial non-intentional disclosure, immediately sought permission to disclose the information in question, but was unable to do so as a result of Secure's existing confidentiality agreement with the supply agreement counterparty and that counterparty's refusal to allow publication. In *Schering-Plough*, although the information selectively disclosed by the company's CEO was consistent with the company's previous public disclosures, it was materially more definite and clearly intended to talk down Wall Street estimates, which is exactly the type of conduct Regulation FD was adopted to prevent. In *Flowserve*, however, a fine was imposed even though the information shared with the small group of analysts merely reaffirmed earnings guidance that had been publicly disclosed less than four weeks before. [597]

p. 4-157

p. 4-158

Another key development in Regulation FD jurisprudence was the unwillingness of a court in the Southern District of New York to find a violation of Regulation FD in the *Siebel II* proceeding. [598] In 2004, the SEC filed a civil action against Siebel charging the company with violating Regulation FD, as well as the prior cease-and-desist order barring it from future violations of Regulation FD. [599] In its complaint, the SEC alleged that Siebel's CFO disclosed material nonpublic information by issuing positive comments in private meetings about the company's business activity that contrasted with negative public statements made during the prior three weeks. [600] The SEC claimed that these comments led to an increase in Siebel's stock price the following day. Siebel filed a motion to dismiss the suit claiming that the remarks were neither material nor nonpublic and that

Regulation FD unconstitutionally restricts free-speech rights under the First Amendment of the U.S. Constitution because the scope of the regulation extends beyond "commercial speech." After examining the statements in their context, the court dismissed the charges and chided the SEC for what it clearly viewed as an overzealous approach to the enforcement of Regulation FD, stating that the SEC had placed "an unreasonable burden on a company's management and spokespersons to become linguistic experts, or otherwise live in fear of violating Regulation FD should the words they use later be interpreted by the SEC as connoting even the slightest variance from the company's public statements." [601] Significantly, the court held that private statements could vary from prior public statements so long as they were "equivalent in substance." [602] The court also held that movements in stock prices were relevant but not determinative in establishing whether the disclosed information was material or nonpublic. [603]

[7] Developments in Regulation FD and Social Media

p. 4-158

p. 4-159

Over the last decade, the rising popularity of web-based platforms as a medium for companies to communicate and engage with public audiences has presented new challenges for regulators and companies alike in determining whether such communications comply with Regulation FD.

In 2008, the SEC issued guidance providing non-exclusive factors for companies to consider in evaluating whether disclosure made on a website is compliant with Regulation FD. [604] In particular, an issuer should consider whether: (1) its website is a recognized channel of distribution; (2) posting of information on its website disseminates the information in a manner making it available to the securities marketplace in general; and (3) there is a reasonable waiting period for investors and the market to react to the posted information.

[a] SEC Social Media Guidance

The 2008 guidance did not address the use of social media channels, and in the years following the 2008 guidance, the SEC and its staff stayed largely silent on the implications of Regulation FD on disclosure made through social media. In December 2012, however, Netflix and its CEO, Reed Hastings, each received a notice from the SEC staff indicating the staff's intent to recommend that the SEC institute cease-and-desist proceedings or bring a civil injunctive action against Netflix and Mr. Hastings for violations of Regulation FD. [605] The notice followed a post by Mr. Hastings on his public Facebook page announcing a milestone in Netflix's streaming content, despite the fact that Mr. Hastings' post reached more than 200,000 followers and provided information that was in line with prior guidance.

On April 2, 2013, the SEC announced its decision not to proceed further in the Netflix matter and issued a report of investigation that builds on its 2008 guidance. [606] The new guidance clarifies that a company and its employees may use social media to report material information without violating Regulation FD, so long as two conditions are met. First, a social media channel used for this purpose must be a "recognized channel of distribution" within the meaning of the

p. 4-159

p. 4-160

2008 guidance. [607] Second, the company must alert the market to the channels used and the information it may disclose using them. Since the issuance of the SEC's report of investigation in April 2013, a number of companies have disclosed on their websites and in their press releases and periodic reports that they or their executives may use social media to disseminate material information for Regulation FD compliance, and listed specific social media channels they intend to use.

Companies that wish to use social media channels to communicate material information should consider taking the following steps to ensure compliance with Regulation FD:

[i] *Alert the Market with Specific Details*

Companies should alert the market well in advance of their intention to use specified social media to disseminate company news, through press releases, periodic reports or prominent postings on their company websites. This notice should include specific details of the social media channels that may be used, such as the account name, the URL or the specific webpage. Once the company has identified the specific social media channels it intends to use, it should continue to identify these channels regularly as part of periodic reports and press releases and on its investor relations page. Companies should also disclose the kind of information that will be communicated through the designated channels, including, for example, expectations that a company will tweet its earnings or that its key executives may comment on company developments using the designated channels.

[ii] *Exercise Caution if Personal Social Media Channels Are Used*

p. 4-160
p. 4-161

The SEC report clarifies that personal social media channels, such as the Netflix CEO's Facebook page, are unlikely to qualify as Regulation FD-compliant means of disseminating information absent prior notice. As in the case of its own channels, the company should include a specific identification of the URL, Twitter handle or the like for any personal social media that may be used.

[iii] *Select Appropriate Social Media Channels, and Use Them*

Companies should keep in mind that the SEC's 2008 guidance also addressed the accessibility of information after posting, such as whether it will be picked up by the media. Based on its report in the Netflix matter, the SEC appears to acknowledge Facebook and Twitter as appropriate media for public disclosure under Regulation FD; companies that choose other channels should pay particular attention to whether those channels would be widely followed. In the case of personal social media channels, the company should ensure that the individual applies site settings that permit maximum accessibility to the public. The SEC's 2008 guidance also relied on whether the company has a pattern or practice of using its website for company disclosures, and it is likewise important that companies in fact use the social media channels they establish for these purposes, to create the kind of investor and media following the SEC expects.

[iv] *Consider Whether Other Concurrent Means of Dissemination May Be Appropriate*

In some cases, it may be prudent for companies to couple publication of information via social media channels with more traditional means of communication, such as a press release or current report, to ensure broad public dissemination. Whether this is desirable will depend mainly on the significance of the information, the length of time the company or individual has been using the channel in question and the breadth of exposure the company in fact achieves through that channel. For matters identified as "material information" in applicable listing standards, [608] such as changes in executive leadership and the announcement of quarterly or annual results, we expect most companies will continue to rely on concurrent press releases.

[v] *Review Communications and Social Media Policies and Training Materials*

p. 4-161
p. 4-162

The SEC's new guidance presents a good opportunity to review internal policies on communications and social media. In particular, if personal social media channels may be used, the sanctioned channels should be identified in the company's communications policy. [609] A determination that no designated spokesperson may use personal social media to disclose company information should likewise be memorialized in the communications policy. Companies should also review their existing employee guidance about responsible use of personal social media. [610] Companies should develop rules for re-tweeting, sharing on Facebook or otherwise endorsing external media regarding the company, and develop a contingency plan to mitigate the risk of hacking or information leaks.

[vi] *Comply with Other Communications Rules and Safe Harbors*

Companies should ensure that disclosures made through social media channels comply with other communications rules and safe harbors under the U.S. federal securities laws. Some of those provisions require that dissemination of specific types of information be accompanied by prescribed legends; [611] others provide safe harbors whereby the disseminated information will not violate other rules if appropriately legended. [612] It may be impractical or impossible to meet these requirements using some social media channels that limit the length of

p. 4-162

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p. 4-163

postings. Some commenters have suggested using abbreviated legends or links to long-form legends or other required information in these cases, and this currently appears to be the majority approach. It is unclear, however, whether these links would satisfy the relevant rules, and pending further SEC guidance, companies should proceed with caution.

[vii] *Implement Appropriate Disclosure Controls and Procedures*

Finally, companies should continue to ensure that their Exchange Act reports are materially accurate and complete. Companies should have disclosure controls and procedures in place to evaluate whether certain disclosures through social media channels, such as tweets about previously unannounced preliminary quarterly or annual financial results, must also be reflected concurrently in their periodic or current reports. Companies should also be mindful that social media communications remain subject to the antifraud provisions of the federal securities laws. In particular, companies should consider how social media communications may alter the "total mix" of information that is publicly available about them, and educate authorized users of personal social media about the importance of balance and the avoidance of cherry-picking in company communications.

[8] Selective Disclosure to Analysts and Measures to Avoid Rule 10b-5 Liability

Aside from Regulation FD, liability for selective disclosure has been based on the principles of securities fraud, particularly the law of insider trading. Under some early insider trading case law, which appeared to require that traders have equal access to corporate information, selective disclosure of material information to securities analysts could generally give rise to liability.

This understanding changed with the Supreme Court's landmark decisions in *Chiarella v. United States* [613] and *Dirks v. SEC*. [614] In *Chiarella*, the Court rejected the "parity of information" approach, which deemed trading to be fraudulent whenever the trader possessed material information not generally available to the public. The Court instead held that there must be a breach of a fiduciary duty or other relationship of trust and confidence before the law imposes a duty to disclose information or abstain from trading. [615]

p. 4-163

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p. 4-164

In *Dirks*, the Supreme Court addressed the disclosure, or "tipping," of material nonpublic information by an insider to an analyst and disclosure by that analyst to its clients. The Court rejected the idea that a person is prohibited from trading whenever he or she knowingly receives material nonpublic information from an insider. Instead, it stated that a recipient of inside information is prohibited from trading only when the information has been made available to him or her "improperly"—that is, in breach of the insider's fiduciary duty to shareholders—and the recipient knew or should have known of that breach. Whether a breach of duty occurs depends on whether the insider receives a direct or indirect "personal benefit" from the disclosure. The Court explained that insiders derive a personal benefit when, for instance, they make a "quid pro quo exchange" for the tip or "gift the confidential information to a trading relative or friend." [616] Because the corporate insider who provided the information to Dirks received no personal benefit (and in fact sought to expose a fraud by disclosing the information), the Court concluded that there was no breach of duty.

The *Dirks* decision was widely construed as providing considerable latitude to insiders who made selective disclosure to analysts, and to the analysts (and their clients) who received selectively disclosed information and acted on it. Commentators interpreted the "personal benefit" requirement to involve primarily a pecuniary gain, and many corporate insiders took comfort in the fact that absent a financial reward, the *Dirks* personal benefit test would seem to insulate them from liability.

There has been surprisingly little testing since *Dirks* of the limits of the personal benefit test in the context of alleged selective disclosure to analysts. [617] In one controversial case, *SEC v. Stevens*, the SEC alleged that a corporate CEO, before making a general release to the public, had disclosed information regarding disappointing revenues to certain analysts and told them that earnings, therefore, might be lower than expected. [618] The SEC further maintained that the CEO had made such disclosures in an effort to enhance his reputation within the investment community. In settling with the SEC, the CEO agreed to pay $126,455, representing the amount of losses avoided by those shareholders who sold the company's stock prior to the eventual public announcement of such financial information. The danger of the SEC's broad interpretation of "reputational benefit" in *Stevens* is that virtually all selective disclosure to the investment community is likely to have been made to some extent on the basis

p. 4-164

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p. 4-165

of self-interest. Thus, any executive, even one who believes he or she is mainly serving the corporation's interests, may be charged with deriving a "reputational benefit" when he or she communicates with analysts.

The *Stevens* case has proven to be something of an anomaly. It is the only post- *Dirks* insider trading case ever brought by the SEC based on selective disclosure to, or trading by, securities analysts or their clients. Indeed, the SEC's recognition of the difficulties it faced in proving "personal benefit" led to its decision to adopt Regulation FD and abandon exclusive reliance on Rule 10b-5 to regulate selective disclosure to analysts. Even though Regulation FD does not apply to foreign issuers, inherent uncertainties about the scope of Rule 10b-5 and the *Stevens* case have led many advisers to conclude that whenever material nonpublic information is disclosed to analysts, it should be publicly disclosed at the same time. [619]

Companies can take a number of measures to avoid the selective disclosure of material nonpublic information to analysts. Permitting the public to listen to a call with analysts, whether by a dial-in procedure or a webcast, will make any disclosures made during the call nonselective, provided adequate notice of the call is publicly given. [620] In addition, U.S. companies can make disclosure nonselective by furnishing the relevant information on a Form 8-K pursuant to Item 7.01 of that form, titled "Regulation FD Disclosure." [621] Foreign companies are similarly able to make disclosure nonselective by furnishing the relevant information on a Form 6-K.

Any selective presentations to analysts should be scripted and reviewed prior to the meeting, both by officials personally familiar with the issues to be

p. 4-165

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p. 4-166

raised, as well as by counsel, to reduce the likelihood of the disclosure of material information. Furthermore, it generally would be advisable to place responsibility for such presentations upon a limited number of officials within the company, enabling them to develop the sophistication to deal effectively with this matter. Finally, if the company anticipates that a sensitive issue will most likely be raised by an analyst during a meeting, it might be advisable for the corporate official to state diplomatically near the beginning of the presentation that he or she is not at liberty to discuss the issue. Because a company generally does not have a duty to disclose material nonpublic information, a "no comment" position is permissible. The Supreme Court in *Basic Inc. v. Levinson* noted that silence is not misleading under Rule 10b-5 absent a duty to disclose and that "‘[n]o comment’ statements are generally the functional equivalent of silence." [622]

Although the consequences of selective disclosure of material information can be serious, the federal judiciary and the SEC, as well as the NYSE and Nasdaq, have recognized that inadvertent disclosures may arise. In the event of any allegation of intentional selective disclosure, procedures to avoid disclosure of material information (such as those described above) can provide useful support for the position that any such disclosure that did occur was inadvertent. If such an inadvertent disclosure were to occur, the company should immediately prepare and disseminate broadly to the investing public a press release of such information [623] and should request that the analysts to whom the disclosure was made maintain confidentiality pending such release. [624]

p. 4-166

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p. 4-167

The preceding discussion regarding potential liability for selective disclosure of material information under Rule 10b-5 produces a corollary principle: management should generally avoid giving favored treatment to particular analysts either in the timing of disclosures or in the frequency of granting interviews. In *SEC v. Geon Industries, Inc.*, a company official was accused of tipping a particular analyst about a planned merger involving the company. [625] The Second Circuit could find no direct evidence that the official had leaked information of the impending merger to the analyst. Nevertheless, the court concluded that such a "tipping" had occurred based on the evidence that the official spoke often with the analyst, "lunched with [him] alone, something [the official] did with no other broker, accepted two bottles of liquor [the analyst] sent him following this lunch, and honored one of the [the analyst's] telephone messages by a return call from home." [626] The court also emphasized that the analyst had made a number of trades in Geon stock following such conversations and meetings. The *Geon* case was decided before *Dirks* and, thus, does not represent a finding of liability on the more limited basis now required by the Supreme Court in *Dirks*.

Footnotes

513 Professional associations representing public companies and analysts also made an effort to shape the parameters of the relationship between these parties. In 2004, the CFA Centre for Financial Market Integrity and the National Investor Relations Institute adopted best-practice guidelines to govern the relationship between corporate issuers and the securities analysts who cover them. *See* CFA Centre for Financial Market Integrity/National Investor Relations Institute, BEST PRACTICE GUIDELINES GOVERNING THE ANALYST/CORPORATE ISSUER RELATIONS (2004). The guidelines address: (i) information flow between analysts and issuers, (ii) analysts' conduct in preparing and publishing research reports and making investment recommendations, (iii) issuers' conduct in providing analysts with access to corporate management, (iv) review of analyst reports by issuers and (v) research that is solicited, paid for or sponsored by the issuer.

514 Selective Disclosure and Insider Trading, SEC Release No. 33-7881 (Aug. 15, 2000); *see* § 4.10[6].

515 *See SEC v. Stevens*, SEC Litigation Release No. 12813 (Mar. 19, 1991), discussed below.

516 Rule 101(b) of Regulation FD provides that both foreign governments and foreign private issuers, as those terms are defined in Rule 405 of the Securities Act, are not considered issuers for the purpose of Regulation FD. Under Rule 405, a foreign private issuer is defined as any foreign issuer, other than a foreign government, except an issuer meeting the following conditions as of the last business day of its most recently completed second quarter: (i) more than 50% of the outstanding voting securities of such issuer are directly or indirectly owned of record by United States residents, and (ii) any of the following: (a) the majority of the executive officers or directors are United States citizens or residents, (b) more than 50% of the assets of the issuer are located in the United States or (c) the business of the issuer is administered principally in the United States.

517 *See United States v. O'Hagan*, 521 U.S. 642, 650–52 (1997); *Dirks v. SEC*, 463 U.S. 646 (1983); *Chiarella v. United States*, 445 U.S. 222 (1980). One recent series of court decisions has created some uncertainty on the precise circumstances in which insider trading liability may be found. The District Court for the Northern District of Texas held that absent a fiduciary (or fiduciary-like) relationship, liability under the misappropriation theory requires not just an agreement not to disclose material nonpublic information, but also an agreement not to trade. *SEC v. Cuban*, 634 F. Supp. 2d 713 (N.D. Tex. 2009). On appeal, the U.S.

Court of Appeals for the Fifth Circuit agreed with the SEC's argument that even in the absence of an express agreement not to trade on material nonpublic information, a party that agrees to keep information confidential may be liable for insider trading where there is an implied understanding that trades will not be made based upon the information. *SEC v. Cuban*, 620 F.3d 551 (5th Cir. 2010). On remand, the District Court denied the defendant's motion for summary judgment, holding that there was sufficient evidence to enable a reasonable jury to find that the defendant implicitly agreed not to disclose material nonpublic information or trade on that information. *SEC v. Cuban*, Civ. Action No. 3:08-CV-2050-D, 2013 WL 791405 (N.D. Tex. 2013). Although a federal jury ultimately found the defendant not liable for insider trading, we believe other courts are likely to look to the arguments made in the *Cuban* line of cases when analyzing liability under the misappropriation theory. *See* SEC Litigation Release No. 22855 (Oct. 23, 2013); *see also* SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Regulation FD, Question 101.05 (Aug. 14, 2009) (SEC staff expressing the view that a recipient of material nonpublic information subject to an express confidentiality agreement who trades or advises others to trade could face insider trading liability). In addition, in *SEC v. Dorozhko*, 574 F.3d 42 (2d Cir. 2009), the Second Circuit held that insider trading liability could be found where a hacker traded on the basis of material nonpublic information acquired through electronic theft, even though there was no breach of fiduciary duty. *See also* § 11.10[3]; *Morrison v. National Australian Bank*, 130 S. Ct. 2869 (2010) (where a "transactional test" was introduced to establish whether a foreign claimant could bring a private right of action under § 10(b) of the Exchange Act).

518 *See Cooperman v. Individual, Inc.*, 171 F.3d 43, 49 (1st Cir. 1999); *see also Shaw v. Digital Equipment Corp.*, 82 F.3d 1194, 1202 (1st Cir. 1996) (recognizing that "the mere possession of material nonpublic information does not create a duty to disclose it"). Despite the lack of disclosure obligations generally under Rule 10b-5, the courts have found an obligation to disclose material nonpublic information (i) when the corporation or a corporate insider trades on confidential information, (ii) when a corporation has made inaccurate, incomplete or misleading disclosure or (iii) when a statute or regulation requires disclosure. *See Backman v. Polaroid Corp.*, 910 F.2d 10, 20 (1st Cir. 1990) (*en banc*).

Although a corporation under, for example, Delaware law has a fiduciary duty to holders of its common stock and, under certain circumstances, holders of its preferred stock, it generally has no fiduciary duty to its creditors, which include holders of debt securities, whether they be straight debt or convertible debt, or warrants to purchase equity securities. *See Lorenz v. CSX Corp.*, 1 F.3d 1406, 1417 (3d Cir. 1993); *Page Mill Asset Management. v. Credit Suisse First Boston Corp.*, No. 98 Civ. 6907, 2000 WL 335557, at *11 (S.D.N.Y. Mar. 30, 2000) (citing *Parkinson v. West End Street Railway*, 173 Mass. 446, 53 N.E. 891, 892 (1899) (Holmes, J.)). Thus, as the court found in *Alexandra Global*, "[b]ecause IKON owed no such fiduciary or other analogous duty to its convertible noteholders, it follows that IKON had no duty to disclose its alleged unpublicized intentions to exercise its redemption rights at a date in the future [notwithstanding that IKON's redemption rights were at a premium and IKON was purchasing its debt from a holder at a discount]." *Alexandra Global Master Fund, Ltd. v. IKON Office Solutions, Inc.*, No. 06 Civ. 5383 (JGK), 2007 WL 2077153, at *8 (S.D.N.Y. July 20, 2007).

We note that other countries may require disclosure of material information if such information would be deemed to affect the price of a company's listed securities. *See*, *e.g.*, Entertainment Rights plc, Financial Services Authority Final Notice (Jan.19, 2009) (fining U.K. company for violation of the UK Listing Authority's Disclosure and Transparency Rule 2.2.1, which generally requires disclosure of "any inside information which directly concerns the issuer").

519 Rule 10b-5(b) under the Exchange Act.

520 The SEC staff has made clear, in the context of Regulation FD, that the disclosure of material nonpublic information at a shareholders' meeting does not constitute public disclosure even if the meeting is open to the public, but is not otherwise webcast or broadcast by any electronic means. SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Regulation FD, Question 102.05 (June 4, 2010). However, disclosure through an Exchange Act filing may constitute public disclosure so long as the issuer has brought the disclosure to the attention of the readers of the filing. SEC, Division of Corporation Finance,

Compliance and Disclosure Interpretations, Regulation FD, Question 102.02 (June 4, 2010).

521 These methods include, *e.g.*, filing a Form 8-K (or, presumably for foreign issuers, a Form 6-K), distributing a press release through a widely circulated news or wire service, holding a press conference to which the public is granted access or posting the information on a company website or Regulation FD-compliant social media platform. *See* § 4.10[7] for a discussion of developments in Regulation FD and social media.

522 NYSE LISTED COMPANY MANUAL §§ 202.01, 202.05 (stating the general rule that "a listed company is expected to release quickly to the public any news or information which might reasonably be expected to materially affect the market for its securities" but outlining circumstances, such as negotiations leading to mergers and acquisitions or arrangements preparatory to an exchange or tender offer, under which "premature public announcement may properly be avoided"); NASDAQ Marketplace Rules, 5250(b)(1), NASDAQ Manual ("Except in unusual circumstances, a Nasdaq-listed Company shall make prompt disclosure to the public through any Regulation FD compliant method (or combination of methods) of disclosure of any material information that would reasonably be expected to affect the value of its securities or influence investors' decisions."). Although the NYSE amended its immediate release policy in May 2009 to allow an issuer to use any method of disclosure allowed by Regulation FD (an approach that matches Nasdaq's), rather than to require exclusively the use of a press release, the NYSE's amended rule continues to "encourage" issuers to use press releases. SEC Release No. 34-59823 (Apr. 27, 2009); NYSE LISTED COMPANY MANUAL § 202.06. While foreign issuers are not required to comply with Regulation FD, NYSE LISTED COMPANY MANUAL § 202.06 requires foreign issuers listed on the NYSE to comply with the timely alert policy set forth in § 202.05 by any method (or combination of methods) allowed by Regulation FD for a domestic U.S. issuer. NYSE LISTED COMPANY MANUAL § 202.06.

523 The NYSE requires issuers to notify the NYSE in advance if news of a material event or a statement dealing with a rumor is released shortly before the opening of or during market hours. NYSE LISTED COMPANY MANUAL §§ 202.03, 202.05, 202.06. Similarly, Nasdaq requires issuers to notify Nasdaq prior to the public announcement of certain specified information during Nasdaq market hours. For these purposes, the NYSE currently requires at least ten minutes' advance notification of any announcement between the hours of 7:00 A.M. and 4:00 P.M., New York time, and Nasdaq currently requires advance notification of any announcement made between 7:00 A.M. and 8:00 P.M., New York time (with notification required by 6:50 A.M., New York time, on the next trading day if announcements are made after 8:00 P.M. or on days the market is closed). NASDAQ Marketplace Rules, IM-5250-1, NASDAQ MANUAL. Advance notification must be provided to Nasdaq prior to announcing news relating to: (i) company financials, such as earnings announcements, (ii) reorganizations and acquisitions, (iii) developments regarding products, customers or suppliers, (iv) management changes, (v) resignation or termination of auditors, (vi) defaults on securities or securities redemption or repurchase plans, (vii) significant legal or regulatory developments or (viii) events requiring the filing of a Form 8-K. NASDAQ Marketplace Rules 5250(b)(1), IM-5250-1, NASDAQ MANUAL.

524 *State Teachers Retirement Board v. Fluor Corp.*, 654 F.2d 843, 852 (2d Cir. 1981).

525 *State Teachers Retirement Board v. Fluor Corp.*, 654 F.2d 843, 852–53 (2d Cir. 1981); *accord In re Verifone Securities Litigation*, 11 F.3d 865, 870 (9th Cir. 1993) ("We decline to hold that a violation of exchange rules governing disclosure may be imported as a surrogate for straight materiality analysis under § 10(b) and Rule 10b-5.").

526 *See In re Sony Corporation*, SEC Release No. 34-40305 (Aug. 5, 1998) (SEC found that Sony failed to identify greater than anticipated losses at Sony Pictures and to discuss a "known trend" involving cumulative losses of more than $1 billion); *see also SEC v. Sony Corp.*, SEC Litigation Release No. 15832 (Aug. 5, 1998) (proceeding against the individual Sony officer responsible for disclosure matters). *See also SEC v. BP*, SEC Litigation Release No. 22531 (Nov. 15, 2012) (BP fined $525 million for misleading investors by significantly understating oil flow rates during the 2010 oil spill on three separate Forms 6-K; BP stated that the flow rate was estimated to be 5,000 barrels of oil per day despite its own internal data that indicated potential flow rates could be as high as 146,000 barrels of oil per day).

527 *See supra* Note 27.

528 *Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988) (internal quotation omitted).

529 *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968) (*en banc*), *cert. denied sub nom. Coates v. SEC*, 394 U.S. 976 (1969).

530 *Azrielli v. Cohen Law Offices*, 21 F.3d 512, 518 (2d Cir. 1994).

531 In *Ganino v. Citizens Utilities Co.*, the Second Circuit relied on *Basic Inc. v. Levinson* and SEC Staff Accounting Bulletin No. 99 in declining to hold immaterial as a matter of law misstatements regarding revenue recognition because the revenue in question amounted to only 1.7% of the defendant's total revenue for the year. *Ganino v. Citizens Utilities Co.*, 228 F.3d 154 (2d Cir. 2000). The court rejected a bright-line test for materiality, emphasizing that materiality judgments must be made in the context of all relevant facts and circumstances. *Ganino v. Citizens Utilities Co.*, 228 F.3d 154, 165 (2d Cir. 2000).

532 SEC, Staff Accounting Bulletin No. 99 (Aug. 12, 1999), Fed. Sec. L. Rep. (CCH) ¶75,563. For example, improper revenue recognition designed to ensure earnings do not fall outside the range of analysts' expectations could be material even if the effect were only one or two cents a share.

533 In both *SEC v. Bausch & Lomb, Inc.*, 565 F.2d 8, 14–15 (2d Cir. 1977), and *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 163–67 (2d Cir. 1980), the Second Circuit found earnings projections to be material. The award of a significant supply contract would also most likely constitute material information. In *State Teachers Retirement Board v. Fluor Corp.*, for example, the Second Circuit held that management's selective disclosure to an analyst regarding the "imminence" of being awarded a major contract could generate liability under Rule 10b-5. *State Teachers Retirement Board v. Fluor Corp.*, 654 F.2d 843, 854 (2d Cir. 1981). The court also noted that even the mere decision to bid on this billion dollar project would represent significant information to the reasonable investor. While the court in *Fluor* noted that the award of a major contract and the decision to bid on a large project could constitute material information, the court nevertheless found that the company's actions did not violate Rule 10b-5, as discussed in more detail below. On remand, the district court further held that capital expenditure projections could be considered material. *State Teachers Retirement Board v. Fluor Corp.*, 566 F. Supp. 945, 950 (S.D.N.Y. 1982).

534 The list of additional events the SEC requires issuers to disclose on Form 8-K is also representative of presumptively material events. *See supra* Note 27.

535 *Raab v. General Physics Corp.*, 4 F.3d 286, 289 (4th Cir. 1993); *accord Lasker v. New York State Electric & Gas Corp.*, 85 F.3d 55, 59 (2d Cir. 1996) (per curiam) (observing that "broad, general statements" are "precisely the type of 'puffery' that this and other circuits have consistently held to be inactionable"); *San Leandro Emergency Medical Group Profit Sharing Plan v. Philip Morris Cos.*, 75 F.3d 801, 807, 811 (2d Cir. 1996) (holding that company statement that "[w]e expect 1993 to mark another year of strong growth in earnings per share" constituted inactionable puffery); *see also In re K-tel International, Inc. Securities Litigation*, 300 F.3d 881, 897 (8th Cir. 2002) (stating that "[i]mmaterial statements include vague, soft, puffing statements").

536 *Omnicare, Inc. v. Laborers Dist. Council Const. Indus. Pension Fund*, 135 S. Ct. 1318 (2015). *See also Tongue v. Sanofi*, 816 F.3d 199 (2d Cir. 2016). For further discussion of *Omnicare* and *Sanofi*, *see* § 11.03[1][C].

537 *See Longman v. Food Lion, Inc.*, 197 F.3d 675, 685–86 (4th Cir. 1999), *cert. denied*, 529 U.S. 1067 (2000).

538 SEC Release No. 34-43154 (Aug. 15, 2000).

539 The Supreme Court has rejected a bright-line rule for materiality in the securities offering context, observing that the test for materiality required an assessment as to whether there is a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available. *See Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309 (2011).

540 To prevail under Rule 10b-5 in private causes of action alleging material misrepresentation or omission, the plaintiff must also prove reliance upon such misleading disclosure. *See Basic Inc. v. Levinson*, 485 U.S. 224, 243 (1988) (holding that "reliance is an element of a Rule 10b-5 cause of action.…Reliance provides

the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury"). *See* § 11.04[2].

541 SEC Release No. 34-22214 (July 8, 1985).

542 SEC Release No. 34-43372 (Sept. 28, 2000).

543 *See*, *e.g.*, *Stransky v. Cummins Engine Co.*, 51 F.3d 1329, 1331 (7th Cir. 1995) (stating that the duty to correct is often confused with the duty to update and that the "former applies when a company makes a historical statement that, at the time made, the company believed to be true, but as revealed by subsequently discovered information actually was not. The company then must correct the prior statement within a reasonable time."); *Backman v. Polaroid Corp.*, 910 F.2d 10, 16–17 (1st Cir. 1990). While the duty to correct generally applies only to statements of historical fact, it may also apply to forward-looking statements if they are based on historical facts that a company later discovers were incorrect. *See In re Burlington Coat Factory Securities Litigation*, 114 F.3d 1410, 1431 (3d Cir. 1997).

544 *See In re International Business Machines Corp. Securities Litigation*, 163 F.3d 102, 110 (2d Cir. 1998); *Weiner v. Quaker Oats Co.*, 129 F.3d 310, 316 (3d Cir. 1997); *Backman v. Polaroid Corp.*, 910 F.2d 10, 16–17 (1st Cir. 1990); *Greenfield v. Heublein, Inc.*, 742 F.2d 751, 758 (3d Cir. 1984), *cert. denied*, 469 U.S. 1215 (1985). *But see Gallagher v. Abbott Laboratories*, 269 F.3d 806, 810-11 (7th Cir. 2001) (reasoning duty to update would undermine purpose of periodic reporting regime); *Stransky v. Cummins Engine Co.*, 51 F.3d 1329, 1332 (holding no duty to update forward-looking statements that become untrue because of subsequent events).

545 *See*, *e.g.*, *Hillson Partners Ltd. Partnership v. Adage, Inc.*, 42 F.3d 204, 219 n.13 (4th Cir. 1994); *Rubinstein v. Collins*, 20 F.3d 160, 170 n.41 (5th Cir. 1994).

546 *See*, *e.g.*, *Helwig v. Vencor, Inc.*, 251 F.3d 540, 561 n.6 (6th Cir. 2001) (*en banc*), *cert. denied*, 536 U.S. 935 (2002); *In re Yahoo! Inc. Securities Litigation*, No. C 11–02732 CRB, 2012 WL 3282819 (N.D. Cal. Aug. 10, 2012).

547 *In re Healthco International Inc. Securities Litigation*, 777 F. Supp. 109, 113 (D. Mass. 1991); *accord In re Burlington Coat Factory Securities Litigation*, 114 F.3d 1410, 1432 (3d Cir. 1997); *Kowal v. MCI Communications Corp.*, 16 F.3d 1271, 1276–77 (D.C. Cir. 1994); *Friedman v. Mohasco Corp.*, 929 F.2d 77, 79 (2d Cir. 1991). The law is clear, however, that statements of opinion by top corporate officials may be actionable if made without a reasonable basis, *see Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1093–94 (1991), or if they are not made in good faith, *see Kowal v. MCI Communications Corp.*, 16 F.3d 1271, 1277 (D.C. Cir. 1994).

548 *See*, *e.g.*, *Oran v. Stafford*, 226 F.3d 275, 286 (3d Cir. 2000); *Weiner v. Quaker Oats Co.*, 129 F.3d 310, 321 (3d Cir. 1997).

549 *McCarthy v. C-COR Electronics, Inc.*, 909 F. Supp. 970 (E.D. Pa. 1995).

550 *McCarthy v. C-COR Electronics, Inc.*, 909 F. Supp. 970, 977 (E.D. Pa. 1995).

551 *McCarthy v. C-COR Electronics, Inc.*, 909 F. Supp. 970, 977 (E.D. Pa. 1995).

552 *Backman v. Polaroid Corp.*, 910 F.2d 10 (1st Cir. 1990).

553 *Backman v. Polaroid Corp.*, 910 F.2d 10, 17 (1st Cir. 1990).

554 *Backman v. Polaroid Corp.*, 910 F.2d 10, 17 (1st Cir. 1990).

555 *In re Time Warner Inc. Securities Litigation*, 9 F.3d 259 (2d Cir. 1993), *cert. denied*, 511 U.S. 1017 (1994).

556 *In re Time Warner Inc. Securities Litigation*, 9 F.3d 259, 267–68 (2d Cir. 1993), *cert. denied*, 511 U.S. 1017 (1994).

557 In a 2010 nonprecedential summary order, the Second Circuit provided a specific example of an affirmative duty to update. The defendant had stated in a press release and on a conference call that it expected to amend a material agreement with a key customer in order to cure an on-going breach, but it subsequently became clear that the customer would not agree to amend. The company's officials failed to disclose that information to the market and later made misleading public statements about the status of the negotiations.

The Second Circuit determined that although the press release contained sufficient cautionary language to negate liability under the "bespeaks caution" doctrine, the conference call statements were made without adequately alerting investors to the risks involved and were therefore not eligible for protection by that doctrine. Moreover, the court found that the company could not use the defense that its misstatements of fact about the failed negotiations were forward-looking statements, even if they were accompanied by cautionary language. *Illinois State Board of Investment v. Authentidate Holding Corp.*, No. 09 Civ. 1751, 2010 WL 889294 (2d Cir. 2010). *See* § 11.03[1][c] for a discussion of forward-looking statements and the "bespeaks caution" doctrine.

558 *See Weiner v. Quaker Oats Co.*, 129 F.3d 310 (3d Cir. 1997).

559 *Weiner v. Quaker Oats Co.*, 129 F.3d 310, 314–18 (3d Cir. 1997). Although the court in *Weiner* discusses the company's duty to update the forward-looking debt-to-equity ratio guideline when it became unreliable, at other points it suggests that the duty may be limited to not repeating a forward-looking statement that has become unreliable. *Weiner v. Quaker Oats Co.*, 129 F.3d 310, 317, 320 n.11 (3d Cir. 1997). On remand, the district court denied the defendants' motion to dismiss, concluding that the company had a "duty to update" its debt-to-equity ratio guideline. *Weiner v. Quaker Oats Co.*, No. 98 C 3123, 2000 WL 1700136, at *11 (N.D. Ill. Nov. 13, 2000).

560 *Weiner v. Quaker Oats Co.*, 129 F.3d 310, 313 (3d Cir. 1997).

561 *Stransky v. Cummins Engine Co.*, 51 F.3d 1329 (7th Cir. 1995).

562 *Stransky v. Cummins Engine Co*., 51 F.3d 1329, 1332 (7th Cir. 1995); *accord Higginbotham v. Baxter International Inc*., 495 F.3d 753, 760 (7th Cir. 2007); *Gallagher v. Abbott Laboratories*, 269 F.3d 806, 810–11 (7th Cir. 2001); *see also Eisenstadt v. Centel Corp*., 113 F.3d 738, 746 (7th Cir. 1997) (observing that no legal duty exists in the Seventh Circuit to revise predictions that subsequent events prove incorrect).

563 The SEC staff has stated, however, that Regulation FD did not change existing law with respect to any duty to update. SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Regulation FD, Question 101.02 (June 4, 2010).

564 *In re Burlington Coat Factory Securities Litigation*, 114 F.3d 1410, 1433 (3d Cir. 1997).

565 The court attempted to distinguish its holding from earlier decisions involving the duty to update, which the court characterized as relating to a potential fundamental change to a company's business. *In re Burlington Coat Factory Securities Litigation*, 114 F.3d 1410, 1433 (3d Cir. 1997).

566 *In re Advanta Corp. Securities Litigation*, 180 F.3d 525, 536 (3d Cir. 1999) (citing *In re Burlington Coat Factory Securities Litigation*, 114 F.3d 1410, 1433 (3d Cir. 1997)) ("[T]he voluntary disclosure of an ordinary earnings forecast does not trigger any duty to update."). *See generally In re Verity, Inc. Securities Litigation*, No. C99-5337CRB, 2000 WL 1175580, at *5 (N.D. Cal. Aug. 11, 2000) (discussing cases regarding duty to update disclosure).

567 *In re Duane Reade Inc. Securities Litigation*, No. 02 Civ. 6478(NRB), 2003 WL 22801416, at *7 (S.D.N.Y. Nov. 25, 2003), *aff'd sub nom. Nardoff v. Duane Reade, Inc.*, 107 F. App'x 250 (2d Cir. 2004).

568 *In re Duane Reade Inc. Securities Litigation*, No. 02 Civ. 6478(NRB), 2003 WL 22801416, at *7 (S.D.N.Y. Nov. 25, 2003), *aff'd sub nom. Nardoff v. Duane Reade, Inc.*, 107 F. App'x 250 (2d Cir. 2004).

569 *In re Duane Reade Inc. Securities Litigation*, No. 02 Civ. 6478(NRB), 2003 WL 22801416, at *7 (S.D.N.Y. Nov. 25, 2003), *aff'd sub nom. Nardoff v. Duane Reade, Inc.*, 107 F. App'x 250 (2d Cir. 2004) (quoting *Stransky v. Cummins Engine Co.*, 51 F.3d 1329, 1333 n.9 (7th Cir. 1995)).

570 *In re Time Warner Inc. Securities Litigation*, 9 F.3d 259, 267 (2d Cir. 1993) (holding that company's hopeful statements regarding strategic alliances "lack[ed] the sort of definite positive projections that might require later correction").

571 *See Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 164 n.12 (2d Cir.1980) ("Liability may follow where management intentionally fosters a mistaken belief concerning a material fact, such as its evaluation of the company's progress and earnings prospects."); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968) ("[M]aterial facts include … information disclosing the earnings and distributions of a company.").

572 *State Teachers Retirement Board v. Fluor Corp.*, 654 F.2d 843, 850 (2d Cir. 1981); *accord Electronic Specialty Co. v. International Controls Corp.*, 409 F.2d 937, 949 (2d Cir. 1969) ("While a company may choose to correct a misstatement in the press not attributable to it, … we find nothing in the securities legislation requiring it to do so."); *see also Eisenstadt v. Centel Corp.*, 113 F.3d 738, 744 (7th Cir. 1997) (noting that "a corporation has no duty to correct rumors planted by third parties"). *But cf. In re Sharon Steel*, SEC Release No. 34-18271 (Nov. 19, 1981) (holding that a company must assume a duty to make corrective disclosure where there is either evidence that the rumors originated from within the company or trading by insiders in the company's shares).

573 *State Teachers Retirement Board v. Fluor Corp.*, 654 F.2d 843, 850 (2d Cir. 1981). While courts have required that rumors be attributable to corporate officials before imposing a duty upon companies to either correct or verify them, the NYSE and Nasdaq place more stringent obligations upon management of listed corporations. Section 202.03 of the NYSE LISTED COMPANY MANUAL states that "[i]f rumors or unusual market activity indicate that information on impending developments has leaked out, a frank and explicit announcement is clearly required," and "[i]f rumors are in fact false or inaccurate, they should be promptly denied or clarified." Furthermore, according to the NYSE LISTED COMPANY MANUAL, "if rumors are correct or there are developments, an immediate candid statement to the public as to the state of negotiations or of development of corporate plans in the rumored area must be made directly and openly." NYSE LISTED COMPANY MANUAL § 202.03. Nasdaq guidance is to the same effect. *See* NASDAQ Marketplace Rules, IM-5250-1, NASDAQ MANUAL. It is important to note that, while the NYSE and Nasdaq place more onerous duties upon companies in this regard, violations of their disclosure rules have been held not to give rise to private causes of action, no issuer's shares have been delisted for violation of the policy and many companies adhere to a no-comment policy if there are rumors of unusual market activity.

574 Selective Disclosure and Insider Trading, SEC Release No. 33-7881 (Aug. 15, 2000).

575 *See* § 4.10.

576 Voluntary compliance with Regulation FD became more widespread in response to several high profile enforcement actions brought by the SEC under the regulation, which are discussed below. In addition, a number of jurisdictions have similar regulations. For example, Korea has its own version of Regulation FD, and the EU has implemented legislation relating to insider dealing and market manipulation that also prohibits selective disclosure of inside information, subject to limited exceptions. See Articles 10(1) and 17(8) of Regulation No 596/2014 of the European Parliament and of the Council on market abuse, which came into effect on July 3, 2016, replacing Directive 2003/6/EC of the European Parliament and of the Council on insider dealing and market manipulation (market abuse), which previously dealt with these matters.

577 Effective October 4, 2010, the SEC removed the specific exemption previously provided for communications with nationally recognized statistical rating organizations and credit rating agencies for the purpose of determining or monitoring credit ratings. The removal was carried out to implement § 939B of the Dodd-Frank Act. SEC Release No. 33-9146 (Sept. 29, 2010). An issuer providing material nonpublic information to a rating agency would be well advised to rely on the exemption provided under Regulation FD for confidential disclosures, unless it can conclusively determine that the rating agency does not fall within one of the specified categories of persons to whom disclosure is prohibited. The exemption for disclosures made to persons under a confidentiality obligation does not require that obligation to be in writing. However, we believe it would be prudent for issuers relying on this exemption to obtain written confidentiality agreements where practicable. Following the Dodd-Frank Act, the major credit rating agencies incorporated confidentiality clauses into their standard agreements to facilitate issuers' ability to disclose confidential information to them without violating Regulation FD.

578 Material nonpublic information may be disclosed to a market professional or a securityholder as long as the recipient expressly agrees to maintain confidentiality until the information is public. SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Regulation FD, Questions 101.04–101.06 (June 4, 2010).

579 SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Regulation FD, Question 101.09 (June 4, 2010).

580 Recently there has been a renewed focus on prohibiting insider trading by government officials, particularly by members of Congress. The Stop Trading on Congressional Knowledge Act, Pub. L. No. 112-105, 126 Stat. 291 (2012), prohibits members of Congress and federal employees from trading securities based on material nonpublic information obtained from their work. Recent Congressional insider trading scandals, including trading of health care stocks by members of Congress with insider knowledge of Medicare developments, continue to draw media and regulatory attention to this issue.

581 Statements made by officials of an issuer not authorized to communicate information to market professionals and securityholders for Regulation FD purposes are made in breach of a duty of trust or confidence to the issuer and are not covered by Regulation FD. Such disclosure may, however, trigger insider trading liability. SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Regulation FD, Question 101.10 (June 4, 2010).

582 Selective confirmation of a forecast by an issuer can trigger the public reporting requirements of Regulation FD, depending on, among other things, the amount of time that has elapsed between the original forecast and the confirmation. If asked about a prior forecast, an issuer should be cautious about saying there is "no change" to, or that it is "still comfortable" with, the forecast because this is tantamount to a confirmation. If the issuer does not wish to confirm the forecast, it simply should say "no comment"; the issuer also may refer back to the prior estimate without implicitly confirming it by making clear that the forecast was as of the date it was given and is not then being updated. SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Regulation FD, Question 101.01 (June 4, 2010).

583 Regulation FD was controversial particularly for this reason, and concerns were expressed that it would reduce the flow of information to investors. In 2001, a senior member of the SEC's Division of Corporation Finance stated that the following nonexclusive factors increase the likelihood that the SEC will consider information released by an issuer to be material for the purposes of Regulation FD: (i) the issuer is releasing the information late in its earnings cycle, (ii) the issuer has not released information to the public in a relatively long period of time or (iii) major intervening news events affecting the issuer have occurred since the issuer's last public communication. Michael Bologna, *Disclosure: Most Companies Seeking to Comply with Reg FD Disclosure Requirements*, SEC. L. DAILY, Apr. 20, 2001. In *In re Fifth Third Bancorp*, the SEC determined that a redemption notice to the holders of Fifth Third's trust preferred securities was material nonpublic information, principally because of the significant disparity between the trading price of the securities and the redemption price. *In re Fifth Third Bancorp*, SEC Release No. 34-65808 (Nov. 22, 2011).

584 A disclosure is "intentional" when the person making it either knows, or is reckless in not knowing, that the information the person is communicating is both material and nonpublic. For example, if an official of an issuer did not plan on making a disclosure at a meeting but, after hearing the direction of the discussion, decided to make it and knew that the information was material and nonpublic, Regulation FD would be violated without simultaneous public disclosure. SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Regulation FD, Question 102.04 (June 4, 2010).

585 In general, any document publicly filed on EDGAR with the SEC within the timeframe required by Regulation FD would satisfy the rule. In considering whether disclosure is sufficient, however, companies must (i) take care to bring the disclosure to the attention of the readers of the document, (ii) not bury the information and (iii) not make the disclosure in a piecemeal fashion throughout the filing. SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Regulation FD, Question 102.02 (June 4, 2010).

Once a Form 8-K is publicly available on EDGAR, an issuer need not wait before making disclosure of the information in a nonpublic forum. SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Regulation FD, Question 102.03 (June 4, 2010).

586 When issuing a press release to satisfy the NYSE's immediate release policy, the exchange requires listed

companies (domestic and foreign) to contact Dow Jones & Company, Inc., Reuters Economic Services and Bloomberg Business News and suggests that the release also be given to a number of other news services. NYSE LISTED COMPANY MANUAL § 202.06(c).

587 *See* § 4.10[7] for a discussion of developments in Regulation FD and social media.

588 Although several days' notice may be reasonable for a quarterly earnings announcement made by an issuer on a regular basis, the notice period may be shorter when unexpected events occur and the information is critical or time-sensitive. In addition, if a transcript or rebroadcast of the analysts' call will be available, such as through an issuer's website, the SEC staff has encouraged issuers to indicate in the notice how, and for what length of time, such a record will be available to the public. SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Regulation FD, Question 102.01 (Aug. 14, 2009).

589 SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Regulation FD, Questions 102.05−102.06 (Aug. 14, 2009). Regulation FD does not prohibit a director from speaking privately with a shareholder or group of shareholders. However, where a director speaks on behalf of the company, Regulation FD prohibits the selective disclosure of nonpublic information. Companies should consider implementing Regulation FD compliance procedures, including pre-clearing comments or having counsel participate, if a director is authorized to speak on behalf of the company and plans on speaking privately with investors. SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Regulation FD, Questions 101.11 (June 4, 2010).

590 Richard H. Walker, Director, SEC Division of Enforcement, Remarks at Compliance and Legal Division of the Securities Industry Association, Regulation FD—An Enforcement Perspective (Nov. 1, 2000).

591 *See In re Raytheon Co.*, SEC Release No. 34-46897 (Nov. 25, 2002) (CFO spoke directly to 11 securities analysts and, based on his knowledge of their earnings estimates, told them that those estimates were "too high," "aggressive" or "very aggressive"); *In re Siebel Systems, Inc.*, SEC Release No. 34-46896 (Nov. 25, 2002) (CEO spoke to a number of individuals at an invitation-only technology conference and disclosed that, contrary to public statements made three weeks earlier, Siebel expected its sales activity levels to be in line with previous years); *In re Secure Computing Corp.*, SEC Release No. 34-46895 (Nov. 25, 2002) (CEO, on calls with two separate portfolio managers (the first of which also involved a representative of a brokerage firm) and in an e-mail to a managing partner of the brokerage firm, disclosed (non-intentionally, and then intentionally) that Secure had entered into a new material supply agreement, and the company failed to publicly release the non-intentionally released information in a timely fashion).

592 *Section 21(a) Report of Investigation: Motorola, Inc.*, SEC Release No. 34-46898 (Nov. 25, 2002) (investor relations director spoke directly to a number of securities analysts and clarified to them that previous guidance that Motorola's sales and orders were experiencing "significant weakness" meant a "25% or more" decline in sales and orders for the quarter, while not making any timely public disclosure of this quantitative information based in part on erroneous advice from in-house counsel).

593 In *In re Schering-Plough Corporation*, the CEO met in separate private meetings with analysts and portfolio managers of four institutional investors, three of which were among Schering's largest investors, and, through a combination of words, tone, emphasis and demeanor, disclosed material nonpublic information, including the fact that analysts' earning estimates were too high and that next year's earnings would decline significantly. The CEO subsequently met with approximately 25 other analysts and portfolio managers and indicated that Schering's 2003 earnings would be "terrible." *In re Schering-Plough Corporation*, SEC Release No. 34-48461 (Sept. 9, 2003).

The charges in *SEC v. Siebel Systems, Inc.* were subsequently dismissed by the court. *SEC v. Siebel Systems, Inc.*, SEC Litigation Release No. 18766 (June 29, 2004); *SEC v. Siebel Systems, Inc.*, 384 F. Supp. 2d 694 (S.D.N.Y. 2005). The significance of the court's ruling is discussed below.

In *In re Senetek PLC*, the CEO and CFO sent nonpublic information on two separate occasions to different research firms that was subsequently included in the firms' research reports on Senetek. *In re Senetek PLC*, SEC Admin. Proc. File No. 3-11668 (Sept. 16, 2004).

In *SEC v. Flowserve Corp.*, the CEO met privately with several analysts and reaffirmed publicly available earnings guidance. The SEC highlighted that the disclosure to the analysts had led to an increase in the price of and trading volume in Flowserve stock and that the director of investor relations waited more than 53 hours after the selective disclosure and nearly 26 hours after the dissemination of the analyst's report before filing a Form 8-K disclosing the information revealed to the analysts. *SEC v. Flowserve Corp.*, SEC Litigation Release No. 119154 (Mar. 24, 2005).

In *In re Electronic Data Systems Incorporated*, company personnel violated Regulation FD in selectively disclosing the cost of settling certain derivative contracts weeks before the amounts were made public in the company's Form 10-Q. *In re Electronic Data Systems Incorporated*, SEC Release No. 34-56519 (Sept. 25, 2007).

594 The SEC settled an enforcement action in September 2009 against the former CFO of American Commercial Lines Inc. after he sent a message to analysts from his personal email account on a Saturday indicating substantially reduced earnings expectations for the quarter. The following Monday, the issuer's stock price decreased nearly 10% on three times the normal trading volume. Notwithstanding his familiarity with Regulation FD, the CFO acted without prior consultation with counsel and without going through the proper investor relations channels for publicly disseminating material information. *SEC v. Black*, SEC Litigation Release No. 21222 (Sept. 24, 2009) (complaint); *In re Black*, SEC Admin. Proc. File No. 3-13625 (Sept. 24, 2009).

In October 2010, the SEC brought and settled enforcement actions against Office Depot, Inc., its CEO and former CFO after investor relations personnel, at the direction of the CEO and CFO, placed unprecedented private calls to analysts in advance of the release of quarterly earnings to signal that the company would not meet consensus earnings estimates. Company personnel did not explicitly state that estimates would not be met, but reminded analysts of prior statements made by company officials and also referred to other companies that had announced lower-than-expected results. Analysts concluded the company would not meet earnings estimates, and between the time calls were initially made and the company's public announcement on Form 8-K six days later that earnings would be negatively impacted by economic conditions, the price of the company's shares fell 7.7%. *SEC v. Office Depot, Inc.*, SEC Litigation Release No. 21703 (Oct. 21, 2010); *In re Office Depot, Inc.*, SEC Admin. Proc. File No. 3-14094 (Oct. 21, 2010); *In re Odland*, SEC Admin. Proc. File No. 3-14095 (Oct. 21, 2010); *In re McKay*, SEC Admin. Proc. File No. 3-14096 (Oct. 21, 2010).

In November 2011, the SEC issued a cease-and-desist order against Fifth Third Bancorp for violation of Regulation FD. In *In re Fifth Third Bancorp*, Fifth Third issued a redemption notice to the holders of a series of its trust preferred securities through DTC, but did not file a Form 8-K or issue a press release to alert the public to the redemption. The redemption price was significantly lower than the price at which the securities were then trading, which resulted in heavy sales of the trust preferred securities by existing holders. Fifth Third filed a Form 8-K announcing the redemption only after it learned of the impact its selective disclosure had on the market. The SEC determined that the redemption notice was material nonpublic information because a reasonable investor would consider it important that a security was to be redeemed at a price lower than the current market price. Without admitting or denying the SEC's findings, Fifth Third consented to the issuance of the cease-and-desist order. *In re Fifth Third Bancorp*, SEC Release No. 34-65808 (Nov. 22, 2011).

In September 2013, the SEC issued a cease-and-desist order against Lawrence D. Polizzotto, former Vice President of Investor Relations of First Solar Inc., for violation of Regulation FD. According to the SEC's order, Polizzotto revealed in phone calls with more than 30 analysts and investors that First Solar was unlikely to receive one of three loan guarantees totaling $4.5 billion from the U.S. Department of Energy for which the company had received conditional commitments, despite knowing the company had not yet publicly disclosed this information. When First Solar disclosed the loss of the loan guarantee the next morning, its stock price dropped by 6%. Without admitting or denying the SEC's findings, Polizzotto consented to the cease-and-desist order. *In the Matter of Lawrence D. Polizzotto*, SEC Admin. Proc. File No. 3-15458 (Sept. 6, 2013).

595 Although the former CFO in the *Black* proceeding agreed to a settlement comprised of a $25,000 civil penalty and a bar against future violations of Regulation FD, the SEC determined not to bring charges against American Commercial Lines itself due in part to its extraordinary cooperation with the SEC. The SEC indicated that it was not bringing charges against the issuer because: (i) prior to the selective disclosure, the issuer had cultivated an environment of compliance by providing Regulation FD training and implementing appropriate policies and controls designed to prevent violations, (ii) the CFO alone was responsible for the violation and he acted outside the control systems established by the issuer, (iii) the issuer acted promptly to correct the selective disclosure once it was discovered, filing a Form 8-K with the SEC on Monday afternoon, (iv) the issuer reported the selective disclosure to the SEC staff the day after it was discovered and provided extraordinary cooperation with the staff's investigation and (v) the issuer took remedial steps to address the improper conduct, including by adopting additional controls to prevent a repetition of similar conduct. *SEC v. Black*, S.D. Ind. Case No. 09-CV-0128 (Sept. 24, 2009); *In re Black*, SEC Admin. Proc. File No. 3-13625 (Sept. 24, 2009); *SEC v. Black*, SEC Litigation Release No. 21222 (Sept. 24, 2009).

In *In the Matter of Lawrence D. Polizzotto*, the SEC determined not to bring an enforcement action against the company, First Solar Inc., because, among other things, (i) the company cultivated an environment of compliance through the use of a disclosure committee that focused on compliance with Regulation FD; (ii) the company promptly issued a press release the morning after discovering Polizzotto's selective disclosure; and (iii) the company quickly self-reported the misconduct to the SEC. SEC Release No. 2013-174 (Sept. 6, 2013).

596 *Section 21(a) Report of Investigation: Motorola, Inc.*, SEC Release No. 34-46898 (Nov. 25, 2002). Recognizing that an officer may better understand the importance of information to investors, the SEC stated that consultation with counsel "will not relieve the officer from responsibility for disclosure of information that he or she personally knows, or is reckless in not knowing, is material and nonpublic." The SEC also noted that if counsel does nothing more than recite the legal standard and then ask the officer in question whether a reasonable investor would consider the information significant, the resulting judgment is the officer's, not counsel's. In addition, the SEC clarified that, although counsel's advice may initially provide an officer with a good faith basis for making a selective disclosure when the advice is received, that officer "may become aware of a very significant market reaction and may learn facts indicating that this reaction was a result of the selective disclosure. At that point, even though the officer's original selective disclosure was not intentional, the issuer has learned that it has made a non-intentional disclosure and must make the prompt public disclosure required by Regulation FD." *Section 21(a) Report of Investigation: Motorola, Inc.*, SEC Release No. 34-46898 (Nov. 25, 2002).

597 The cease-and-desist order to which Flowserve consented referred to the SEC's view that the selective disclosure had been "intentional" in this case. The SEC stated that "selective disclosure is ‘intentional’ when the person making the disclosure knows, or is reckless in not knowing, that the information being communicated is both ‘material’ and ‘nonpublic.’" SEC Release No. 34-51427 (Mar. 24, 2005). On the basis of that definition, the SEC concluded that the CEO's selective disclosure had been intentional. While in hindsight the information may have been material since the stock price and trading volume of Flowserve did in fact increase significantly following the publication of the research analyst report revealing the CEO's remarks, one could argue that the CEO could reasonably have thought that merely reaffirming previously issued publicly available earnings guidance would not be material to investors.

598 *SEC v. Siebel Systems, Inc.*, 384 F. Supp. 2d 694 (S.D.N.Y. 2005).

599 *SEC v. Siebel Systems, Inc.*, SEC Litigation Release No. 18766 (June 29, 2004). Siebel's CFO and investor relations director were also charged with aiding and abetting the Regulation FD violations.

600 The SEC also charged Siebel with violating Rule 13a-15 under the Exchange Act, which requires issuers to maintain disclosure controls and procedures to ensure the proper handling of information required to be disclosed in reports filed or submitted under the Exchange Act and to ensure that management is provided the information necessary to make timely disclosure decisions. The SEC alleged that Siebel's failure to publicly disseminate the information in compliance with Regulation FD was evidence of inadequate

disclosure controls and procedures in violation of Rule 13a-15. This represented the first time the SEC had charged an issuer with a violation of Rule 13a-15, and it bears noting that this claim was made in connection with Regulation FD rather than financial statements or periodic reports. This charge highlights the need for companies to address the disclosure requirements under Form 8-K, because a failure to file, or a late filing of, a required Form 8-K may serve as the basis for allegations that the issuer's disclosure controls and procedures were inadequate.

601 *SEC v. Siebel Systems, Inc.*, 384 F. Supp. 2d 694, 704 (S.D.N.Y. 2005).

602 *SEC v. Siebel Systems, Inc.*, 384 F. Supp. 2d 694, 705 (S.D.N.Y. 2005).

603 The court also dismissed the charge relating to the violation of Rule 13a-15 on the basis that there were no factual allegations providing independent support for this claim absent the alleged violation of Regulation FD. *See supra* Note 601. Because the court ruled that the SEC had failed to state a cause of action, the court did not have an opportunity to consider Siebel's constitutional claims.

604 *Commission Guidance on the Use of Company Websites*, SEC Release No. 34-58288, at Section II.A.2 (Aug. 1, 2008), 73 Fed. Reg. 45,862, 45,868 (Aug. 7, 2008).

605 *See* Netflix 8-K of Dec. 6, 2012 reporting receipt of the Wells Notice.

606 *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: Netflix, Inc., and Reed Hastings*, SEC Release No. 34-69279 (Apr. 2, 2013).

607 The SEC's 2008 guidance set out several factors for companies to consider when determining whether a social media outlet is a "recognized channel of distribution," including (1) whether and how companies let investors and the markets know that the company has a website that should be looked to for information, (2) whether the company has provided awareness that it will post important information there and whether it has a pattern or practice of doing so, (3) whether the company's website is designed to lead investors and the market efficiently to information about the company, whether the information is prominently disclosed in a location known and routinely used for such disclosures and whether it is presented in a format readily accessible to the general public, (4) the extent to which information posted on the website is regularly picked up by the market and readily available media and reported there or the extent to which the company has advised the media about the information, (5) the steps the company has taken to make its website and the information accessible, (6) whether the company keeps its website current and accurate, (7) whether the company uses other methods to disseminate information and whether and to what extent those other methods are the predominant methods the company uses to disseminate information and (8) the nature of the information. *Commission Guidance on the Use of Company Web Sites*, SEC Release No. 34-58288, 20-22 (Aug. 1, 2008); 73 Fed. Reg. 45,862, 45,867-68 (Aug. 7, 2008).

608 *See* NYSE LISTED COMPANY MANUAL §§ 202.05, 202.06; NASDAQ Stock Market Rule 5250(b), IM-5250-1. Note in this regard that the NYSE continues to encourage the use of press releases when disseminating material information within the meaning of its rules.

609 Under a staff Compliance and Disclosure Interpretation, if a company's policy identified authorized spokespersons, it is not responsible for selective disclosures by others. SEC, *Compliance and Disclosure Interpretations*, Regulation FD, Question 101.10 (Aug. 14, 2009). While the guidance set forth in the SEC report on Netflix did not address its implications for this C&DI, creating a record of authorized social media channels nevertheless seems prudent.

610 Companies should be aware, however, that a policy that flatly prohibits employees from disclosing information through their personal social media is of questionable enforceability, as it could be construed as an unlawful work rule that would tend to chill employees when engaging in protected organizing activity under § 7 of the National Labor Relations Act. *See* Office of General Counsel, National Labor Relations Board, Memorandum OM 11-74 (Aug. 18, 2011), Memorandum OM 12-31 (Jan. 24, 2012) and Memorandum OM 12-59 (May 30, 2012) (finding certain restrictions and prohibitions in social media policies to be overbroad and unlawful under the National Labor Relations Act). Companies should be sure to clarify that social media restrictions are not intended to impinge on § 7 rights, in part by providing examples in their policies of acceptable versus unacceptable uses of social media.

611 *See*, *e.g.*, Rule 165 under the Securities Act (written communications made "in connection with or relating to" a business combination transaction where securities are offered as consideration) and Rule 14a-12 under the Exchange Act (solicitation before furnishing a proxy statement).

612 *See*, *e.g.*, Rule 135 under the Securities Act (press release notice of proposed public offering) and § 21E of the Exchange Act (forward-looking statement).

613 *Chiarella v. United States*, 445 U.S. 222 (1980).

614 *Dirks v. SEC*, 463 U.S. 646 (1983).

615 Although a decision in the district court for the Northern District of Texas cast doubt on whether a breach of a duty of trust and confidence requires an explicit agreement not to trade, in addition to an agreement to keep material nonpublic information confidential, the Fifth Circuit Court of Appeals reaffirmed in September 2010 that no explicit agreement is required if the parties understood that they were not to trade on the information when it was disclosed. *See supra* Note 517.

616 *Dirks v. SEC*, 463 U.S. 664 (1983).

617 *See* § 11.05[2][a][ii] for a discussion of recent cases on the nature of the personal benefit that must be received in the context of alleged selective disclosure to friends or family (rather than to securities analysts) to establish liability under the misappropriation theory.

618 *SEC v. Stevens*, SEC Litigation Release No. 12813 (Mar. 19, 1991).

619 The requirements and scope of Regulation FD are discussed above. *See* §§ 4.10[6] and [7].

620 According to the SEC staff, adequate advance notice under Regulation FD must include the date, time, subject matter and call-in information for the analysts' call. SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Regulation FD, Question 102.01 (June 4, 2010). Public notice should be provided a reasonable period of time in advance of the conference call. For example, while several days' notice may be reasonable for a quarterly earnings announcement made by an issuer on a regular basis, the notice period may be shorter when unexpected events occur and the information is critical or time sensitive. In addition, if a transcript or rebroadcast of the analysts' call will be available, such as through an issuer's website, the SEC staff has encouraged issuers to indicate in the notice how, and for what length of time, such a record will be available to the public. SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Regulation FD, Question 102.01 (Aug. 14, 2009).

621 A company may elect to submit nonpublic information required to be disclosed by Regulation FD pursuant to Item 8.01 of Form 8-K, providing for disclosure regarding "Other Events," rather than Item 7.01. Unlike information filed pursuant to Item 8.01, however, the information in a report furnished pursuant to Item 7.01 is not automatically incorporated by reference in short-form registration statements under the Securities Act or deemed to be "filed" for purposes of § 18 of the Exchange Act or otherwise subject to the liabilities of that section, unless the registrant specifically states the information is to be considered filed under the Exchange Act or incorporates it by reference into a filing under the Securities Act or the Exchange Act.

622 *Basic Inc. v. Levinson*, 485 U.S. 224, 239 n.17 (1988).

623 A company subject to Regulation FD is required to disclose the information generally within 24 hours pursuant to a Regulation FD-compliant method of disclosure.

624 The NYSE LISTED COMPANY MANUAL requires listed companies promptly and publicly to release material information that has been inadvertently leaked to analysts and offers explicit instructions regarding such press releases. NYSE LISTED COMPANY MANUAL §§ 202.03–202.06. Section 202.06(C) states that such news must be disseminated "by the fastest available means," which ordinarily requires a "release to the public press by telephone, facsimile or hand delivery, or some combination of such methods." Adequate disclosure to the investment community requires companies to release information to the Dow Jones, Reuters and Bloomberg news services. NYSE LISTED COMPANY MANUAL § 202.06(C). The NYSE LISTED COMPANY MANUAL also encourages companies to promptly distribute their releases to the Associated Press and United Press International, as well as to newspapers in New York City and in cities in which the company has its headquarters, plants or other major facilities. Copies of such releases should be sent to

the company's NYSE representative.

A company listed on Nasdaq is obliged to disclose to the Nasdaq MarketWatch Department material information that the company is not otherwise disclosing to the investing public or the financial community. NASDAQ Marketplace Rules, IM-5250-1, NASDAQ MANUAL. Where changes in market activity indicate that information has become known to the investing public, Nasdaq may work with the company to effect a timely public release of such information, subject to the company's views as to the business advisability of disclosing the information and the nature of the event itself.

The importance of keeping the stock exchange on which the company is listed fully informed about inadvertent disclosures of material information was illustrated in *SEC v. Geon Industries, Inc.*, 531 F.2d 39 (2d Cir. 1976), and *State Teachers Retirement Board v. Fluor Corp.*, 654 F.2d 843 (2d Cir. 1981). The Second Circuit ruled in *Geon* that an officer of the company had violated Rule 10b-5 because, when asked by an AMEX representative if there were any developments regarding the previously announced merger of Geon with Burmah Oil Co., Ltd. to account for the imbalance of sell orders in Geon stock, the officer failed to disclose information that would indicate the possible collapse of the merger. *See Geon Industries, Inc.*, 531 F.2d 39, 47 (2d Cir. 1976). On the other hand, in *Fluor*, the Second Circuit's decision that the company was not liable under Rule 10b-5 relied, in part, on the fact that company officials had informed a NYSE representative that the unannounced award of a substantial contract could be the reason for increased trading volume in company securities. *See State Teachers Retirement Board v. Fluor Corp.*, 654 F.2d 843, 851 (2d Cir. 1981). Following an inadvertent disclosure of material information to an individual or group of individuals, the company should also consider contacting the stock exchange on which it is listed to discuss the possible need for a halt in trading of the company's securities pending dissemination of the press release. *In Fluor*, the Second Circuit's decision that the company was not liable under Rule 10b-5 also emphasized that the company had acted in "good faith" by endorsing the NYSE decision to halt trading.

625 *SEC v. Geon Industries, Inc.*, 531 F.2d 39 (2d Cir. 1976).

626 *SEC v. Geon Industries, Inc.*, 531 F.2d 39, 47 (2d Cir. 1976).

U.S. Regulation of the International Securities and Derivatives Markets, § 4.11, DEREGISTRATION AND DELISTING

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 4.11 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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[1] Delisting from an Exchange

A foreign private issuer can withdraw a class of securities from listing on a national securities exchange (such as the NYSE or Nasdaq) by filing an

p. 4-168

application on Form 25 with the SEC. [627] The delisting of the security will be effective ten days after a Form 25 is filed with the SEC. [628] The withdrawal from registration under § 12(b) of the Exchange Act will take effect 90 days after the filing of the Form 25, or such shorter period as the SEC may determine. [629]

In addition, Rule 12d2-2(c) under the Exchange Act requires an issuer filing a Form 25 to satisfy the following requirements: (i) comply with the applicable exchange's rules for delisting and applicable state laws, (ii) submit a written notification to the exchange no fewer than ten days before the issuer files a Form 25 of its intent to withdraw its security from listing and/or registration on such exchange, [630] and (iii) contemporaneously with providing a written notice to the exchange, issue a public notice of its intent to delist and/or withdraw its security from § 12(b) registration via a press release, and if it has a publicly accessible website, post such notice on that website. Moreover, the applicable exchange is required to provide notice on its own website of the issuer's intent to delist by the next business day after it receives such notice from the issuer. [631] The notices by the issuer and the exchange on their respective websites must remain posted until the delisting becomes effective. [632]

The NYSE allows a company to delist a security pursuant to Rule 12d2-2(c) upon approval by its board of directors. [633] Nasdaq allows an issuer to voluntarily terminate its listing upon compliance with all requirements of Rule 12d2-2(c). [634]

[2] Termination and Suspension of Periodic Reporting

[a] Termination

The SEC adopted rules in 2007 that make it easier for foreign private issuers to exit the Exchange Act reporting regime. [635] The SEC proposed and adopted

p. 4-168

p. 4-169

these rule amendments out of concern that, due to several trends, including the increased internationalization of the U.S. securities markets in recent decades, it has become difficult for foreign private issuers to exit the Exchange Act reporting system even when there is relatively little U.S. trading interest in its U.S.-registered securities. [636] The rules allow a foreign private issuer to terminate Exchange Act reporting for its equity securities by meeting a quantitative benchmark provision based on its U.S. trading volume relative to its worldwide trading volume, as an alternative to the 300 record holder standard. [637] The rules also enable a foreign private issuer to terminate, rather than merely suspend, its § 15(d) reporting obligations and to claim the benefits of Rule 12g3-2(b) exemption immediately upon the effectiveness of its termination of reporting pursuant to Rule 12h-6. [638]

Under Rule 12h-6, a foreign private issuer is able to terminate its Exchange Act registration and reporting obligations regarding a class of equity securities if it satisfies (i) the quantitative benchmark condition, (ii) the prior reporting condition, (iii) the one-year dormancy condition and (iv) the foreign listing condition, each as described below.

p. 4-169

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p. 4-170

The quantitative benchmark condition can be satisfied by meeting either one of the following tests:

- The average daily trading volume (the "ADTV") of the class of equity securities in the United States has been no greater than 5% of the ADTV of that equity security on a worldwide basis during a recent 12-month period; [639] or
- There are less than 300 holders of record on a worldwide basis or less than 300 holders of record resident in the United States. [640]

A foreign private issuer that has delisted a class of equity securities from a U.S. national securities exchange or automated inter-dealer quotation system or that has terminated a sponsored ADR facility will be subject to a one-year waiting period before it may file Form 15F to deregister unless it satisfied this trading volume test on the date of its delisting or termination. [641]

The prior reporting condition requires that the issuer have had SEC reporting obligations for at least one year before deregistration, have filed or furnished all reports required for such period, and have filed at least one annual report. [642]

The one-year dormancy condition prohibits sales of a foreign private issuer's securities in the United States in a registered offering during the 12 months preceding the deregistration, subject to certain exceptions. [643] The primary purpose of this condition is to preclude a foreign private issuer from exiting the

p. 4-170

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p. 4-171

Exchange Act reporting system shortly after it has engaged in U.S. capital-raising through a public offering. [644]

The foreign listing condition requires that the foreign private issuer have maintained for at least 12 months a listing of the subject class of equity securities on an exchange in a foreign jurisdiction, which, either singly or together with one other foreign jurisdiction, constitutes the primary trading market for such securities. [645] The purpose of this foreign listing condition is to help assure that there is a non-U.S. jurisdiction that principally regulates and oversees the issuance and trading of the issuer's securities and the issuer's disclosure obligations to investors. [646]

Rule 12h-6 enables a foreign private issuer to terminate its Exchange Act reporting obligations regarding a class of debt securities as long as the issuer has filed or furnished all reports required under § 13(a) or § 15(d) of the Exchange Act, including at least one Exchange Act annual report on Form 20-F, and has its class of debt securities held of record by less than 300 holders either on a worldwide basis or who are U.S. residents. [647]

Under Rule 12h-6, a foreign private issuer has to file a Form 15F with the SEC to certify its compliance with the requirements for termination of its Exchange Act reporting obligations. As with the filing of Form 15 under the previous rules, the filing of Form 15F automatically suspends an issuer's reporting duties. If the SEC has not objected, the suspension would become a permanent termination 90 days after the filing of the Form 15F. If the Form 15F is subsequently withdrawn or denied, the issuer will be required, within 60 days of the date of the denial or withdrawal, to file or submit all reports that would have been required had it not filed the Form 15F. [648] After filing the Form 15F, an issuer has no continuing obligation to make inquiries concerning the information contained in the Form 15F, including its assessment of trading volume or ownership of its securities. However, if, during the 90-day waiting period, the issuer has actual knowledge of information that causes it reasonably to believe that, at the date of filing the Form 15F, it was not qualified to deregister under Rule 12h-6, the issuer must withdraw its Form 15F. [649]

Under Rule 12h-6, a foreign private issuer must publish, either before or on the date that it files its Form 15F, a notice in the United States that discloses its intent to terminate its Exchange Act reporting obligations. The issuer must publish the notice, such as a press release, through a means reasonably designed to provide broad dissemination of the information to the public in the United

p. 4-171

p. 4-172

States. The issuer is also required to submit a copy of the notice, either under cover of a Form 6-K, before or at the time of filing of the Form 15F, or as an exhibit to the Form 15F. [650]

The SEC has indirectly indicated that companies that terminate their reporting obligations under Rule 12h-6 are not issuers for purposes of the Sarbanes-Oxley Act. [651] They should not be considered as such, because they no longer have securities registered under § 12 of the Exchange Act and are not required to file reports under § 15(d) of the Exchange Act. We believe the termination of a company's issuer status in this context should be effective when a certification on Form 15F is filed. These companies would again become subject to the Sarbanes-Oxley Act if and when they have reporting duties at the beginning of any fiscal year or have filed a Securities Act registration statement. [652]

[b] Suspension

[i] *General*

As a consequence of having a registration statement declared effective under the Securities Act, an issuer becomes a reporting company under § 15(d) of the Exchange Act. Section 15(d) provides that an issuer's duty to report is automatically suspended, if at the beginning of any fiscal year (other than the year in which the relevant registration statement became effective), the class of securities covered by the relevant registration statement is held of record by fewer than 300 persons worldwide. In determining the number of record holders, an issuer may treat a custodian as a single record holder and holders of securities pursuant to a deposit agreement or similar arrangement as record holders. [653] It is

p. 4-172

p. 4-173

not necessary to "look through" any securities held by any such holders to ultimate beneficial owners.

Suspension of an issuer's reporting duty on the basis of § 15(d) requires, but is not conditioned on, the filing of a notice on Form 15, within 30 days of the beginning of the first fiscal year in which the duty is suspended, and depends on the number of holders as of the beginning of the issuer's fiscal year. [654] If the limit on the number of holders is exceeded on the first day of a subsequent fiscal year, the issuer's reporting obligations will cease to be suspended as of that day. [655] As noted above, by availing themselves of Rule 12h-6 when they qualify, foreign issuers can terminate, rather than merely suspend, their § 15(d) obligations. For this reason, the availability of Rule 12h-6 should reduce the number and complexity of situations for foreign issuers involving suspension of reporting obligations under § 15(d).

The SEC has stated that a company whose duty to report under § 15(d) is automatically suspended would not be an issuer subject to the Sarbanes-Oxley Act during the time that the duty is suspended, regardless of whether it filed a notice on Form 15. [656] Such a company would, however, again become subject to the Sarbanes-Oxley Act if and when it no longer meets the requirements for suspension of reporting duties at the beginning of any fiscal year (unless it has terminated its Exchange Act registration and reporting obligations pursuant to Rule 12h-6) or if it files a Securities Act registration statement. [657]

[ii] *Issuers Emerging from Bankruptcy*

While companies in bankruptcy are not relieved of their Exchange Act reporting obligations, the SEC will generally accept modified Exchange Act reports from issuers subject to proceedings under the U.S. Bankruptcy Act. [658]

p. 4-173

p. 4-174

Although foreign private issuers have not requested or obtained relief from the SEC in these circumstances, in all likelihood the SEC would apply the same standards to such companies as it applies to U.S. companies, discussed in detail below, as modified to apply to annual reports on Form 20-F and current reports on Form 6-K.

In deciding whether to accept modified Exchange Act reports, the SEC considers (i) how difficult it is for the issuer to obtain the information necessary to complete the reports, (ii) the issuer's financial condition, (iii) the issuer's efforts to advise its securityholders and the public of its financial condition and activities and (iv) the nature and extent of the trading in the issuer's securities. However, generally speaking, as soon as such conditions cease, unless relief is granted, the full requirements of the Exchange Act again apply, including the requirement for audited financial statements for all required periods even though the issuer may have been subject to bankruptcy proceedings during some portion of those periods. The SEC has further indicated that, in deciding whether to grant relief, it looks to (i) the timeliness of an issuer's Form 8-K announcing its bankruptcy filing and (ii) whether an issuer files a Form 8-K announcing that its reorganization plan has become effective, including a "fresh-start" audited balance sheet as of the date of the issuer's release from Chapter 11 under the U.S. Bankruptcy Code. [659]

A limited number of SEC no-action letters have granted relief to particular issuers while still in bankruptcy modifying the requirements for their post-reorganization filings under the Exchange Act. [660] Such relief was granted on the basis that, while still in bankruptcy, the issuer would file its bankruptcy reports under cover of Form 8-K during the time it is required to file reports with the bankruptcy court, with each such Form 8-K filed no later than 15 days after such reports are required to be so filed. In addition, the relief required the issuer, upon release from proceedings under the U.S. Bankruptcy Code, to file the appropriate Form 8-K and its audited balance sheet and comply fully with its reporting obligations under the Exchange Act for all periods commencing after such release, presenting audited financials for such periods. In filings under the Securities Act, however, the SEC will not provide relief from audited financial statement requirements, even if some portion of the periods required to be audited include the period during which an issuer was subject to bankruptcy proceedings.

Footnotes

627 Rule 12d2-2(c) under the Exchange Act. Rule 12d2-2 has been amended in order to simplify the delisting procedure. *See* SEC Release No. 34-52029 (July 15, 2005).

628 Rule 12d2-2(d)(1) under the Exchange Act.

629 Rule 12d2-2(d)(2) under the Exchange Act.

630 The written notice to the exchange must include a description of the security involved together with a statement of all material facts relating to the reasons for filing such application for withdrawal from listing and registration. Because delisting would not become effective until ten days after filing the Form 25, the issuer should provide written notice to the exchange, as well as the public notice, at least 20 days before the planned delisting date. *See* SEC Release No. 34-52029 (July 15, 2005).

631 Rule 12d2-2(c)(3) under the Exchange Act.

632 Rule 12d2-2(c)(2)(iii) and (c)(3) under the Exchange Act.

633 NYSE LISTED COMPANY MANUAL § 806.02.

634 NASDAQ Marketplace Rules, Rule 5840(j), NASDAQ MANUAL.

635 SEC Release No. 34-55540 (June 4, 2007). The principal changes are set out in Rule 12h-6 under the Exchange Act adopted by the SEC pursuant to its exemptive authority under § 12(h) of the Exchange Act. The SEC also eliminated certain provisions of Rules 12g-4 and 12h-3 under the Exchange Act relating to foreign private issuers. As amended, Rule 12g-4 allows termination of registration of a class of securities under § 12(g) of the Exchange Act, and Rule 12h-3 allows suspension of a reporting obligation under § 15(d) of the Exchange Act, if the class of securities is held of record by less than 300 persons worldwide (or less than 500 persons worldwide where the total assets of the issuer have not exceeded $10 million on the last day of each of the issuer's most recent three fiscal years). Although Rules 12g-4 and 12h-3, as

amended, do not exclude foreign private issuers, few, if any, foreign private issuers are expected to proceed under these rules. As discussed below, while new Rule 12h-6 retains the 300 record holder standard for debt securities and as an alternative test for equity securities, it provides significant advantages to foreign private issuers compared to Rule 12g-4 or 12h-3. These advantages include: (i) an easier method of counting the record holders and (ii) the ability to terminate (rather than merely suspend) § 15(d) reporting obligations.

636 *See* SEC Release No. 34-53020 (Dec. 23, 2005); SEC Release No. 34-55005 (Dec. 22, 2006); SEC Release No. 34-55540 (Mar. 27, 2007). The adoption of Rule 12h-6 was driven in part by renewed interest in the deregistration rules, which arose both because companies with securities listed in the United States had been able to more readily turn to the non-U.S. and Rule 144A markets to raise capital, and because of the real or perceived burdens and risks of U.S. registration, including those associated with complying with the Sarbanes-Oxley Act. Foreign issuers had found that the "look-through" rules previously used to determine whether they had 300 U.S. shareholders were so difficult to implement that they often could not determine whether they qualified to terminate their registration. They had also objected to the previous rules on the basis that the 300 shareholder threshold was very low in a world of internet trading and global markets, and that, even after deregistration, Rule 12g3-2(a) required them to determine annually whether they had to re-register their securities.

637 Rule 12h-6 revised the method of counting record holders for securities issued by foreign private issuers. *See infra* Note 640.

638 *See* § 4.02[3][a][iv] for a discussion of the Rule 12g3-2(b) exemption.

639 Rule 12h-6(a)(4)(i) under the Exchange Act.

640 Rule 12h-6(a)(4)(ii) under the Exchange Act. Instead of having to look through the accounts of brokers, banks and other nominees on a worldwide basis to determine the number of its U.S. resident holders, as is required under Rule 12g3-2(a), a foreign private issuer can limit its inquiry to brokers, banks and other nominees located in the United States, the issuer's jurisdiction of legal formation and, if different, the jurisdiction of its primary trading market. Rule 12h-6(e) under the Exchange Act.

641 *See* Rule 12h-6(b) under the Exchange Act. Foreign issuers have employed a number of different strategies in the past to expedite deregistration, although the introduction of Rule 12h-6 has significantly facilitated the process. Deregistration can still present challenges to foreign issuers looking to satisfy the Rule 12h-6 requirements.

642 Rule 12h-6(a)(1) under the Exchange Act.

643 Rule 12h-6(a)(2) under the Exchange Act. Rule 12h-6(a)(2) excludes from this condition securities issued (i) to the issuer's employees, (ii) by selling securityholders in non-underwritten offerings, (iii) upon the exercise of outstanding rights granted by the issuer if the rights are granted *pro rata* to all existing securityholders of the class of the issuer's securities to which the rights attach, (iv) pursuant to a dividend or interest reinvestment plan, or (v) upon the conversion of outstanding convertible securities or upon the exercise of outstanding transferable warrants issued by the issuer. However, the exceptions under clauses (iii), (iv) and (v) above do not apply to securities issued pursuant to a standby underwritten offering or other similar arrangement in the United States. *See* Note to Rule 12h-6(a)(2) under the Exchange Act.

644 SEC Release No. 34-55540 (Mar. 27, 2007).

645 *See infra* Note 25 for the definition of "primary trading market."

646 SEC Release No. 34-55540 (Mar. 27, 2007).

647 Rule 12h-6(c) under the Exchange Act.

648 Rule 12h-6(g) under the Exchange Act.

649 Form 15F, Item 11.

650 Rule 12h-6(h) under the Exchange Act.

651 *See* SEC Release No. 34-55540 (Mar. 27, 2007) (noting that, as a result of terminating their Exchange Act reporting obligations under Rule 12h-6, foreign firms may save costs required for an investment in an

internal control system in order to comply with the Sarbanes-Oxley Act). A company is an issuer for purposes of the Sarbanes-Oxley Act if it (i) has securities registered under § 12 of the Exchange Act, (ii) is required to file reports under § 15(d) of the Exchange Act or (iii) files or has filed a registration statement under the Securities Act that has not yet become effective and that has not been withdrawn.

652 *See* § 4.07 for a detailed discussion of the Sarbanes-Oxley Act.

653 Rule 12g5-1 under the Exchange Act. The SEC has stated that institutional custodians, such as Cede & Co. acting as nominee holder for The Depository Trust Company, are not single record holders for purposes of the Exchange Act's registration and periodic reporting obligations. Instead, each of the custodian's accounts for which the securities are held is a record holder (meaning, in the case of The Depository Trust Company, that participants are record holders while indirect participants are not). *See* SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Exchange Act Rules, Question 152.01 (Sept. 30, 2008).

654 § 15(d) of the Exchange Act and Rule 15d-6 thereunder.

655 Rule 12h-3(e) under the Exchange Act. An issuer that has had a Securities Act registration statement declared effective by the SEC and has not filed a Form 15F pursuant to Rule 12h-6 would be required to monitor the number of U.S. holders of its securities in order to determine whether registration under § 12 would be required. While it is highly unlikely in this scenario that the SEC would bring an action requiring registration of such securities if the relevant shareholder limits were exceeded, a technical obligation for the issuer to register the securities would nevertheless exist unless such issuer (i) had terminated its obligation pursuant to Rule 12h-6, (ii) had obtained from the SEC an order terminating its § 15(d) obligation or (iii) met the criteria to avail itself of the Rule 12g3-2(b) exemption. *See Sun Healthcare Group, Inc.* (avail. Sept. 29, 2010); *Hungarian Telephone and Cable Corp*. (avail. Feb. 27, 2009); *Trio-Kenwood Corporation* (avail. Mar. 1, 1983) (permitting foreign private issuers with suspended § 15(d) reporting obligations to rely on Rule 12g3-2(b)).

656 SEC, Division of Corporation Finance, Sarbanes-Oxley Act of 2002—Frequently Asked Questions, Question 2 (Nov. 8, 2002, *rev'd* Nov. 14, 2002).

657 *See* § 4.07 for a detailed discussion of the Sarbanes-Oxley Act.

658 *See* SEC Release No. 34-9660 (June 30, 1972).

659 *See* SEC, Division of Corporation Finance, Staff Legal Bulletin No. 2 (Apr. 15, 1997), Fed. Sec. L. Rep. (CCH) ¶60,002.

660 *See*, *e.g.*, *Opticon Medical, Inc*. (avail. June 28, 2002).