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SEC/CORPORATE

SEC Division of Corporation Finance Issues 12 New and Revised C&DIs Regarding Non-GAAP Measures

As noted in the May 13 edition of *Corporate and Financial Weekly Digest*, SEC Chair Mary Joe White, Deputy Chief Accountant Wesley R. Bricker and other high-ranking members of the staff of the SEC have expressed concerns regarding non-GAAP disclosure practices. Correspondingly, on May 17, the Securities and Exchange Commission's Division of Corporation Finance issued 12 new and revised Compliance and Disclosure Interpretations (C&DIs) relating to the use of non-GAAP financial measures. The new and revised C&DIs included the following interpretive guidance:

- **Misleading Non-GAAP Measures:** The SEC clarified that certain adjustments may result in a non-GAAP measure that is misleading (whether or not the measure is expressly prohibited) and, therefore, prohibited by Regulation G (which set forth rules for presentation by registrants of non-GAAP financial information in all forums). For example, adjustments that are presented inconsistently between periods or exclude charges but do not exclude gains can be misleading. Similarly, presenting a performance measure that excludes normal, recurring, cash operating expenses necessary to operate a registrant's business could be misleading. The staff of the SEC (Staff) also indicated that non-GAAP measures that substitute individually tailored revenue recognition and measurement methods for those of GAAP could be misleading. Accordingly, a registrant could not present a non-GAAP performance measure that is adjusted to accelerate revenue recognized ratably over time in accordance with GAAP as though it earned revenue when the customer is billed. Other measures that use individually tailored recognition and measurement methods for financial statement line items other than revenue may also be misleading.
- **Per Share Presentation:** The Staff clarified prior guidance that prohibited the per share presentation of non-GAAP liquidity measures in documents filed or furnished with the SEC. Specifically, the Staff stated that whether per share data is prohibited depends on whether the non-GAAP measure can be used as a liquidity measure (even if management presents it solely as a performance measure). To determine whether a non-GAAP measure can be used as a liquidity measure, the Staff will focus on the substance of the non-GAAP measure and not management's characterization of the measure. Consistent with this guidance, the Staff expressly states that free cash flow, EBIT and EBITDA should not be presented on a per share basis.
- **Prominence of non-GAAP Disclosure**: Item 10(e)(1)(i)(A) of Regulation S-K requires that when a registrant presents a non-GAAP measure it must present the most directly comparable GAAP measure with equal or greater prominence. This requirement applies to non-GAAP measures presented in documents filed with the SEC and also earnings releases furnished under Item 2.02 of Form 8-K. The Staff provided several examples of disclosure of no-GAAP measures that the Staff views as "more prominent" than the comparable GAAP measure. The examples include (but are not limited to):
  - omitting comparable GAAP measures from an earnings release headline or caption that includes non-GAAP measures;
  - using font styles (e.g., bold, italics, etc.) that emphasize the non-GAAP measure over the comparable GAAP measure;
  - presenting a non-GAAP measure before the most directly comparable GAAP measure (including in a headline or caption);
  - describing a non-GAAP measure as, for example, "record performance" or "exceptional" without at least an equally prominent descriptive characterization of the comparable GAAP measure;

  - providing tabular disclosure of non-GAAP financial measures without preceding it with an equally prominent tabular disclosure of the comparable GAAP measures or including the comparable GAAP measures in the same table; and
  - providing discussion and analysis of a non-GAAP measure without a similar discussion and analysis of the comparable GAAP measure in a location with equal or greater prominence.
- **Taxes**. The Staff clarified that a registrant should provide income tax effects on its non-GAAP measures depending on the nature of the measures. If a measure is a liquidity measure that includes income taxes, it might be acceptable to adjust GAAP taxes to show taxes paid in cash. If a measure is a performance measure, the registrant should include current and deferred income tax expense commensurate with the non-GAAP measure of profitability. In addition, adjustments to arrive at a non-GAAP measure should not be presented "net of tax." Rather, income taxes should be shown as a separate adjustment and clearly explained.

The new and revised C&DIs is available here.

PCAOB Re-Proposes Auditor Reporting Standard to Enhance Auditor Reports

On May 11, the Public Company Accounting Oversight Board (PCAOB) re-proposed its standard for information that auditors are required to provide in their audit opinions. As noted in its press release regarding the re-proposed standard, the PCAOB desires to make auditor's reports more informative for investors. In 2013, the PCAOB proposed a standard that would require a firm to disclose in its audit reports critical audit matters arising from an audit of an issuer's financial statements. The PCAOB received extensive comments in response to its original proposal and held a public roundtable to discuss the previously proposed standard and comments received. As a result, the PCAOB has re-proposed the standard with modifications to its original proposal.

In the re-proposed standard, the PCAOB would not change the pass/fail model of the existing auditor's report or the auditor's role of attesting to management-prepared information. Under the re-proposed standard, the PCAOB would, however, require auditors to provide additional information in the auditor's report regarding critical audit matters (as modified from the original proposal in 2013). The re-proposed standard, among other things, would limit the source of potential critical audit matters to matters communicated (or required to be communicated) to the audit committee and narrow the definition of critical audit matters, from the definition originally proposed, to those matters involving "especially challenging, subjective or complex auditor judgment." Comments on the re-proposed standard are due by August 15.

The PCAOB's press release regarding its re-proposed standard is available here.

The PCAOB's report on the full re-proposed standard is available here.

A fact sheet on the re-proposed standard is available here.

DERIVATIVES

See "CFTC Issues Residual Interest Deadline Report" in the CFTC section, "PRA Publishes Meeting Minutes with Notes on the Application of Best Execution to FX Derivatives and FX Spot Transactions" in the UK Developments section, and "European Commission Adopts MiFIR Delegated Act" in the EU Developments section.

CFTC

CFTC Issues Residual Interest Deadline Report

On May 13, the Commodity Futures Trading Commission's Division of Swap Dealer and Intermediary Oversight (DSIO) issued the Residual Interest Deadline for Futures Commission Merchants Report (Report). The Residual Interest Deadline is the time by which a futures commission merchant (FCM) must assure that it is holding in its customer segregated accounts a sufficient amount of its own funds (i.e., its residual interest, that is at least equal to the amount by which its customers' segregated accounts, in the aggregate, are undermargined). The Residual Interest Deadline is currently 6:00 p.m. Eastern on the date of settlement. DSIO staff determined that changing the

Residual Interest Deadline to the time of settlement or another time would not be practicable for customers or FCMs and, therefore, recommended that the Residual Interest Deadline remain at 6:00 p.m.

Comments on the Report may be submitted until June 13.

A copy of the report is available here.

UK DEVELOPMENTS

PRA Publishes Meeting Minutes With Notes on the Application of Best Execution to FX Derivatives and FX Spot Transactions

On May 16, the UK Prudential Regulation Authority published the minutes (Minutes) of a Foreign Exchange Joint Standing Committee meeting held on April 22.

Notably, the Minutes summarize a presentation given by the Financial Conduct Authority (FCA) as to the application of best execution obligations under the Markets in Financial Instruments Directive (MiFID) to foreign exchange (FX) derivatives and FX spot transactions. The FCA noted that FX derivatives, and FX spot transactions that are ancillary to transactions with financial instruments, are already covered by MiFID best execution obligations. However the FCA also confirmed that for all other FX spot transactions outside the scope of MiFID, the obligations owed vary according to the trading relationship between market participants and clients. The FCA noted the following three broad categories of trading relationships and confirmed that:

> **Agent**
> Where market participants act as agent for clients and execute orders on their behalf, with a responsibility to obtain an "optimal outcome," the FCA considers that "best execution" principles are "an appropriate benchmark."
>
> **Principal**
> Where market participants act as principal and provide two-way quotes to clients and clients are able to obtain quotes from other market participants, no best execution requirements arise.
>
> **Principal With Some Discretion**
> Where market participants act as "principal with some discretion" and where clients could be found to be legitimately relying on them, market participants have obligations to attempt to achieve an "optimal outcome." The FCA noted that managing stop-loss orders could be a potential example in the context of this trading relationship.

A copy of the Minutes is available here.

EU DEVELOPMENTS

Cybersecurity Directive Adopted by the EU Council

On May 17, the Council of the EU (Council) announced it had formally adopted the new EU Directive concerning measures for a high common level of security for network and information systems (Cybersecurity Directive).

The Cybersecurity Directive establishes EU-wide security and incident notification requirements for operators of essential services (such as banking and financial market infrastructures) and digital service providers (such as online marketplaces and online search engines). It also establishes obligations for EU Member States to adopt national strategies on the security of network and information systems and to designate national authorities for similarly related tasks.

Next steps are for the Cybersecurity Directive to be approved by the EU Parliament at second reading. The Council notes that it expects the Cybersecurity Directive to go into effect in August 2016.

For further information on the development of the Cybersecurity Directive, see the *Corporate & Financial Weekly Digest* edition of December 11, 2015.

A copy of the text of the Cybersecurity Directive (dated April 21, 2016) is available here.

A copy of the Council's Press Release is available here.

European Commission Adopts MiFIR Delegated Act

On May 18, the European Commission (EC) adopted a delegated act to supplement the Markets in Financial Instruments Regulation (MiFIR). The delegated act is in the form of a regulation (Delegated Regulation) and covers definitions, transparency, portfolio compression and supervisory requirements on product intervention and position management under MiFIR.

Chapter I of the Delegated Regulation details specifications to determine a liquid market for equity instruments (including shares, depositary receipts, exchange traded funds and certificates), which impacts pre- and post-trade transparency obligations under MiFIR. Chapter II relates to the requirements for trading venues and systematic internalizers to provide market data on a reasonable commercial basis, and Chapter III defines the scope of obligations on systematic internalizers with regards to making quotes public, order execution and transparency. Chapter IV sets out details in relation to derivatives and portfolio compression, and Chapter V contains the criteria that the European Securities and Markets Authority, the European Banking Authority and national competent authorities of EU Member States must take into account when looking to exercise product intervention and position management powers under MiFIR.

As mentioned in previous updates, the European Council and European Parliament will consider the Delegated Regulation, and once formally approved, the Delegated Regulation will go into effect 20 days following its publication in the *Official Journal of the European Union*.

For more information, see the *Corporate & Financial Weekly Digest* edition of April 29, 2016 and *Corporate & Financial Weekly Digest* edition of April 15, 2016.

A copy of the Delegated Regulation (and accompanying Annex) is available here.

For additional coverage on financial and regulatory news, visit *Bridging the Week*, authored by Katten's Gary DeWaal.

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SEC/CORPORATE

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UK DEVELOPMENTS

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