Speech

# The Regulation of Corporation Finance – A Principles-Based Approach

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It is common to hear these days that the pace of change is ever-increasing. Whether or not that is true is open to debate, but recent events in the capital markets seem to provide some support for that idea. When I became Director of the Division of Corporation Finance in May 2017, I remarked to the staff that the securities laws are exciting and dynamic, in part because novel questions are always coming up. Over the years, the Division has been in a great position to experience the excitement that comes from unforeseen challenges and novel issues. If we have learned – better yet, been reminded of – one thing about the federal securities laws during this time, it is how resilient and adaptable they are.[1]

There are no more fundamental securities law questions than "What is a security?" and, if you are dealing with a security, "What information should be disclosed to investors?" Regardless of how much things change, the approach to analyzing and answering these questions largely remains the same. The same principles the Supreme Court used to determine whether citrus grove interests were securities in *Howey*[2] are used today to analyze financial instruments the Court could not have dreamed of nearly 80 years ago. Similarly, the Commission's principles-based approach to disclosure can be applied to new, complex and evolving situations. Significant examples include Brexit, the upcoming LIBOR transition, cybersecurity developments, climate change, and most recently, the global coronavirus (COVID-19) pandemic we are battling today.

This is not to say that fine-tuning of and updates to our securities law framework and disclosure regime are not appropriate. The Commission has done just that over the years and recent examples include a number of disclosure rule updates, changes to the proxy process for shareholder proposals and proxy voting advice, amendments to the accredited investor definition and changes to the framework for exempt securities offerings.

### Digital Assets

In early 2017, the Commission and the Division were faced with questions about how to apply the federal securities laws to blockchain technology, digital assets and initial coin offerings. The Commission first

responded to these questions with a 21A Report of Investigation in The DAO matter.[3] In the report, the Commission considered a number of questions, including whether the tokens issued through the DAO platform were securities. The Commission considered this question using the "investment contract" analysis set forth in *Howey* and other relevant case law.

Since then, the Division has provided extensive guidance to help market participants analyze the application of the federal securities law to digital assets. This guidance includes factors to consider when assessing whether a digital asset is offered as an investment contract, and is thus a security, and factors to consider when attempting to structure digital assets so they function more like a consumer item and less like a security.[4] In 2018, the Commission launched the agency's Strategic Hub for Innovation and Financial Technology (FinHub) to serve as a resource for public engagement on the Commission's FinTech-related issues and initiatives. In 2019, FinHub issued a framework for analyzing whether a digital asset is offered and sold as an investment contract.[5] The framework is an analytical tool to help market participants assess whether the federal securities laws apply to the offer, sale or resale of a particular digital asset.

The Division also has issued responses to no-action requests indicating that it will not recommend enforcement action to the Commission if the digital assets described in the requests are offered or sold without registration under the federal securities laws.[6] Issuers have now qualified offering statements under Regulation A for the offer and sale of digital asset securities and the Division has declared a registration statement effective for the initial public offering of a token programmed using a smart contract that is compatible with the Ethereum blockchain. In addition, a number of issuers that conducted unregistered token offerings have, pursuant to settlements with the Commission, registered those tokens as securities under the Exchange Act and are now public reporting companies. The information contained in those registration statements and periodic reports has enabled investors in the unregistered offering to make informed decisions about whether to keep their tokens or surrender them and have their funds returned to them.

Being able to apply the federal securities laws to new and emerging technologies like digital assets without having to create an entirely new regulatory framework – as some other jurisdictions have had to do – is a testament to the flexible nature of our securities regime. It has allowed us to keep pace with innovation, facilitate capital formation and protect investors in a deliberate, thoughtful and effective manner.

## Principles-Based Disclosure

I have addressed the merits of the Commission's principles-based disclosure regime a number of times.[7] Our disclosure requirements emphasize materiality and are intended to provide investors with the information they need to make informed investment and voting decisions. A number of these requirements are prescriptive, or line-item requirements, meaning all companies to which the requirements apply must provide the disclosure. However, I believe that our principles-based requirements, which articulate an objective and allow companies to satisfy the objective by providing disclosure appropriately tailored to their facts and circumstances, in most cases are the ones that provide investors with the most meaningful information. These requirements can be highly effective in eliciting disclosure about complex and evolving areas like climate change, Brexit, cybersecurity and the LIBOR transition.

COVID-19 is the latest example. When the pandemic arrived and marketplace, supply chain and other disruptions began, having a principles-based disclosure regime meant that we already had the rules in place necessary to provide investors with material information. For example, a well-written Management's Discussion and Analysis should allow investors to see a company's results and prospects through the eyes of management and risk factors should address the most significant things that make an investment in a company and its securities subject to uncertainties or risk. These requirements did not need to be rewritten to require companies to provide information about how COVID-19 was affecting their business, prospects and financial condition. Companies following our principles-based requirements would draft their disclosures to do exactly that. Importantly, investors can take comfort that the disclosures are responsive to these principles-based rules, which are grounded in materiality and reinforced by a system subject to the rigors of regulatory oversight.

The Division moved quickly to assist companies and their advisors with their COVID-19 related disclosure obligations, and in March and June 2020, issued Disclosure Guidance Topics. The first provided the Division's

views regarding disclosure and other securities law obligations that companies should consider with respect to COVID-19 and addressed topics such as cost of capital, funding sources, impairment and other accounting charges, business continuity plans and remote work arrangements for staff.[8] In it, the Division also provided guidance with respect to reporting earnings and financial results. The second Disclosure Guidance Topic focused more specifically on operations, liquidity and capital resources disclosures companies should consider with respect to business and market disruptions.[9]

## A Principles-Based Approach to Rulemaking

This principles-based approach to disclosure can be seen in the rulemakings that the Division has recommended in the past few years. For example, the Commission recently approved amendments that modernize the Regulation S-K business, legal proceedings and risk factor disclosure requirements.[10] The amendments to the business description requirements emphasize a principles-based approach by requiring disclosure of information that is material to an understanding of the general development of a company's business. Similarly, the risk factor disclosure requirement has been refined to focus on material risks. For the first time, Regulation S-K now contains a specific topic related to human capital. Again, the requirement is principles-based as it calls for disclosure of human capital resources, including metrics used by management in managing those resources, to the extent that disclosure would be material to an understanding of a company's business. This approach recognizes that companies are unique and operate in a wide variety of industries. It allows companies to tailor their human capital disclosure to their specific facts and circumstances, rather than specifying information that all companies must provide. This enables investors to understand what human capital metrics and information are important to managing a particular company's business.

Proposed amendments to Management's Discussion and Analysis[11] and guidance on the use of key performance indicators and metrics in MD&A[12] provide another example. MD&A is rooted in materiality and is often most informative when written in a way that allows investors to see a company's results and prospects through the eyes of management. There is perhaps no more principles-based disclosure requirement. The proposed amendments and guidance seek to reinforce the principles-based nature of MD&A.

But the principles-based approach does not end with disclosure. I believe that the Division's entire approach to rulemaking during recent years – from the rules it chooses to recommend to the specific provisions of those rules – can be described as principles-based. The principles we have adhered to are aligned with the Commission's overall mission of promoting capital formation and protecting investors. The Division has revisited a number of existing rules with a view toward making the capital formation process for both public and private companies more attractive and efficient while maintaining or enhancing investor protections.

A focus of my tenure has been making the public markets more attractive for companies. Companies that go public engage in a process that strengthens them in many ways. Improved accounting policies, disclosure controls, management focus and board oversight are just a few. Companies also benefit from scrutiny by financial, accounting and legal advisors. Remaining in the public reporting system ensures that these improvements are not diminished over time. All of this benefits investors not only by increasing the number of investment opportunities, but additionally from improved investment opportunities.

To that end, the Division has engaged in a number of rulemakings designed to encourage companies to go public and engage in registered capital raising transactions. Extending the "test-the-waters" accommodation[13] was intended to accomplish just that. The accommodation allows all issuers – not just emerging growth companies – to gauge market interest in a potential initial public offering or registered securities offering by engaging in discussions with institutional investors prior to, or following, the filing of a registration statement. Revising the financial disclosure requirements for guaranteed or collateralized debt offerings[14] is a rulemaking intended to encourage companies to opt for public, rather than private, financings. We had observed that the rules in this area were burdensome, caused delays to market and had resulted in issuers conducting these offerings privately. The amendments should cause more transactions to be conducted publicly while at the same time providing investors with better, easier to understand disclosures as well as protections that are not available in private offerings.

While encouraging companies to go public and conduct securities offerings on a registered basis is important, not every company is meant to be public and not every transaction is meant to be registered. Similar to our public markets approach, the Division's approach to rulemakings for the private markets has been principles-based and focused on capital formation, providing investment opportunities and maintaining investor protections.

Recent amendments to the accredited investor definition[15] will allow certain financially sophisticated individuals to qualify as accredited investors regardless of whether they meet the rule's income or net worth thresholds. The amendments should provide those individuals with more investment opportunities and allow companies to access a larger pool of capital. The amendments should also maintain investor protections because the newly-accredited individuals are financially sophisticated and arguably understand how to assess an investment opportunity, including its risks. The Commission recently approved the Division's recommended rule changes designed to harmonize, simplify and improve the exempt offering framework.[16] The system had developed in a patchwork fashion over many years, resulting in friction that, in certain respects, impeded capital formation and limited investment opportunities. The changes are wide-ranging and seek to improve the framework in a way that promotes capital formation while preserving and enhancing investor protections.

The Division's principles-based approach to rulemaking attempts to improve the securities markets overall, not just the public markets or the private markets. Some of our rulemakings better facilitate companies going public, but these are not undertaken at the expense of the private markets. Nor do rulemakings that improve the private markets mean that the public markets will suffer. Creating, maintaining and improving upon a system where all types of companies can raise capital efficiently and investors are properly protected is beneficial to everyone.

## What SHOULD I Disclose?

In addition to market and technological changes, social changes also are underway. When it comes to the business environment, we are in an era when some have been questioning the role or proper purpose of the corporation today. I expect this question will continue to gain attention and will be a topic receiving significant management and board consideration at our public companies.

While the federal securities laws may not address the specifics of this question, thoughtful and proactive compliance with the federal securities laws, particularly our laws and rules around trading in company securities and corporate disclosure, is not a bad first step as companies set out on the path of defining their proper purpose as corporate citizens. The importance of good disclosure to the broader markets and the public cannot be overstated. Disclosure that is specific and tailored to a company's circumstances, that is well-vetted by accounting, legal and financial gatekeepers, provides everyone with information that can be trusted and acted on with confidence. The disclosure that companies make in their Commission filings is special in no small part because it is vetted by gatekeepers, subject to potential staff review and, of course, subject to the liability standards of the federal securities laws. These processes and rigor add credibility and weight to statements made in a report or document filed with the Commission.

There are many different approaches that companies can take when preparing disclosure. I encourage an approach that does not begin with the question "What must I disclose?" Rather, for the good corporate citizen, the question is better framed as "What should I disclose?" Companies should disclose the information that investors and the markets will find useful and important, regardless of whether there is some technical argument that compliance with specific disclosure requirements can be met with less illuminating disclosure. Similarly, the question should not be "When must I disclose the information?" I think asking "Is this disclosure timely for our investors?" is a better framework. Of course, even under that framework, within the bounds of the requirements of our laws and regulations, considerations of the company's strategic interests remain relevant and appropriate. A healthy perspective is to view corporate disclosure as an opportunity to engage and build trust with shareholders as opposed to an obligation or requirement to be minimized. Disclosures that are transparent, accurate, balanced and fair can build shareholder loyalty and serve long-term company interests. Good things can happen when companies strive to meet the meaning and intent, not just the letter, of the law.

## Corporate Hygiene

The same principles apply to corporate compliance in areas beyond disclosure. Some refer to the way a company ensures that its officers and directors are following trading policies, and avoiding trading at times when the market is not well informed, as "corporate hygiene." While it is always important to practice good corporate hygiene, it is especially important to do so during times of uncertainty and volatility. As such, it is not surprising to see issues in this area attracting media and public attention recently. Many of these issues are not strict securities law issues but, like good disclosure, good corporate governance and hygiene can improve confidence in our markets and the companies that operate in them and in our communities.

Examples of where companies can practice good corporate hygiene include the design and operation of insider trading policies and Rule 10b5-1 plans and the grant of stock option and other equity awards.

A well-designed and administered insider trading policy has controls that prevent senior executives and directors from trading once a company comes into possession of material non-public information, even if an individual officer or director did not personally have knowledge of the information. This prohibition would obviously cover the time period – sometimes referred to as the "8-K gap" – between the occurrence of a material event and the required disclosure of the event to the public under Commission rules. It would also cover the time period between the occurrence of a material event and public disclosure of the event where no specific Form 8-K disclosure requirement exists. For example, although they are not specifically addressed by our disclosure rules, cybersecurity incidents may constitute material information that should be disclosed to investors. In 2018, the Commission issued interpretive guidance to assist public companies in preparing disclosure about cybersecurity risks and incidents.[17] The guidance also encourages companies to consider how their insider trading policies prevent trading on the basis of material nonpublic information related to cybersecurity risks and incidents.

A well-designed and administered Rule 10b5-1 plan should help to eliminate any suggestion of impropriety or unfairness which, in turn, can facilitate long-term interest alignment and other principles of good corporate governance. A not so well-designed plan, on the other hand, can result in questions about impropriety and unfairness even when it is in technical compliance with the securities laws. In particular, questions can arise about the timing of plan implementation, amendment or termination when trading occurs, or does not occur, around those events. Companies can help demonstrate that Rule 10b5-1 plans are executed in good faith by requiring mandatory seasoning, or waiting periods, before trading can commence or recommence after a plan is adopted, amended or terminated. Plans with these requirements can also bolster investor confidence in public companies, their management teams and in markets generally. Boards of directors and their compensation committees would be well-advised to consider the interplay between company share repurchase plans and trading by directors and senior executives generally when approving, amending or terminating Rule 10b5-1 plans.

Companies would also be well-advised to consider carefully whether it is appropriate to issue stock options and other types of equity compensation to executives while the company may be in possession of material non-public information. Under the terms of many equity compensation plans, for example, stock options may not be granted with exercise prices below fair market value. Stock options with exercise prices at or above fair market value provide an incentive for recipients to work towards increasing company value. If a company grants an award based on the fair market value or trading price of its stock, but the market is not in possession of material information, a number of undesirable results may occur. The grant may be inconsistent with the terms of the compensation plan approved by shareholders. The grant could also be inconsistent with accounting rules if the trading price is not a good indicator of fair market value. The grant, to the extent it starts out well in the money, may also dilute the recipient's incentive. And of course if a grant appears to be "spring-loaded" with the benefit of undisclosed material positive developments, a loss of market confidence in management and the board can occur and costly litigation challenging the accounting and legality of the grant may follow.

There is a common, simple principle at play in these examples. And that principle is that companies, management teams, their boards of directors and advisors are well-served when they ask "What should we do?" rather than "What can we do?" as they seek to comply with the federal securities laws. As things

continue to change, I have tremendous confidence that framing the question this way will lead to the best answers under the federal securities laws.

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[1] This statement represents the views of the Director of the Division of Corporation Finance of the U.S. Securities and Exchange Commission ("SEC" or "Commission"). It is not a rule, regulation, or statement of the SEC. The Commission has neither approved nor disapproved its content. This statement does not alter or amend applicable law and has no legal force or effect. This statement creates no new or additional obligations for any person.

[2] *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).

[3] *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO*, U.S. Securities and Exchange Commission, Release No. 81207 (July 25, 2017), *available at* https://www.sec.gov/litigation/investreport/34-81207.pdf.

[4] *See* William Hinman, Director, Division of Corporation Finance, *Digital Asset Transactions: When Howey Met Gary (Plastic)*, Remarks at the Yahoo Finance All Markets Summit: Crypto (June 14, 2018), *available at* https://www.sec.gov/news/speech/speech-hinman-061418.

[5] Strategic Hub for Innovation and Financial Technology, U.S. Securities and Exchange Commission, *Framework for "Investment Contract" Analysis of Digital Assets* (Apr. 3, 2019), *available at* https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets.

[6] *See* TurnKey Jet, Inc., Division of Corporation Finance No-Action Letter (Apr. 3, 2019), *available at* https://www.sec.gov/divisions/corpfin/cf-noaction/2019/turnkey-jet-040219-2a1.htm and Pocketful of Quarters, Inc., Division of Corporation Finance No-Action Letter (July 25, 2019), *available at* https://www.sec.gov/corpfin/pocketful-quarters-inc-072519-2a1.

[7] *See, e.g.*, William Hinman, Director, Division of Corporation Finance, *Applying a Principles-Based Approach to Disclosing Complex, Uncertain and Evolving Risks*, Remarks at the 18th Annual Institute on Securities Regulation in Europe (Mar. 15, 2019), *available at* https://www.sec.gov/news/speech/hinman-applying-principles-based-approach-disclosure-031519.

[8] Division of Corporation Finance, *CF Disclosure Guidance: Topic No. 9 Coronavirus (COVID-19)* (Mar. 25, 2020), *available at* https://www.sec.gov/corpfin/coronavirus-covid-19.

[9] Division of Corporation Finance, *CF Disclosure Guidance: Topic No. 9A Coronavirus (COVID-19) – Disclosure Considerations Regarding Operations, Liquidity, and Capital Resources* (June 23, 2020), *available at* https://www.sec.gov/corpfin/covid-19-disclosure-considerations.

[10] Modernization of Regulation S-K Items 101, 103, and 105, Release No 33-10825 (Aug. 26, 2020) [85 FR 63726], *available at* https://www.sec.gov/rules/final/2020/33-10825.pdf.

[11] Management's Discussion and Analysis, Selected Financial Data, and Supplementary Financial Information, Release No. 33-10750 (Jan. 30, 2020) [85 FR 12068], *available at* https://www.sec.gov/rules/proposed/2020/33-10750.pdf.

[12] Commission Guidance on Management's Discussion and Analysis of Financial Condition and Results of Operations, Release No. 33-10751 (Jan. 30, 2020) [85 FR 10568], *available at* https://www.sec.gov/rules/interp/2020/33-10751.pdf.

[13] Solicitations of Interest Prior to a Registered Public Offering, Release No. 33-10699 (Sept. 25, 2019) [84 FR 53011], *available at* https://www.sec.gov/rules/final/2019/33-10699.pdf.

[14] Financial Disclosures about Guarantors and Issuers of Guaranteed Securities and Affiliates Whose Securities Collateralize a Registrant's Securities, Release No. 33-10762 (Mar. 2, 2020) [85 FR 21940], *available at* https://www.sec.gov/rules/final/2020/33-10762.pdf.

[15] Accredited Investor Definition, Release No. 33-10824 (Aug. 26, 2020) [85 FR 64234], *available at* https://www.sec.gov/rules/final/2020/33-10824.pdf.

[16] Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, Release No. 33-10844 (Nov. 2, 2020), *available at* https://www.sec.gov/rules/final/2020/33-10844.pdf.

[17] Commission Statement and Guidance on Public Company Cybersecurity Disclosures, Release No. 33-10459 (Feb. 21, 2018) [83 FR 8166], *available at* https://www.sec.gov/rules/interp/2018/33-10459.pdf.