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Errors in Previously Issued Financials? A 'Big P' Problem

The issue can strike fear into the heart of the most seasoned CFO or investment banker: a securities offering has just priced and the issuer gets word that its financial statements contain an error. A flurry of questions will immediately arise. If the financial statement error involves only a small dollar amount, will anyone care about such a de minimis mistake? Can the financial statements still be relied upon? If the error is discovered after pricing but before closing, can bankers simply reconfirm with accounts and possibly close on schedule? The answers to these questions hinge on a determination of the materiality of the error. In the context of potentially faulty financial statements, however, the process by which materiality is determined is complex and can be lengthy. Depending on the timing of the discovery of the error and its magnitude, this event can wreak havoc on a capital markets deal.

The focus of this article will be somewhat narrow: what steps should be taken upon the discovery of an error in the financial statements either during or in close proximity to a capital markets offering.[1] Most of the discussion points will deal with issuer-related activities. Bankers, however, might also find benefit in understanding the steps and analyses that issuers must undergo when dealing with such a situation.

[1] Although this article discusses accounting literature and financial statement items, we, of course, are not accountants and cannot provide any advice on accounting issues.

Is the error material?

One of the first questions to be asked upon discovery of an error in the financial statements is whether the error is material. Sometimes the dollar magnitude of the error is so significant that materiality is obvious. Other times, however, it's not so easy. In fact, even in situations where a financial statement error seems insignificant compared to other line items, deal participants are well advised to avoid making any quick conclusions. In these situations, the first step should be a "SAB 99" analysis.

"SAB 99" refers to the SEC Staff Accounting Bulletin No. 99, "Materiality." In SAB 99, the staff of the SEC provides guidance on legal and accounting considerations in the interpretation of materiality with respect to financial statement items. In SAB 99, the SEC acknowledges that certain "rules of thumb" have evolved over the years whereby materiality has been determined based on a quantitative threshold. For example, some may contend that an error below a 5 percent income threshold, absent unique circumstances, would be deemed immaterial. Although not disavowing such thresholds, SAB 99 makes it clear that using a quantitative analysis is only the first step in determining materiality.

After an initial "rule of thumb" test, SAB 99 states that a full analysis of an error's materiality needs to be conducted. The SEC points out in SAB 99 that the accounting literature and securities laws use the same general analysis when considering materiality. The accounting literature states that:

> The omission or misstatement of an item in a financial report is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item.[2]

From the legal perspective, the Supreme Court has held that a fact would be material if:

> [there is] a substantial likelihood that the … fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.[3]

Because an assessment of materiality requires an analysis of the "surrounding circumstances" (as the accounting literature puts it) or the "total mix" of information (as the Supreme Court puts it), SAB 99 concludes that "financial management and the auditors" must consider more than just **quantitative** factors when considering materiality –**qualitative** factors must be considered too.[4]

The SEC in SAB 99 cites a non-exhaustive list of qualitative factors that may be utilized when assessing the materiality of a financial statement error:

- whether the misstatement arises from an item capable of precise measurement or whether it arises from an estimate and, if so, the degree of imprecision inherent in the estimate
- whether the misstatement masks a change in earnings or other trends
- whether the misstatement hides a failure to meet analysts' consensus expectations for the enterprise
- whether the misstatement changes a loss into income or vice versa
- whether the misstatement concerns a segment or other portion of the registrant's business that has been identified as playing a significant role in the registrant's operations or profitability
- whether the misstatement affects the registrant's compliance with regulatory requirements
- whether the misstatement affects the registrant's compliance with loan covenants or other contractual requirements
- whether the misstatement has the effect of increasing management's compensation – for example, by satisfying requirements for the award of bonuses or other forms of incentive compensation
- whether the misstatement involves concealment of an unlawful transaction

[2] FASB, Statement of Financial Accounting Concepts No. 2, Qualitative Characteristics of Accounting Information, paragraph 132 (1980).

[3] *TSC Industries v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

[4] The guidance in SAB 99 provides the rationale for the due diligence question frequently posed to issuers and auditors: "Discuss any known errors in the financial statements that meet quantitative thresholds but for which [the issuer] has decided not to restate based on qualitative information."

SAB 99's importance in assessing materiality in financial statement errors cannot be overstated. In addition to its general guidance on qualitative issues, SAB 99 provides analysis on several specific circumstances involving financial statement errors (e.g., intentional misstatements, aggregating and netting misstatements and auditor's responses to such events). Accordingly, when deal participants are faced with such an issue, SAB 99 should prove an invaluable resource.

The SAB 99 Memo

An issuer's assessment of the materiality of an error in the financial statements is often documented in a "SAB 99 memo." A SAB 99 memo is an internal memorandum, often drafted by the CFO, CAO or Controller, which discusses the financial statement error in the context of the analyses proscribed in SAB 99. The memo should include a discussion of the quantitative factors on "key performance indicators."[5] In addition, it should discuss the qualitative factors cited in SAB 99. According to the SEC, different qualitative factors can lead to different outcomes among companies with the same error, even if the quantitative factors are of the same size.[6] At a certain point, issuers should consider sharing a draft of the memo with the external accountants to ensure that both internal and external accounting teams are comfortable with its conclusion. Issuers should keep in mind that, to the extent a financial statement error is considered to be immaterial and thus a previously halted capital markets deal is allowed to resume, underwriters and counsel will certainly request a copy of the SAB 99 memo for diligence purposes.

"Big R" and "Little r" Restatements

When the error is material, the financial statements will be required to be restated, which is sometimes called a "Big R restatement." A Big R restatement requires an issuer to revise previously issued financial statements via an amendment to the 10-K or 10-Q, as applicable, to correct the error in those previously issued financial statements. When such a Big R restatement is necessary, the previously issued financial statements cannot continue to be relied upon. In such case, the issuer (assuming it is subject to the reporting requirements under the 1934 Act) must file a Form 8-K under Item 4.02 stating that previously issued financial statements should not be relied upon. This 8-K must be filed within four business days of making that conclusion.

When the error is immaterial, generally, the error may be corrected in a future 10-K or 10-Q, which is sometimes called a "Little r restatement." In these circumstances, the error is usually corrected by revising the incorrect number in such financial statement the next time the financial statement for such period is filed (e.g., for comparative purposes). The issuer, its counsel and its outside accountant will need to consider the nature of such prospective disclosure and whether special disclosure explaining the error is warranted. In Little r restatements, a 4.02 8-K is not required because the previously issued financials are not materially misstated and, thus, can continue to be relied upon.

In the context of a contemplated capital markets deal, one thing seems clear: a Big R restatement will bring the offering to a complete halt. The issuer will need to correct the material misstatement in its historical financial statements (and file corrected historical financial statements) prior to resuming any offering of securities.

The result of a Little r restatement is more hopeful, but issuers and underwriters may not be out of the woods yet. If a capital markets deal resumes upon the conclusion that the financial statement error is immaterial, underwriters' counsel will need to perform its own diligence of the financial statements, including confirmation that the external auditors will be in a position to deliver the required comfort letters. In certain circumstances, external auditors may seek to qualify the standard comfort letter language when a Little r restatement is pending. Underwriters are loathe to accept certain types of "qualified" comfort letters. So, all the parties to the transaction will need to ensure that the comfort letter is "market norm."

[5] SEC Regulations Committee, April 3, 2009 - Joint Meeting with SEC Staff SEC Offices - Washington DC.

[6] Id.

Disclosure considerations

An issuer will immediately need to give consideration to its general disclosure obligations under the securities laws, including the impact and timing on any periodic reporting obligations. In addition to suspending any capital markets transaction, the issuer's insider trading window should immediately be closed upon discovery of the financial statement error and during the materiality analysis.

To the extent the error requiring a Big R restatement was not originally identified by the SEC, the issuer will need to timely inform the SEC of the coming restatement. In addition to notifying the SEC, in certain cases it may be helpful to consult the staff of the SEC's Office of the Chief Accountant or the Division of Corporation Finance.

Big R restatements may lead to an inability to file timely periodic reports. Some (if very limited) relief is provided by Rule 12b-25 under the 1934 Act. Rule 12b-25 can extend the original filing deadline for any late periodic report and the SEC will then treat the late report as having been timely filed. In order to take advantage of Rule 12b-25, (i) an issuer must complete Form 12b-25 within one business day of the report's original due date, (ii) the delayed report must be filed by the end of the extension period (five calendar days for Form 10-Q and 15 calendar days for Form 10-K) and (iii) an issuer must represent that it could not timely file the periodic report without unreasonable effort or expense.

To the extent it is unable to file timely its 1934 Act documents, an issuer may also need to review its debt documents to ensure that failure to file timely will not cause any issues under its covenants.

Finally, when it comes time to issue a press release regarding a Big R restatement, the issuer needs to ensure that it contains the most complete and accurate disclosure possible. In these highly stressful and fluid situations, certain issuers rush to get out information that later proves to be incomplete or inaccurate. Further, in disclosing the errors and the impending restatement, issuers need to be cognizant of Regulation FD issues. Note that the issuer may want to coordinate the filing of the press release with the release of the Item 4.02 8-K.

Inform the Audit Committee and Disclosure Committee

The issuer's audit committee and disclosure committee will need to be informed immediately of any material misstatement or omission in previously issued financials. The evaluation of whether an internal investigation is needed, and the oversight of any such investigation, will be coordinated by the audit committee. In the case of an accounting issue that is the result of misconduct, independent counsel should be considered.

Material weakness or significant deficiency?

When confronted with an error in previously issued financial statements, at some point a question will arise about the certifications of the disclosure controls and internal control over financial reporting for the previously issued financial statements. S-K Item 307 requires that issuers make disclosures each quarter on the effectiveness of their disclosure controls and procedures. An error in previous financial statements could impact an issuer's ability to state in its periodic reports that its disclosure controls are adequate. For the report on the effectiveness of internal control over financial reporting, there is no requirement for an issuer to reevaluate the effectiveness of its internal controls or to reissue a revised management's report on internal control over financial reporting because of a restatement of its financial statements. An issuer, however, may need to consider whether the original disclosures in management's report are still appropriate given the errors and should revise the original disclosures to include any other material information that is necessary. A deficiency does not need to result in a material misstatement for the deficiency to be considered material weakness. A "material weakness" is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.[7] The evaluation should therefor consider the likelihood that the identified deficiency could have resulted in a material misstatement. Finally, issuers may need to report any resulting change in internal control over financial reporting under S-K 308(c).

[7] Statement on Auditing Standards (SAS) No. 115, "*Communication of Internal Control Related Matters Identified in an Audit.*"

Listing requirements

In a Big R restatement scenario, an issuer should contact any securities exchange listing its shares after the decision to restate is made but prior to any public announcement. Both the NYSE and NASDAQ require companies to timely file their SEC reports. Filing late periodic reports can result in delisting proceedings instituted by the exchanges.[8] Late reports due to restatements, however, rarely result in delistings. The exchanges have broad discretion over delistings and may seek additional information to determine an issuer's response to its financial statement issues. An issuer should keep its listing agent informed regarding progress and next steps.

Conclusion

When an error is discovered in the financial statements, all financing activities should grind to an immediate halt. If contemplating an offering, pencils should be put down until the determination is made as to whether the error is material and whether the financial statements can be relied upon. If it appears after a SAB 99 analysis that a capital markets deal can resume, an issuer should be aware that underwriters will need to perform specific diligence on the matter prior to jumping back into the market. Without proper diligence, banks may well be reluctant to launch a capital markets issuance with the knowledge that certain financial statement items – albeit immaterial – are incorrect. If the error is identified after pricing but before closing, absent a manifestly immaterial error, the odds of closing on schedule are slim.[9] Given the complexity of most current financial statement disclosure, SAB 99 analyses need to be thorough and, usually, are time-consuming. This does not bode well for a T+3 capital markets deal. And because financial information is arguably the most important metric for an investor making an investment decision, all deal participants will need to be comfortable to proceed. Failure to properly analyze even a seemingly immaterial financial statement error can subject both the issuer and underwriters to significant increased risk for litigation and liability for securities law violations.[10]

[8] See NYSE Listed Company Manual Sections 802.01E and 804 and NASDAQ Marketplace Rules 5810, 5815 and 5825.

[9] Note that this scenario – where securities are priced on incorrect disclosure – is very different than the "plant blows up after pricing" scenario which was the subject of article entitled "*When Very Bad Things Happen After Pricing: Legal and Practical Considerations*," Baseload, September 2013.

[10] Of course, underwriters will presumably have due diligence defenses but that usually does not preempt an activist plaintiff's counsel from including underwriters as defendants in a securities lawsuit.

Transmission REITs: Update

The lead article in our last Baseload dealt with the topic of Transmission REITs ("Will the Wires REIT Become the Next Midstream MLP?", Baseload, September 2014). Since that time, Moody's Investors Service published a report on October 30, 2014 entitled "US Utility Transmission Assets: Power Transmission REITs Poised to be Sector's Next Phase of Financial Engineering." On December 3, 2014, members of the Hunton & Williams REIT practice and the Power and Energy Capital Markets practice, along with Wells Fargo Securities Inc. and Green Street Advisors, presented a seminar entitled "Transmission REITs: The Next Total Return Vehicle for the Utility Industry?" It seems this topic is poised to be a pivotal issue in the industry for 2015.

To the extent you would like further information on this topic, please contact your Hunton & Williams representative or any of member of the Power & Energy Capital Markets Group listed on the back page hereto.

The SEC Continues to Fix Windows

Late last year, SEC Chairwoman Mary Jo White announced a new approach to the agency's enforcement philosophy – one that (until now) may have been more familiar to city-dwellers than to corporate issuers. In an October 2013 speech at the Securities Enforcement Forum, Chairwoman White laid out how she views the SEC's mission:

> In today's fast moving, complex and changing markets, it is important that we strive to be everywhere to enforce our securities laws and to protect investors. It is important because investors in our markets want to know that there is a strong cop on the beat – not just someone sitting in the station house waiting for a call, but patrolling the streets and checking on things… Investors do not want someone who ignores minor violations, and waits for the big one that brings media attention. Instead, they want someone who understands that even the smallest infractions have victims, and that the smallest infractions are very often just the first step toward bigger ones down the road.

Analogizing to the "Broken Windows" strategy of law enforcement pioneered in New York City and other cities in the 1990's, Chairwoman White emphasized the importance of policing "even the smallest infractions" (although she was also careful to state that the agency would continue pursuing more significant violations). In her words, "I believe the SEC should strive to be that kind of cop – to be the agency that covers the entire neighborhood and pursues every level of violation."

As has been the case with many of the SEC's recent actions, the Chairwoman's remarks were not without controversy. Many commentators have pointed out the inherent difficulties in simultaneous pursuit of cases both big and small (or, in Chairwoman's White's words, being "an agency that makes you feel like we are everywhere"), given the Commission's limited resources. Not surprisingly, within the agency itself, there is disagreement. At ***this*** year's Securities Enforcement Forum, Republican SEC Commissioner Mike Piwowar took issue with the "Broken Windows" strategy, noting "[i]f every rule is a priority, then no rule is a priority."

Despite such opposition, it is clear the SEC is putting its plan into action. In September, the Commission instituted a rare "crackdown" on beneficial ownership reporting violations,[1] charging 28 individuals and six public companies with violations of the federal securities laws. The individuals charged were officers, directors and major shareholders of companies who were habitually late in filing their beneficial ownership reports. In addition, the six companies were charged for contributing to the filing failures by their insiders or for failing to report filing deficiencies. A total of 33 of the 34 charged individuals and companies ended up settling the charges, paying penalties totaling $2.6 million.

And in November, the Commission announced enforcement actions against ten companies for failure to file current reports on Form 8-K to report significant (for the companies involved) non-registered sales of common stock.[2] The ten companies, all micro-cap issuers, agreed to cease-and-desist orders prohibiting future violations and were assessed penalties totaling $350,000 (penalties of $25,000 or $50,000 for <u>each</u> company). Notably, the SEC's allegations did not include violations of Section 5 of the Securities Act (regarding prospectus delivery requirements) or Rule 10b-5 (the primary antifraud provision of the securities laws). Prior to these actions, it was rare for the Commission to enforce 8-K violations without also pursuing wider fraud or Section 5 violations. Further, the relatively small monetary penalties for each company suggest that the violations were technical in nature and certainly not egregious – not the sort of thing that is indicative of widespread fraud. Nonetheless, the recent actions serve as a reminder that, in the words of the Director of SEC's New York regional office: "The reporting requirements in the federal securities laws are not mere suggestions, they are legal obligations that must be obeyed. Those who fail to do so run the risk of facing an SEC enforcement action."

So what lessons can utility issuers and their advisors take from these actions? Are they harbingers of an unforgiving reporting regime? Will every minor technical reporting violation by a company bring the

[1] Section 16(a) and Section 13(d) of the Securities Exchange Act of 1934 require officers, directors and certain major shareholder to file reports with the SEC disclosing transactions in an issuer's stock.

[2] Pursuant to Item 3.02 of Form 8-K, an issuer must report sales of equity securities over certain thresholds in a transaction that is not registered under the Securities Act of 1933. Pursuant to Item 1.01 of Form 8-K, an issuer must report its entry into a material definitive agreement not made in the ordinary course of its business.

weight of the SEC down upon its head? Probably not. Although relatively small, the violations recently pursued by the Commission seemed to be systemic and recurring, and/or material to investors. In the case of the beneficial reporting actions, the agency went after individuals with a history of recurring reporting delinquencies and the companies that may have facilitated the same. In the case of the 8-K violations, the Commission focused on “smaller reporting companies” who failed to report dilutive sales of equity that represented more than five percent of the issuer’s shares (a presumably material action to investors in those companies). It remains unlikely that the SEC will aggressively pursue one-off and isolated deficiencies. But the actions do serve as a reminder that the SEC will not hesitate to act, even for seemingly minor infractions, if the agency believes it will serve its mission.

Steven C. Friend, Editor
212.309.1065
sfriend@hunton.com

Kevin C. Felz, Editor
212.309.1053
kfelz@hunton.com

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If you have questions related to any of the articles in this issue, please contact any of the below members of the Capital Markets Group of the Energy and Infrastucture practice at Hunton & Williams LLP:

Dee Ann Dorsey
212.309.1174
ddorsey@hunton.com

Bud Ellis
212.309.1064
ellisb@hunton.com

Kevin C. Felz
212.309.1053
kfelz@hunton.com

Michael F. Fitzpatrick, Jr.
212.309.1071
mfitzpatrick@hunton.com

Steven C. Friend
212.309.1065
sfriend@hunton.com

Peter K. O'Brien
212.309.1024
pobrien@hunton.com

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