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Current Topics in the Power and Utilities Capital Markets

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Contents

A Big Deal: The Materiality Analysis for Utility Issuers

One of the foundations of US securities laws is that, in connection with a securities offering, issuers have an obligation to publicly disclose information to allow potential investors to make an informed decision. In order to facilitate this principle, the US securities laws have developed the concept of materiality. In the context of a capital markets offering, most disclosure issues are viewed through the prism of materiality. Unfortunately, materiality is not a "one-size fits all" analysis. For instance, a material event for a prospective equity investor may not necessarily be material to a prospective debt investor of the same issuer. Similarly, an unintentional omission or misstatement of a small dollar amount on an issuer's financial statements often can be viewed as immaterial. An intentional mistake of the same dollar amount, however, may well be viewed as material. As discussed in further detail below, these seemingly incongruous outcomes result from a fluid and flexible analysis of materiality that is highly dependent upon the specific facts of the particular event in question.

The definition of "material"

The US Supreme Court has defined the concept of materiality as:

There is a substantial likelihood that a reasonable investor would attach importance in making an investment decision because the disclosure would significantly alter the "total mix" of available information.[1]

The Court additionally set the standard that an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote, in the context of a merger.[2] This concept was further expanded in *Basic Inc. v. Levinson*, where the potential materiality of omitted information was expressly adopted as part of the materiality analysis.[3] These concepts of materiality have been generally adopted and applied to disclosure in capital markets offerings.

1 TSC Industries, Inc., v. Northway, Inc., 426 U.S. 438 (1976).

2 *Id.*

3 Basic Inc. v. Levinson, 485 U.S. 224 (1988).

The SEC in Staff Accounting Bulletin No. 99 "Materiality," ("SAB 99") also provided guidance with respect to analyzing materiality. In the context of determining materiality with respect to financial statement disclosure, the SEC in SAB 99 cites the Statement of Financial Accounting Concepts No. 2:

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 the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item.

These definitions are helpful guidance when assessing materiality. But phrases such as "total mix of information" and "in light of surrounding circumstances" seemingly inject highly nebulous concepts into the materiality analysis. The use of such phrases forces the individual making the materiality analysis to consider unique facts and circumstances surrounding the event in question. That makes each materiality analysis a case-by-case examination – rather than a bright-line test applicable to each and every disclosure event.

Factors to assess if an event is material

When determining materiality, the specific facts and circumstances surrounding the event must be scrutinized. Given the variety of different industries, products, customers, locations and risks of issuers accessing the capital markets, a more generic standard could lead to either underinclusive or an overinclusive disclosure. Accordingly, the US securities laws have required each company to make an assessment of its unique characteristics when making a materiality determination. For example, the inability of customers to remain current on their obligations due to COVID-related issues has impacted industries across the board. From a materiality perspective, however, such an adverse impact may well have a more pronounced and, arguably, material impact on issuers in different industries. If tenants cannot pay rent to a REIT landlord, the REIT's financial position will be directly and adversely impacted. If conducting an offering, a potential investor in that REIT would probably deem such information to be material. For a rate regulated utility, however, certain regulators may allow such utility to defer "bad debt" expense related to COVID and potentially even recover such expenses at a later date through the regulatory process. In such a scenario, the impact of COVID may have a much more benign impact on a utility than a REIT. From a materiality standpoint, therefore, utility investors may deem such disclosure less relevant than REIT investors.

The facts and circumstances analysis of the materiality standard also applies to different types of capital markets offerings. Although the legal concept of materiality does not distinguish between debt and equity investors, certain events could result in a precipitous decline in the value of an issuer's equity but have little or no impact on the value or ratings of such issuer's debt. Again, in certain circumstances, one could conclude that disclosure of the same event would alter the total mix of available information for an equity investor – but have little impact on a debt investor.

The concept of materiality has evolved over time with new issues and developments in the world. The SEC notes that the US securities laws are dynamic and respond to changing circumstances.[4] Additionally, the SEC has provided guidance over the years on various emerging issues that may prompt a materiality test for companies ranging from Y2K disclosure to climate change to cybersecurity and, most recently, to the impact of the COVID-19 pandemic.

4 Statement of the Commission Regarding Disclosure of the Year 2000 Issues, Release No. 34-40277 (Aug. 4, 1998).

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 in a company's financial statements below a five 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 the initial "rule of thumb" test, SAB 99 states that a full analysis of an error's materiality needs to be conducted. SAB 99 goes on to list certain considerations to analyze when considering materiality:

- 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

Although SAB 99 is focused predominantly on materiality with respect to financial statements, the SEC points out in SAB 99 that the accounting literature and securities laws use the same general analysis when considering materiality.

The specific events that would trigger a Form 8-K filing also provide helpful guidance as to assessing materiality of an event. While most of the "triggering items" in Form 8-K are unquestionably material (e.g., bankruptcy, acquisition or disposition of significant assets, results of operations, material impairments, etc…), issuers may also file 8-Ks

for Regulation FD events (Item 7.01 of Form 8-K) and for disclosure of "other events that the registrant deems of importance to security holders." (Item 8.01 of Form 8-K). With respect to Item 7.01, the SEC has stated that "either the filing or furnishing information on Form 8-K to satisfy Regulation FD will not, by itself, be deemed an admission as to the materiality of the information."[5] Further, an Item 8.01 8-K filing is not necessarily conditioned on materiality, but rather information "[deemed] of importance" to investors.

So, to flip the issue around, is an event that prompts the filing of an 8-K always material? In the context of a capital markets offering, it would be highly unusual for an issuer to file a Form 8-K to disclose a non-material event. Again, however, a facts and circumstances analysis would need to be performed to assess such materiality. For example, in the regulated utility industry, it is not uncommon for utilities to disclose via Form 8-K the various procedural thresholds in their rate proceedings. These thresholds are not necessarily material but many utilities believe such disclosure to be informative to the investment and analyst community. Although rare, there have been instances in which the issuer has deemed it important to file such an 8-K in the midst of a capital markets offering. Given the general presumption of materiality of a Form 8-K filing, such a move is certainly not without risk. By employing a facts and circumstances analysis, however, the parties, especially the underwriters and their counsel, would need to agree on the immateriality of the event. As important, they would need to agree that the mere appearance of the filing of an 8-K prior to closing would not have an adverse market reaction.

The materiality concept under the US securities laws also influences similar analysis in the public accounting industry. In January 2020, the American Institute of Certified Public Accountants (AICPA) Auditing Standards Board issued

5 SEC Release No. 33 -7881 Section II. B.4a.

guidance in Statement on Auditing Standards No. 138[6] and Statement on Standards for Attestation Engagements No. 20.[7] Specifically, the guidance revises the materiality standard for audits of financial statements and attestation engagements such that misstatements, including omissions, are material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the financial statements. Previously, the standard was that misstatements, including omissions, were considered material if they, individually, or in the aggregate "could reasonably be expected to influence the economic decision of users." The new materiality standard now aligns with the description of materiality used by the U.S. judicial system, the auditing standards of the PCAOB, the SEC and the FASB.

Threshold questions when considering materiality

When assessing the materiality of event, the issuer, its counsel and auditors, the underwriters and their counsel should take into account the following questions:

1. Is there a substantial likelihood that a reasonable investor would consider the information important when making a decision to invest in the company's securities?

Information that would be considered material must have a substantial likelihood to significantly change the "total mix" of information available as determined by a reasonable investor when making an investment decision.

6 American Institute of Certified Public Accountants, Statement on Auditing Standards No. 138 Amendments to the Description of the Concept of Materiality (Dec. 2019).

7 American Institute of Certified Public Accountants, Statement on Standards for Attestation Engagements No. 20 Amendments to the Description of the Concept of Materiality (Dec. 2019).

2. Is the information in question contingent or speculative?

The company and its counsel should determine whether an event or information that could be considered material is probable to occur or is significant to the company if it did occur. Events with limited probability of occurring but that could have major significance to the company could be considered material information despite the lack of probability of occurrence.

3. Could individual non-material information be considered material in the aggregate?

This question is commonly asked with respect to financial statement misstatements. Companies and their auditors should be mindful that past misstatements deemed immaterial may be carried forward in multiple years' financial statements and could add up to a material misstatement in the current financial statements. Such aggregate misstatement may be determined to be material for investors.

Conclusion

The materiality concept under US securities laws provides both flexibility but also a burden on companies, underwriters and their counsel to make a determination on which information is required to be publicly disclosed. Given the frequency and various contexts in which these determinations arise, practitioners are well advised to regularly revisit the framework that dictates how these determinations are to be made.

SEC Enforcement Focus

The Securities and Exchange Commission (SEC) Division of Enforcement is responsible for the civil enforcement of federal securities laws. The SEC aims to protect investors and identify, remedy and punish misconduct by securities issuers and financial institutions. In November 2019, the SEC Division of Enforcement released its 2019 Annual Report, outlining five core guiding principles:

i. focus on the retail investor,

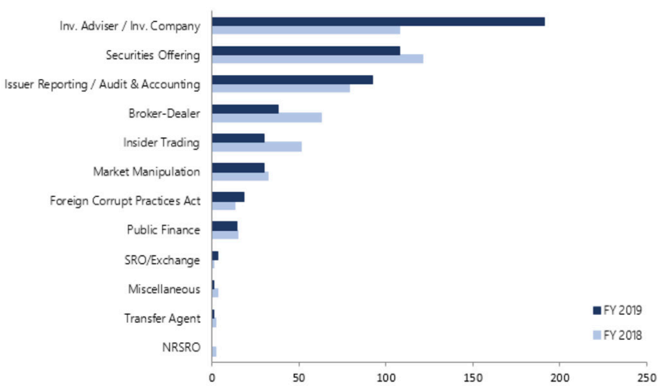
ii. focus on individual accountability,

iii. keep pace with technological change,

iv. impose remedies that most effectively further enforcement goals, and

v. constantly assess the allocation of its resources.

The chart below (taken from the report) shows that much of the standalone enforcement actions brought last year related to investment advisor and investment company violations, securities offerings, and auditor/accounting matters.



Source: 2019 Annual Report by the SEC Division of Enforcement

Based on our review of the 2019 report, we have attempted to summarize below certain of the recent enforcement actions described in the report that may be of particular interest to issuers and underwriters in the power industry. When crafting disclosure, negotiating underwriting agreements and advising members of a working group, it is always helpful to recall these specific areas of focus of the Division of Enforcement.

Disclosure Violations and Regulation FD

In March 2019, the SEC charged a car manufacturer, two of its subsidiaries and its former chief executive officer of defrauding US investors by making deceptive claims regarding the company's clean diesel fleet and environmental impact. The car manufacturer knew its fleet of cars in the United States exceeded legal vehicle emissions limits and knowingly made false and misleading statements regarding the fleet's quality and environmental compliance. During this period from April 2014 to May 2015, the car manufacturer issued more than $13 billion in bonds and asset-backed securities in U.S. markets.

In March 2019, the SEC charged a construction retailer with making false statements to investors. In 2015, the construction retailer publicly released statements to refute a television news program that alleged its suppliers sold the retailer products that did not comply with regulatory requirements. The construction retailer's statements said third party testing showed its products complied with formaldehyde emissions standards and that the company did not work with suppliers whose products did not comply – even though the construction retailer knew its largest Chinese supplier was non-compliant. The construction retailer's misleading statements regarding its quality control and regulatory compliance programs led to $33 million in total disgorgements, prejudgment interest, criminal and regulatory penalties.

In April 2019, the SEC won a final judgment at trial against a biotech company chief financial officer for misleading investors regarding the biotech company's prospects for receiving approval from the Food and Drug Administration (FDA) for its flagship drug. The biotech company raised $53 million in a public stock offering in January 2013 but did not disclose that in May 2012, the FDA explicitly recommended that the biotech company conduct an additional clinical trial for its flagship drug.

Finally, in August 2019, the SEC charged a pharmaceutical company with violations of Regulation FD. In 2017, the pharmaceutical company shared material non-public information twice with analysts regarding the company's interactions with the FDA. In one instance, the pharmaceutical company described an FDA meeting regarding new drug approval as "positive and productive," despite not releasing any public or market-wide disclosures regarding the meeting. In another instance, the pharmaceutical company sent to analysts undisclosed details regarding another FDA meeting that were not included in a press release issued early that same morning and prior to market open. The analysts included the undisclosed details in their published research notes, likely fueling additional trading and cushioning the press release's disappointing news. The pharmaceutical company paid penalties of $200,000.

Regulatory Compliance

Foreign Corrupt Practices Act (FCPA)

Section 30 of the Securities Exchange Act of 1934 (Exchange Act) prohibits issuers from using an instrumentality of interstate commerce corruptly to offer, pay, promise payment, or authorize payment to influence a foreign official's actions or decisions in the foreign official's official capacity. In 2019, the SEC pursued 18 different actions for FCPA violations against 15 entities and 5 individuals, extracting nearly $515 million in disgorgement of illegal profits, penalties, and fees.

In February 2019, the SEC charged a technology company and three of its senior executives for facilitating bribery payments to an Indian government official. In 2014, the technology company was in the process of building a large campus in Chennai, India. The government official demanded a $2 million bribe to facilitate the construction company's building. The technology firm's president and chief legal officer authorized the bribe and instructed subordinates to conceal the bribe by reflecting them in company records as contractor change orders. The technology firm later authorized $1.6 million of additional bribery payments, also disguised as change order requests. The technology company's president and chief legal officer faced charges for violating anti-bribery, books and records and internal accounting controls laws. The technology firm agreed to pay $25 million to settle the charges ($19 million as disgorgement and prejudgment interest, and $6 million in penalty fees).

In May 2019, the SEC charged a Brazilian telecommunications company with violations of the FCPA books and records and internal accounting controls requirements. In 2013 and 2014, the telecommunications company hosted hospitality programs in connection with the Confederations Cup and World Cup, respectively. The telecommunications firm provided tickets to 127 government officials it believed were able to influence legislative actions, regulatory approvals and business dealings in which the company had an interest. The telecommunications company did not reflect these gifts in its books and records and did not maintain a system of internal accounting controls nor a system that enforced the firm's anti-bribery and anticorruption policies. As a result, the telecommunications company paid $4.125 million and agreed to a cease-and-desist order to settle the charges.

In August 2019, the SEC settled charges with a German bank that violated books and internal accounting controls provisions of the Exchange Act. Since at least 2006, the German bank, in violation of an explicit policy it enacted in 2010 in the Asia Pacific region, hired relatives of foreign officials in China and Russia at the foreign officials' requests to retain business and benefits in their respective countries. These new hires, referred to as "Referral Hires," skipped the bank's competitive merit-based hiring process and were less qualified than those hired through the bank's formal recruitment process. However, Referral Hires allowed the German bank to generate new business; hire requests often explicitly asked the banker to quantify the earned fees anticipated from the referring client (e.g., from the Referral Hire's father or mother, a foreign official). The bank ultimately agreed to pay nearly $11 million in disgorgement of the illegally generated Referral Hire fees, nearly $2.4 million in prejudgment interest and a $3 million civil penalty.

In September 2019, the SEC charged a clean fuel technology company and its former chief executive officer for offering to pay bribes to a Chinese government official. In 2016, the clean fuel technology company sought to (i) obtain business through a framework supply agreement between itself and its Chinese joint venture company and (ii) receive authorization to receive a cash dividend payment from its Chinese joint venture's largest shareholder, a state-owned entity at which the Chinese government official held a senior position. To incentivize the Chinese government official to authorize the desired business and dividend, the clean fuel technology company, at its former chief executive officer's direction, transferred a portion of its shares in its Chinese joint venture to a Chinese private equity fund where it believed the Chinese government official held a financial interest. In violation of the FCPA, the clean fuel technology company maintained false records that concealed the true beneficiary of the joint venture share transfer and lacked internal accounting controls to prevent this fraud. The former chief executive officer also executed certifications to internal controls, which were false. The clean fuel technology company paid a total of more than $4 million in disgorgement and penalty fees, while the former chief executive officer paid more than $120,000 in civil penalty fees.

Insider Trading

In 2019, the SEC pursued charges for insider trading against those who traded based on material non-public information and against those who tipped off others who then traded.

In December 2018, the SEC charged a banking consultant with insider trading related to an airline merger transaction. The banking consultant's then-fiancé, an investment banker, worked on the airline merger transaction. The banking consultant eavesdropped on a telephone conversation his now-wife had regarding the transaction. He purchased aggressive out-of-the-money options that were due to expire in only weeks; this made him the only investor at times who held these options. The banking consultant made more than $250,000 in illegal profits based on an initial investment of roughly $4,000. The banking consultant settled without admitting nor denying the allegations and returned his illegal profits, as well as a one-time penalty fee for the same amount.

In February 2019, the SEC filed insider trading charges against a senior attorney at a technology firm. The senior attorney received confidential information regarding his employer's quarterly earnings announcements prior to their public release. The attorney traded the company's securities in advance of the public quarterly earnings announcements in 2015 and 2016 three times, providing him with approximately $382,000 in illegal profits and losses avoided. Part of this attorney's responsibilities were to review and approve the company's insider trading policy and notify employees

of their obligations thereunder; so the SEC perceived his violations of insider trading regulations as particularly offensive. The attorney also faces criminal charges in addition to these civil charges under the SEC's complaint.

In April 2019, the SEC charged a senior attorney at an entertainment park company with insider trading based on material non-public information regarding the company's revenue. After the attorney received a confidential draft of the entertainment park company's 2018 second quarter earnings, which showed strong financial performance following a prolonged period of disappointing financial results, he purchased 18,000 shares in the company. The attorney then immediately sold his 18,000 shares after the company announced its earnings. The stock price increased by 17 percent. In addition to the SEC's complaint, the attorney also faces criminal charges with the U.S. Department of Justice.

In June 2019, the SEC won a judgment against two defendants for insider trading violations before the United States District Court for the Southern District of New York. The SEC's complaint related to a licensing agreement between two large pharmaceutical companies that was leaked by one defendant, a vice president at one of the pharmaceutical companies, to the other defendant, his close friend and business associate. The recipient of the information shared it with a friend, who shared the information with an insider-trading ring, many of whom traded based on the information. The ring ultimately made roughly $1.5 million in illegal profits, of which one of the defendants received $222,000. The court ordered a civil penalty of $750,000 and a five-year officer and director bar against the first defendant, the vice president of the pharmaceutical company. Final penalties against the second defendant and the insider trading ring are pending.

In August 2019, the SEC won an insider trading case against a securities broker who learned of three impending corporate transactions from an M&A tax partner who assisted in the deals. The securities broker tipped off his former colleague and friend, who then traded securities in the three target acquisition companies and made more than $100,000 in illicit trading profits, sharing more than a fifth of that with the securities broker. The SEC won at trial, with the jury finding the securities broker guilty on all counts and violation of multiple securities laws.

In August 2019, the SEC charged an analyst at a large international investment bank for insider trading conducted based on information that a client of the investment bank planned to acquire an electronic imaging company. The analyst purchased call options for the electronic imaging company and sold these options for a profit of slightly under $100,000 after the acquisition was made public. The analyst was required to receive authorization before he was allowed to trade securities, so he attempted to hide this illegal trading by concealing his brokerage account from the investment bank. The outcome of this case is still to be determined, but the SEC seeks disgorgement of the illegal profits, interest, penalties, and injunctive relief.

Auditor/Accounting

Accounting Fraud

The SEC also pursued enforcement actions for lapses in proper accounting practices, those both that were mere misstatements, as well as purposeful fraud.

In February 2019, the SEC settled with the defendant for $16 million in penalty fees over charges that the defendant, a car rental company, made multiple company filings with inaccurate financial statements and disclosures. The car rental company submitted inaccurate filings from February 2012 through March 2014, perpetuating a misstatement of its pre-tax income and additional accounting errors, ultimately impacting financial statements across multiple business units and over multiple reporting periods. The car rental company also ignored its own latest internal analysis to lower projected earnings, even after it knew the prior disclosed range included a flawed calculation methodology. Though the car rental company never admitted nor denied the SEC's findings, many of its misstatements and flawed methodologies were an attempt to achieve internal budgets, business plans, and earnings estimates.

In a September 2019 settlement, the SEC won $40 million in penalty fees over charges that a car manufacturer paid its automobile dealerships to fraudulently inflate and underreport monthly sales figures from August 2012 to July 2016. The car manufacturer maintained a backlog of unreported sales, only recognizing them as recent sales when actual sales fell short of targets. This allowed the car manufacturer to market to investors in monthly press releases that it had an uninterrupted streak of sales growth every month. The car manufacturer included these press releases in its reports filed with or furnished to the SEC. These metrics were important in the car manufacturer's industry, as they demonstrated its competitive position and continued demand for its products. When some automobile dealerships accused the car manufacturer of the fake sales numbers and

sued the car manufacturer for attempting to bribe them into filing fake sales reports, the car manufacturer publicly denied the allegations.

In September 2019, the SEC settled charges against an information and media analytics firm and its former chief executive officer for providing misleading and false statements regarding key performance metrics. From February 2014 through February 2016 and at the chief executive officer's direction, the information and media analytics firm entered into fraudulent non-monetary transactions to increase reported revenue. The firm and its transaction counterparty negotiated and agreed to exchange data sets without consideration, though the firm recognized the revenue from the transactions at fair value; this inflated the firm's revenue and allowed it to exceed its revenue targets for seven consecutive quarters. The firm deceptively appeared to experience nearly two years of steady growth. Though the firm did not admit nor deny the SEC's charges, both the firm and its former chief executive officer paid penalties of $5 million and $700,000, respectively, in addition to agreeing to cease from future violations of anti-fraud provisions.

In an enforcement case against a paint manufacturer, the SEC settled with the defendant without a monetary penalty, due to the company's significant cooperation, self-reporting and remediation. The paint manufacturer improperly recorded expense accruals and misclassified certain income as continuing operations from December 2016 through April 2018. This inflated the paint manufacturer's income for two reporting years and certain quarters within the two-year period. These financial misstatements were also included in various press releases and SEC filings, coming to 14 instances of accounting misconduct. However, because the paint manufacturer self-reported and identified material weaknesses in its internal controls for financial reporting for improvement, the SEC settled its case in September 2019 without a financial penalty.

Non-Generally Accepted Accounting Principles Disclosure

While publicly traded issuers in the United States must follow Generally Accepted Accounting Principles (GAAP) according to the Financial Accounting Standards Board, many issuers also report supplemental non-GAAP financial figures. These non-GAAP disclosures are a way for issuers to provide additional color and assist investors and analysts as they analyze the issuer's operating results.

In August 2019, the SEC charged a real estate investment trust (REIT) and four of its former executives with fraud for a scheme to manipulate a key non-GAAP metric. Investors and analysts use the metric, the Same Property Net Operating Income Growth Rate (SP NOI Growth Rate), to assess a REIT's financial performance. The SP NOI Growth Rate is particularly important for REITs, as it is an adjusted version of the net operating income growth rate that shows the REIT's ability to generate growth from existing properties, as opposed to new property acquisition or construction. The REIT in this case publicly reported a steady SP NOI Growth Rate that consistently grew, even though its actual SP NOI Growth Rate was volatile and often fell outside the REIT's publicly issued guidance range. The REIT's Chief Executive Officer, Chief Financial Officer, Chief Accounting Officer, and an Accounting Department manager would inaccurately report when revenue was recognized, incorporate lease termination income into the SP NOI and reduce the SP NOI for the comparison period to make the growth rate appear higher; they referred to this manipulation as "mak[ing] the sausage." The REIT paid $7 million in penalty fees in the settlement with the SEC and agreed to hire an independent consultant to review and assess controls related to non-GAAP measures.

Auditor Independence and Integrity

Finally, the SEC is also increasingly concerned with auditor independence and integrity. Public Company Accounting Oversight Board (PCAOB) rules require audit firms to provide independent professional services with integrity.

In October 2018, the SEC suspended three accountants at an audit firm for improper professional conduct conducted during the audit firm's audit of a publicly traded insurance company. In 2013, the audit team was unable to complete its necessary audit procedures before the insurance company client filed its annual report with the SEC. The senior manager on the audit team instructed the audit team to approve all paperwork regardless of its completion and to load and sign blank or placeholder papers in the audit firm's electronic files, pre-dating the audit documentation. Following the client's filing with the SEC, the audit team eventually finished its necessary audit procedures and saved over existing documentation work papers with the sign-offs. When the audit firm was required to produce snapshots of its work papers from the period during the audit, the SEC found deficiencies between the pre-dated work papers and those that were finalized with the completed procedures. The SEC found the audit partners on the audit firm's engagement failed to exercise proper professional care and suspended the partners, as well as the senior manager from appearing and practicing before the SEC as accountants. The SEC also banned them from auditing or preparing financial reports for public companies, with the opportunity to be reinstated after a prescribed period has passed for each.

In February 2019, the SEC charged an audit firm with a conflict of interest violation that resulted in a $2 million fine. The SEC's charges alleged that the audit firm allowed dozens of its employees to maintain bank accounts with one of the client's subsidiaries while it issued audit reports for its client. The account balances exceeded depositary insurance limits, violating SEC independence requirements. The audit firm did not have quality controls to ensure auditors were independent from their audit clients. The $2 million monetary fine accompanied censure, an order to cease-and-desist from future violations and suspension of senior executives at the audit firm who themselves maintained bank accounts in violation of the SEC independence requirement with the audit client's subsidiary.

And in June 2019, the SEC settled an action against an audit firm for violations of PCAOB rules. The settlement required the audit firm to pay a $50 million penalty and compliance with a number of required undertakings to ensure remediation, including engagement of an independent compliance consultant. In the settlement, the audit firm admitted it had a widespread integrity issue related to mandatory ethics, integrity and compliance training. Some partners at the audit firm had shared answers to the ethics exams amongst themselves and with staff to allow them to pass. Some at the audit firm even manipulated the exam system to lower the required minimum passing score, with some submitting fewer than 25% correct answers.

Impact of the COVID-19 Pandemic on SEC Enforcement Efforts

Despite business closures, limited travel and social distancing, the SEC continued to bring forward enforcement actions in the first and second quarters of 2020. Furthermore, despite continued business closures, the SEC brought more enforcement actions in the second quarter of 2020 than it did in the first quarter. However, while first quarter actions were primarily brought in federal district court, the SEC brought second quarter actions in both federal district court and through administrative filings in near-equal number. In the first quarter, nearly half of the SEC's enforcement actions were offering fraud. In the second quarter, the majority of enforcement actions were still offering fraud, though the SEC also pursued false statement, manipulation, conflicts, and FCPA enforcement actions.

In April 2020, the SEC brought forward an offering fraud action in federal district court in Florida. A pharmaceutical company misled investors into believing it would offer an IPO following an acquisition deal to become the largest cannabis operation in the United States. The claims were false; no acquisition was planned, nor was there a pending IPO or trademarked logo for the future cannabis company. The principal of the company misappropriated investor funds and the case remains pending.

In May 2020, the SEC brought a false statement action against a company whose trade execution was contrary to what customers understood; instead of using an advanced and sophisticated system, the company used a low cost system that allowed certain customer accounts to route through a partnering broker with lower fees. The SEC allowed the company to pay a settlement penalty of $5 million due the company's cooperation.

In April 2020, the SEC brought a manipulation action against a securities trader who, after purchasing shares in a privately held firm, directed others to purchase and trade the firm's securities after it went public to match and peg purchases and drive the share price up, allowing him to sell shares at a profit. The trader did not file reports of the interest he beneficially held in the firm's securities. The trader's accomplices paid disgorgement and prejudgment interest of nearly $1 million; the trader was barred from the securities business and paid a civil penalty of $40,000 and disgorgement and prejudgment interest of more than $63,000.

In May 2020, the SEC brought an action against a rating agency because it failed to establish and maintain written policies and procedures to comply with Rule 17g-5(c)(7)(i) while actively identifying and contacting prospective clients through marketing calls. The rating agency paid a penalty of $3.5 million and agreed to correct and implement compliant procedures.

Float On: The Market Tweak to the ARRC's Language

Our team has been following new developments in connection with the LIBOR transition closely. As readers may recall, in August 2017, the UK Financial Conduct Authority announced it will discontinue using the London Interbank Offered Rate (LIBOR) index at the end of 2021. With trillions of dollars in loans, bonds, derivatives and other financial contracts based on the rate, market participants have been working to develop standards to bridge the gap for instruments that are priced today in LIBOR but with maturities that extend past 2021.

In April 2019, the Alternative Reference Rates Committee (the ARRC) released its final "fallback language" recommendations for USD-denominated floating rate notes and syndicated loans. In particular, the ARRC's guidance contained sample language with a waterfall of specific successor rates (each such rate, a Benchmark). The initial successor rate is expected to be the secured overnight financing rate (SOFR) published daily by the Federal Reserve Bank of New York. The initial priority in the waterfall is "Term SOFR," which is expected to be the forward-looking term rate based on SOFR, followed by the "Compounded SOFR," which is a compounded average of daily SOFRs if the Term SOFR does not exist. In certain instances, if the current Benchmark begins to be quoted for a more limited number of terms, the ARRC language instructs issuers, if possible, to use an "Interpolated Benchmark."

Because SOFR is expected to be lower than LIBOR and other Benchmarks in the waterfall could differ from LIBOR, a spread adjustment will be necessary for instruments originally priced using LIBOR. Without the added spread (often referred to as the "Benchmark Replacement Adjustment" in floating rate disclosure), there would be a potential asymmetry in overall coupon relative to LIBOR.

The ARRC's initial suggested language (specifically, the definition of "Benchmark Replacement"), however, did not make clear that when using an Interpolated Benchmark, the coupon was always to be the product of the Interpolated Benchmark together with the Benchmark Replacement Adjustment. The first deal of which we are aware that used the new model language was done by JPMorgan Chase & Co. and priced on April 29, 2019. In the JPMorgan deal and in most other applicable floating rate deals subsequent, the definition of Benchmark Replacement was amended to include language to make clear that if the issuer must determine an "Interpolated Benchmark" with respect to the then current-Benchmark (because the current Benchmark begins to be quoted for a more limited number terms), the issuer must still add the Benchmark Replacement Adjustment for such Benchmark. It may have been that the drafters of the model language from the ARRC were thinking of an interpolated rate as only applying to LIBOR. But it seems to us that the modification to the language makes sense, as other Benchmarks in the waterfall may too need to utilize an interpolated rate during the period in which any such Benchmark is phased out.

Issuers should be mindful of using the ARRC language without the above modification, as it could cause confusion down the road when setting a new rate after the end of LIBOR, particularly for issuers unable to find a calculation agent to take on such role.

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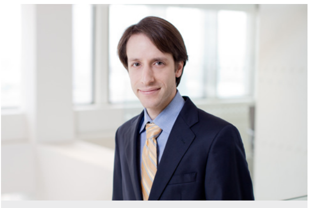

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