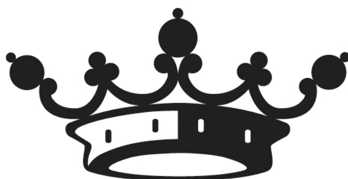
INSIDE THE MINDS

SEC Compliance Best Practices

Leading Lawyers on Understanding New Regulations and Developing Compliance Strategies

2012 EDITION



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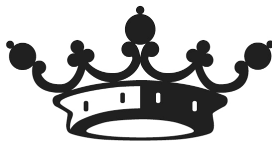
Handling SEC Compliance Issues on Behalf of US and China-Based Clients

Giovanni Caruso

Partner

Loeb & Loeb LLP



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Introduction

Changes in Securities and Exchange Commission (SEC) regulations and interpretations seem to be developing at an ever-increasing pace, making it difficult for public companies, especially smaller public companies, to keep up with the rule changes and new compliance requirements. These changes and developments occur for a variety of reasons—economic, political, technological, and emotional.

Regardless of how or why these developments occur, however, it is up to public companies to deal with the issues raised, and it is up to their counsel to help them. Counsel for public companies may need to be more proactive with their clients than they have been in the past and should be prepared to spend an increasing amount of time explaining the regulatory scheme to their clients, especially if the companies are smaller public companies that do not have significant internal staff or if the companies are non-United States and not familiar with US regulations.

Changing SEC Compliance Issues

I believe that many significant SEC public company disclosure regulations in recent years can be categorized as one of the following:

1. Regulations that increase information and power given to public stockholders—for example, rules related to eXtensible Business Reporting Language (XBRL), say-on-pay rules, and policy changes permitting fewer foreign companies to file their initial public offering (IPO) documents confidentially
2. Regulations that disincentivize certain transactions or reduce the attractiveness of certain companies—for example, increasing regulations relating to reverse mergers (including recently enacted securities exchange requirements that restrict the ability of reverse merger companies to list on exchanges) and the SEC's current policy of giving significant scrutiny to the accounting groups of public companies headquartered in China

Let us take two examples that have recently impacted smaller public companies: the XBRL rules and the SEC's current policy toward the accounting groups of companies headquartered in China.

Although the XBRL rules began to be implemented by some companies a couple of years ago, they only became effective for the smallest public companies in 2011. Securities and Exchange Commission, Securities Act Release No. 33-9002; Securities Exchange Act Release 34-59324. XBRL is an XML-based language used to communicate financial and business data electronically. The codes used in XBRL describe financial data in a format that computers can classify, sort, and analyze and that then allows analysts and investors to use various analytic tools to better analyze the financial data of publicly traded companies, but does not alter the accounting standard underlying the financial statements.

A company submits its financial statements in XBRL format to the SEC as an exhibit to periodic reports on Forms 10-Q, 10-K, and 20-F and to Forms 8-K and 6-K that contain revised or updated financial statements, as well as some registration statements. While previous Electronic Data-Gathering, Analysis, and Retrieval (EDGAR) filings could have taken just a few hours to process by a printer (so that it was possible for a company to submit its filing to be converted close to the due date of the filing, as many smaller companies did), filings requiring XBRL exhibits take significantly longer to process by printers because of the specific tagging of financial information that is required—i.e., each number in a company's financial statements must be specifically coded pursuant to a classification specified by the SEC.

Smaller public companies, with significantly fewer people working on public company compliance than their larger counterparts, have had difficulty complying with the new rules on a timely basis. This has resulted from being required to complete their financial statements in a shorter timeframe than previously, because of the requirements of producing an XBRL document with the same number of personnel and increased obligations—i.e., those related to producing and reviewing the formatting of an XBRL-coded document.

Beginning in late 2010 and early 2011, a number of smaller public companies announced restatements to their financial statements due to either outright fraud on the part of their management or a failure to comply with appropriate accounting standards. Although not all of these companies were located in China, a significant number of them were, and the market for smaller companies based in China became tainted by these restatements

and the media scrutiny they received. It did not help matters that many of these companies became public through alternative means (a means outside of a typical registration filing and review process with the SEC), such as reverse mergers, where a public shell company (a company with no operations) acquires a private operating company, resulting in the private company's stockholders acquiring a majority of the public company stock and the business of the private company continuing in the public vehicle.

Although not targeting Chinese companies specifically, in June 2011, the SEC put out an investor bulletin warning investors about investing in reverse merger companies. The numerous instances of restatements and general media and market negativity toward companies headquartered in China led the SEC to more strenuously scrutinize the accounting staff of these companies in reviews of the public filings of such companies. (Examples of the questions posed by the SEC are included as Appendix B). The questions were unusual for SEC reviews in that they asked for details about the education and experience of the accounting staff of the applicable company, how financial statements were prepared, whether the company sought the assistance of consultants in preparing its financial statements, and the internal control processes of the company.

Over the course of several comment letters and responses, it became apparent in many cases that the SEC would not end the comment process unless the applicable company agreed to amend previously filed reports to indicate that the company did not have adequate internal control over financial reporting and disclosure controls and procedures because of the lack of staff with sufficient experience with US generally accepted accounting principles (GAAP), even if the company's financial statements did not require restatement.

Increasing Burden on Smaller Public Companies

The new XBRL rules have significant implications for smaller public companies. Since many smaller public companies do not have internal legal counsel, compliance with rules and rule changes often falls to a group of executives (or sometimes an executive) who have significant responsibilities outside of compliance, such as the chief financial officer (CFO) or the chief operating officer (COO). Even if there is an internal legal counsel, there

may only be a general counsel and no subordinate attorneys. So, while larger companies can delegate new responsibilities among a large pool of people or hire a new person to take on additional responsibilities in connection with rule changes, smaller public companies do not have the resources to do so. Therefore, the new XBRL rules make it difficult to complete the company's financial statements more quickly than the company has been obligated to in the past and review the new XBRL exhibit, while still having the applicable report filed on time.

For smaller Chinese companies whose accounting groups are facing additional scrutiny, the difficulty is even greater. Not only do these companies feel unjustifiably scrutinized (since they have not committed any frauds or been required to restate their financial statements), but they also feel as though the SEC has changed the rules on them midstream. As with companies struggling to comply with XBRL, these companies often have a small group of people performing compliance functions and doing significant training in US GAAP. Many times these companies have not had to restate their financial statements and insist that their internal accounting staff, with the assistance of consultants for more complicated matters, is sufficient to produce accurate financial statements. However, what it seems the SEC would like is that they hire additional accounting personnel with significant accounting experience. Often, these companies do not believe they have the resources to hire more personnel and are required to indicate that they have weaknesses in their internal controls over financial reporting and disclosure controls and procedures, which can create a negative impression in the marketplace.

Developing Compliance Strategies

Generally, all public companies, regardless of size, should have three broad goals for their compliance program, all of which are of equal importance: timeliness of disclosures, accuracy of disclosures, and completeness of disclosures. Timeliness is obvious: companies must file reports by the times specified in SEC regulations or be subject to repercussions, whether regulatory (not being permitted to make use of Form S-3 (a short-form Securities Act registration document) or market-related (the negative associations investors will make with a company that cannot get its financial statement filed in a timely fashion).

There is some overlap between accuracy of disclosures and completeness of disclosures, but accuracy relates to making sure what is disclosed is accurately stated—making sure the language used in disclosures communicates what the company intends it to communicate—and completeness relates to making sure everything that should be disclosed is disclosed—for example, that all material aspects of a transaction are described to the marketplace. Ideally, a company should review its filing process after each periodic report is filed to determine whether there is any way the process could be improved.

A first step for the management teams of many companies in organizing themselves to meet their compliance obligations is setting up a disclosure committee. Ideally, such a committee should have a charter so that its members, the applicable responsible parties, and the obligations of the committee members are clear. Charters for disclosure committees vary significantly, some providing the obligations of the disclosure committee in only broad strokes, while other committee charters get into minute detail, such as when meetings are to be held and when information is to be presented to the chief executive officer (CEO) or CFO. (A number of public companies post their charters for these committees, and it is simple to obtain samples for the charters via the Internet).

One type of committee is not preferable to the other—each company must decide on its own what is best for it. An important fact to note is that while a more detailed charter may often look more impressive, not complying with a charter would be problematic if something negative takes place. In other words, if you are not sure whether you will be able to do something, do not say you will, or you will be held responsible for not doing so, regardless of whether it would have mattered. For example, if a charter specifies when the committee will meet, committee members should be sure that they meet at the specified times or risk the possibility that they will be held accountable for not having met when the charter specified that they should have.

Membership on the committees is usually determined by the most senior members of the management team (CEO, CFO, et al.) and/or the board of directors or a committee thereof, though the board may take a less active role. The CEO and CFO are sometimes members of the committee, but

will be actively involved, regardless of whether they are official members, since they provide certifications included in the company's Securities Exchange Act reports relating to the company's internal control process. Generally, such committees will include the general counsel, the controller, senior executives of significant subsidiaries or divisions, and representatives from the internal investor relations function of the company.

Responsibilities for members of the compliance committee include assisting the CEO and CFO in connection with ensuring the accuracy of the company's filings and the functioning of the company's internal controls over financial reporting and disclosure controls and procedures. Generally included in such obligations is signing internal certifications backing up the certification obligations of the CEO and CFO to the company's Securities Exchange Act reports.

The board of directors of some companies also forms a compliance committee (sometimes the functions of a compliance committee are included in an audit committee's responsibilities), either for general oversight over compliance matters or with respect to a specific area the board of directors feels is important for it to keep an eye on—for example, government regulations that particularly affect a company's operations or internal control processes. The compliance committee may also be involved in determining the members of the disclosure committee or receive reports from the disclosure committee.

Compliance at Smaller Public Companies

Smaller public companies, however, may not need a separately designated disclosure or compliance committee. Many times, the management of a smaller public company is centralized, and the compliance obligations of such a company might be handled by the CEO, CFO, and COO and/or controller. Such individuals often have final authority over every significant contract or arrangement the company enters into and are intimately involved in often relatively insignificant matters relating to the company.

For such companies, the risks associated with creating a compliance program are different from those of a larger public company. While a larger public company risks failing to meet its obligations because certain information was not communicated up the chain of command

appropriately, smaller public companies risk failing to meet their compliance obligations because the persons responsible for making the disclosures are getting pulled in a number of directions and may not focus on the applicable compliance issue in a timely fashion.

Often, the members of the management team of smaller public companies have broader responsibilities than those of larger public companies and may therefore have less time to keep up with rules changes and new compliance obligations. Where a larger public company may have an in-house legal department that keeps up-to-date on new developments and keeps relevant members of management informed about their obligations, smaller public companies do not generally have a staff devoted to compliance issues.

Such companies may need more help from their outside counsel to keep up-to-date on their reporting obligations, and helping educate the management teams of such clients is an important responsibility of the attorneys who represent them. This education process includes providing guidance on new laws as they are enacted, but it also includes reminding them, for example, of when their reports are due, or that they need to plan to prepare their financial statements further in advance to meet their XBRL obligations. This may sometimes seem too simple, but in a smaller public company where a CFO may be responsible for many things besides financial reporting, it is easy for something to be missed simply because there were so many other things happening at that time.

A simple way to help a smaller public company maintain compliance with applicable rules is to provide it with a checklist and/or timeline for major events (filing a 10-Q, filing a proxy statement, etc.). (*See* Appendix C for a sample timeline provided to a non-US company listed on NASDAQ.) Not only should this document help the management team understand its timing obligations, but it should also outline significant milestones for certain portions of the work to be completed and the reasons certain things are done at certain times. Therefore, these documents should serve an education function for the client, as well. Notwithstanding that you may have provided such documents to a client in the past, you may have to provide them annually, since, again, there might not be a centralized compliance function that would keep such materials for future use.

Another way to assist smaller public companies in meeting their compliance obligations is to maintain a good relationship with a particular company's auditors. By doing so, an auditor may call you when there is a disagreement between the auditor and the company, giving you the opportunity to act as a mediator to resolve the issue. Having a good relationship with a company's auditor also results in less tension when there is a conflict in the advice you are giving and the advice the auditor is giving, since you are more likely to communicate directly to resolve an issue, as opposed to communicating through the company, which makes it easier for issues to get muddled.

Helping Clients Comply with Changing SEC Rules

Given the increase and changes in regulations, over the last couple of years, I have found myself having to be more proactive with clients with respect to SEC compliance obligations. For example, with the new XBRL requirements, I have found myself reminding clients every few weeks about their upcoming obligations and helping them understand how the new requirements will work and what they will need to do to maintain compliance. This guidance was given in the form of not only formal firm memos, but also follow-up e-mails and calls, conversations with services providers about the stage the client was at in connection with a particular filing, and generally making sure that the client and its service providers were focused on the XBRL requirements.

With respect to SEC scrutiny of the accounting function of Chinese companies, the initial questions raised by the SEC were often fairly innocuous. After having seen these questions in a previous SEC review, however, with subsequent companies it became fairly obvious where the questions would lead. Once a company received the first round of comments from the SEC, we would have a conference call with the appropriate members of the management team at the company. We would discuss what had happened with previous clients, how the comments were likely to proceed, and what the end result was likely to be. Some clients listened to what we had to say and were content to shorten the review process by doing what would likely be the end result of the comment and response process. Others chose to let the review run its course, either from a sense of being "right" or because they felt the SEC was not being fair in

its analysis. Either way, however, the client knew what to expect and was not surprised by the ultimate result.

Overcoming SEC Compliance Challenges

With smaller public companies, it is imperative to have the trust of the management team to help them comply with applicable SEC regulations. If management does not trust you, it is more difficult for them to simply pick up the phone to discuss an issue (especially when the issue may not be particularly flattering), and it may eventually lead to the loss of the client. Of course, building trust takes time, and with new clients there is generally not sufficient history to have built a repository of trust. In addition, many smaller public company clients may not wish to discuss issues extensively for fear of running up significant legal fees.

Although not a complete solution to either, I believe that an important way to deal with these issues is to allow a client to express his concerns fully before trying to come up with a resolution. Taking the time to listen makes the client believe you are trying to work with him or her and makes sure you do not give an answer that may not be suitable given all the facts (trying to give a quick answer is generally not the best course of action). Also, a definitive answer is seldom required immediately. If you do not know an answer, tell the client you will need to look something up quickly and will respond shortly; alternatively, give a preliminary response, but indicate that you will confirm it after you are off the phone. No reasonable client will expect you to have every answer at the tips of your fingers, and it is far better for you to go back and check something before giving a definitive response than giving a definitive response and being wrong.

Another stumbling block in building a compliance program with a client is cultural issues. Most US clients have a sufficient background in the compliance system to understand what the SEC is looking for in its disclosures. The same may not be true for offshore clients.

I will use the example of Chinese clients, since I have more experience with those than with others. It is often difficult to get Chinese clients to understand that the disclosure system requires that anything material to the company be disclosed, even if it is not specifically enumerated in a rule. So where a US client may give an expansive response to a question, including

things that are tangentially related in case they might change the answer, a Chinese client may give you a direct answer without thinking about the potential tangential issues.

For example, asking a US client who is an individual whether he owns any stock is sufficient to elicit that his family members owned stock or that his family had a trust that owned stock. However, a Chinese client who is an individual who owned stock only through family members might respond simply that he did not own any stock. It would be imperative for you to ask follow-up questions about family members and other indirect ownership issues. Although different cultures will have different issues, it is these types of subtleties that can result in a breakdown in a compliance program.

One resource I find I increasingly rely on is the SEC's website (http://www.sec.gov). Although far from ideal, the SEC's website has vastly improved in recent years and can be immensely helpful in locating answers to compliance questions. For example, interpretations by the Division of Corporation Finance have been made available in a relatively well-organized fashion and are updated regularly (http://www.sec.gov/divisions/corpfin/cfguidance.shtml). The Division of Corporation Finance Financial Reporting Manual (http://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.shtml) has also been made available in an easily searchable format.

And the SEC is now providing comment letters and responses on its company pages, offering an opportunity for those who are unsure of how to deal with an issue to see how others have handled the same situation with the SEC. Although certain aspects of the website leave something to be desired (the word search function is particularly cumbersome), it is, overall, an important tool in maintaining compliance.

Conclusion

The amount of change that has occurred in SEC rules and compliance since I began practicing securities law astounds me, and the pace of change only seems to be increasing. These rising and ever-changing compliance obligations have increased pressure on smaller public companies, making it more and more difficult for them to adequately comply with applicable

compliance requirements. This has resulted in more being required of the outside counsels who work with these companies, from being more proactive in reminding them of their obligations, to having to be involved in more ministerial matters, such as assisting the company in meeting timelines with its printer so that an XBRL filing is made on a timely basis or maintaining a good relationship with a company's auditors, that attorneys might not previously have been involved in.

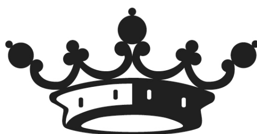
Engaging in these ministerial functions on behalf of a client may not be particularly legal in nature (or fun), but it does go a long way toward building trust and appreciation on the part of a management team, while failing to do so can have exactly the opposite effect, especially if the client is unable to satisfy its reporting obligations.

Key Takeaways

- Advise public company clients that they should have three broad goals for their SEC compliance program: timeliness of disclosures, accuracy of disclosures, and completeness of disclosures.
- Educate the management team by providing guidance on new laws as they come out, reminding them of when their reports are due and that they need to plan to prepare their financial statements further in advance to meet their new XBRL obligations.
- Provide clients with a checklist and/or timeline for major events to help the management team understand its timing obligations, and outline significant milestones and the reasons certain things are done at certain times. Remind clients about their upcoming obligations through e-mails, memos, and calls.
- Gain the trust of the management team to help them comply with applicable SEC regulations. Allow a client to express his concerns fully before trying to come up with a resolution to an issue. Do not give hasty answers.
- Hold a conference call with the appropriate members of the management team once a company receives the first round of comments from the SEC to discuss what has happened with previous clients, how the comments are likely to proceed, and what the end result is likely to be.

Giovanni Caruso, a partner at Loeb and Loeb LLP, represents public and private companies in a broad range of corporate and securities matters, including general corporate governance, private placements, mergers and acquisitions, and federal law compliance in connection to the Securities Act and Exchange Act and Sarbanes-Oxley, as well as the various exchanges (NASDAQ, NYSE, and the NYSE Amex). Mr. Caruso also regularly represents issuers and underwriters in special purpose acquisition company (SPAC) offerings.

Mr. Caruso has drafted and negotiated a variety of agreements in connection with his representation of clients and has experience in drafting various securities documents, such as annual, quarterly, and current reports; registration statements; and private placement documents.



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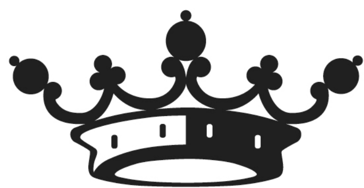

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