

To Our Clients and Friends

Memorandum

friedfrank.com

Non-GAAP headlines hit the bottom line: SEC imposes civil penalties for lack of “equal prominence”

On December 26, 2018, the SEC ordered a registrant to pay a \$100,000 civil penalty and to cease and desist from further violations of Section 13(a) of the Exchange Act and Rule 13a-11 thereunder in response to the registrant’s alleged failure to comply with Regulation S-K Item 10(e)’s “equal or greater prominence” standard for the use of non-GAAP financial measures. In addition to serving as a reminder that curbing noncompliant use of non-GAAP measures remains a significant priority of the SEC’s Division of Corporation Finance, this enforcement action may signal increased willingness by the SEC to exercise its full regulatory power in addressing instances of alleged noncompliance.

Regulation S-K Item 10(e)(1)(i)(A) requires that, whenever a non-GAAP financial measure is included in a filing with the SEC, the registrant must include a presentation, with equal or greater prominence, of the most directly comparable financial measure calculated and presented in accordance with Generally Accepted Accounting Principles (GAAP). Instruction 2 to Form 8-K Item 2.02 provides that the same equal or greater prominence standard also applies to disclosures furnished under Item 2.02 (e.g., earnings releases). Further, Non-GAAP Financial Measures Compliance and Disclosure Interpretation 102.10 (as published May 17, 2016) indicated that the SEC would consider the following examples of disclosure of non-GAAP financial measures, among others, to violate the Item 10(e) standard:

- omitting comparable GAAP measures from an earnings release headline or caption that includes non-GAAP measures;
- presenting a non-GAAP measure using a style of presentation (e.g., bold, larger font) that emphasizes the non-GAAP measure over the comparable GAAP measure;
- a non-GAAP measure that precedes the most directly comparable GAAP measure (including in an earnings release headline or caption);
- describing a non-GAAP measure as, for example, “record performance” or “exceptional” without at least an equally prominent descriptive characterization of the comparable GAAP measure; and
- providing discussion and analysis of a non-GAAP measure without a similar discussion and analysis of the comparable GAAP measure in a location with equal or greater prominence.

The registrant in question had published two earnings releases that included headlines such as “Total revenue and Adjusted EBITDA up XX% and XX% year-over-year, respectively.” Although these headlines included total revenues, they omitted net income/loss, the GAAP financial measure most directly comparable to Adjusted EBITDA. One of the earnings releases cited by the SEC’s Division of Enforcement also included bullet point highlights that included Adjusted EBITDA, Adjusted Net Income and Adjusted Net Income per share, but omitted comparable GAAP net income/loss figures. In each

case, the GAAP figure was included elsewhere in the earnings release, but not in the headline or bullet points. In accepting an offer of settlement from the registrant, the SEC found these disclosures had violated Regulation S-K Item 10(e)(1) and, therefore, Section 13(a) of the Exchange Act and Rule 13a-11 thereunder, and imposed a \$100,000 civil penalty.

Since the 2003 adoption of Regulation S-K Item 10(e) and related disclosure rules under Regulation G, scrutiny of registrants' use of non-GAAP financial measures has been a significant focus of the SEC. During this time, in addition to issuing and updating several Compliance and Disclosure Interpretations, the SEC's Division of Corporation Finance has issued numerous comment letters identifying alleged shortcomings in registrants' non-GAAP disclosure. However, the SEC has seldom used its civil enforcement authority in response to allegedly noncompliant presentations. Registrants should treat this development as an opportunity to review their non-GAAP disclosure practices with their counsel, financial reporting and investor relations teams against the backdrop of potential civil liability or monetary penalties, particularly as the market heads into another earnings season.

* * *

Authors

Lee T. Barnum

Joshua Wechsler

John Lawrence

Ezra Schneck

Idan Shkaltz

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents. If you have any questions about the contents of this memorandum, please call your regular Fried Frank contact or an attorney listed below:

Contacts:

London

Ashar Qureshi +44.20.7972.9173 ashar.qureshi@friedfrank.com

New York

Andrew B. Barkan +1.212.859.8468 andrew.barkan@friedfrank.com

Lee T. Barnum +1.212.859.8883 lee.barnum@friedfrank.com

Daniel J. Bursky +1.212.859.8428 daniel.bursky@friedfrank.com

Joshua T. Coleman +1.212.859.8633 joshua.coleman@friedfrank.com

Mark S. Hayek +1.212.859.8890 mark.hayek@friedfrank.com

Meredith L. Mackey +1.212.859.8974 meredith.mackey@friedfrank.com

Joshua Wechsler +1.212.859.8689 joshua.wechsler@friedfrank.com