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Brexit: Disclosure Implications for SEC Reporting Companies

In the short period since the June 23 UK referendum on whether to remain in, or leave, the European Union, the United Kingdom has faced a remarkable range of political, monetary, economic and even constitutional challenges.

Political: The Prime Minister, David Cameron, intends to resign, effective tomorrow, and following an election contest that saw the key figures associated with the Leave campaign, Boris Johnson, Michael Gove and Andrea Leadsom, fall by the wayside, Theresa May will step into the role as Prime Minister. Speculation is rife as to whom Theresa May will appoint to her "unity cabinet" from among the members of the Cameron cabinet and other ministers, and where those appointed lined up on the Remain-Leave continuum. Another key question is whom she will select to lead the negotiations with Brussels over the withdrawal from the EU. The leader of the opposition Labour Party, Jeremy Corbyn, has been challenged by Angela Eagle, the former shadow business secretary, after most of his "shadow cabinet" resigned *en masse*. The Labour leadership contest was formally launched yesterday. While some commentators continue to question whether the new Prime Minister should govern without a new general election, a snap election does not appear in the offing.

Monetary: The pound has dropped to its lowest level against the dollar in more than 30 years. There is little consensus among economists on what the impact of the drop in the pound means for the UK economy and, in particular, whether sterling at or below $1.30 will lead to a marked increase in exports from the UK or a significant reduction in the UK current account deficit. And, if exports are not stimulated, a low value of the pound could raise domestic prices faster than wages, thus further eroding consumer confidence and living standards. Among the components of the consumer price index most correlated with the fall in the pound are air travel, vegetables, gas and other fuels.

Economic: The Bank of England has warned that "[t]he current outlook for UK financial stability is challenging." Asset valuations in commercial real estate appear to be declining markedly, and a growing number of UK commercial property funds have suspended redemptions. One closely followed index of business confidence among British executives (published by the Center for Economics and Business Research) has plunged, which could well lead to further reductions in the levels of investment and hiring beyond the depressed levels of the past few months. Consumer confidence in the UK, as measured by one survey (GfK), recorded its largest drop in the shortest period of time. In the meantime, the UK has lost its AAA rating.

Constitutional: Lawsuits have been filed challenging the right of the Prime Minister to give the Article 50 notice without authorization of Parliament. Questions have been raised about whether Parliamentary authorization is needed for any replacement treaty with the EU. And at the same time the leader of the Scottish National Party is demanding a new referendum in Scotland over whether it remains part of the UK. An eventual departure from the EU also raises issues relating to the border between Ireland and Northern Ireland.

No one can know with certainty where any of this is heading. It has become clear that the Leave campaign had no clear conception of what a post-Brexit world could or should look like. Even now, while there is significant focus on alternate trade models, there is no consensus – even among those advocating Brexit – as to which would be optimal, let alone realistic. A key issue for access will be free movement of people, one of the four fundamental pillars of the EU, which conflicts with the anti-immigration message of the Leave campaign. In part because of the absence of consensus, Theresa May appears to be in no rush to trigger the Article 50 process. Yet the EU has said emphatically that until notice is given, it will not start to negotiate terms. In light of an upcoming referendum in Italy (relating to constitutional reform) and national elections in 2017 in the Netherlands (March), France (May) and Germany (September), it is far from clear when EU trade negotiators (taking their instructions from member states) will be prepared to engage constructively to negotiate those terms.

Public Disclosure

What does all of this mean for SEC reporting companies now? SEC reporting companies will need to consider their disclosure obligations as they prepare their annual and quarterly reports (in the case of domestic companies) and annual reports (in the case of foreign private issuers). Brexit could implicate disclosure contained in, among other places, the Risk Factors section, Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A"), the Business section and the Note on Forward-Looking Statements. Similar disclosures will be reflected in earnings releases and, in the case of foreign private issuers, information required to be disclosed in the home market. Companies with greater exposure to the pound will be assessing the need for profit warnings (following in the footsteps of a few that issued warnings in the immediate aftermath of the referendum).

The two areas that will need the greatest amount of attention are the risk factors and the MD&A. In both cases, it is critically important that reporting companies focus on the potential impact and risks to them in specific, not generic, terms. Management should consider – both for operational reasons as well as for purposes of assessing what public disclosure is required or desirable – the challenges, risks and/or opportunities that Brexit presents for their business, financial condition and results of operations.

As management considers the implications of Brexit and the current uncertainty, it should ask, for example:

- What portion of the company's business is physically located in the UK?

- Does the company have substantial exports to the UK or substantial exports from the UK? Are those exports or imports coming from other EU countries, such that import duties (for goods or services moving in either direction) may be materially affected by Brexit?

- To what extent are the company's revenues and costs denominated in pounds? To what extent has the company hedged its currency exposure? How long do those hedges remain in place? What is the likely mark-to-market exposure on existing hedging arrangements?

- Does the company's trade between the UK and other EU countries involve goods (which may well benefit from a future trade deal) or services (which are likely to need special arrangements to access the EU, which may or may not be put in place)?

- What level of import duties would apply to imports of key supplies or components or exports of products or services to the EU, in the absence of agreement on trade between the UK and the EU?

- If the company is in the financial sector, does it rely on EU "passporting" arrangements to provide services in the rest of the EU? If so, does it have existing operations elsewhere in the EU that could provide an easy alternative passport? Has the company assessed what it would take to change its corporate structure and obtain the requisite EU-country authorization(s) to gain an alternative EU passport?

- To the extent that the business is adversely affected by the fall in the pound due to reliance on dollar-denominated imports, how long can the business avoid raising prices?

- To what extent will the company need to cut back on investments or hiring plans?

- To what extent is the business retail-focused, and how susceptible is the business to trends in consumer confidence? What is the mix between discretionary purchases and less discretionary purchases?

- To what extent do the company's UK operations rely on personnel (particularly those with specialist skills) from the EU? To what extent is the business dependent on EU-wide recognition of qualifications or the ability to transfer staff elsewhere in the EU?

- To what extent does the company rely on research grants or subsidies from the EU or pan-EU collaboration arrangements (which tend to benefit sectors such as automotive, aerospace, pharmaceuticals and chemicals)?

- To what extent will the company's business be impacted by disruption to data transfers between its operations in the EU and in the UK?
- Is the company considering refinancing sterling-denominated indebtedness? Does the decline in the pound or key performance indicators threaten covenant compliance?
- To what extent is the business exposed to counterparty risk of financial or other institutions most recently subject to market pressure?

This list is not intended to be exhaustive, and of course the relevance of the questions will vary significantly across industries and relative exposure to the UK and EU markets. UK companies and other companies with significant operations in the UK will face a far broader range of implications than others, though the consequences of Brexit may well extend to companies organized, or with significant operations, in the EU. In addition, the contagion effect for other areas, including emerging markets, cannot be discounted.

MD&A

A properly drafted MD&A is intended to provide investors with the information "necessary to an understanding of [a company's] financial condition, changes in financial condition and results of operations." The MD&A needs to include a discussion of liquidity, capital resources, results of operations and off-balance sheet arrangements, as well as such other information that the company believes to be necessary to an understanding of its financial condition, changes in financial condition and results of operations. In addition to explaining historical performance, the SEC requires the identification of any known trends, demands, commitments, events and uncertainties that will, or that are reasonably likely to, favorably or unfavorably, impact the company's financial condition and results of operations. Companies will want to consider, in light of the considerations of the sort outlined above, to what extent Brexit may have a material impact on any of these items.

The SEC staff regularly emphasizes the need for companies to focus on the importance of early warning disclosures, particularly where known trends and uncertainties are reasonably likely to create a significant disconnect between historical and future financial performance, to avoid later surprise disclosures. Although the uncertainties surrounding Brexit will present a particular challenge, in that the probable impact of future events will be hard to predict with any level of certainty, management should strive to provide as much meaningful guidance as possible, as early as possible.

Although information about Brexit and its possible economic and monetary impact has been widely reported, a company cannot assume that investors are aware of publicly available market or industry information that might impact the company. As a result, the disclosure requirements applicable to known trends are not limited to company-specific disclosure; the trends that may be industry-specific or broadly applicable would still need to be addressed. Companies should however avoid providing generic explanations or warnings. Rather, the disclosure needs to be tailored to the company and its financial statements, and should address how the company and its financial statements are specifically affected by Brexit and its consequences.[1]

Many of the implications of Brexit are in the realm of speculation, but could certainly rise to the level of known trends and uncertainties. Therefore, reporting companies can expect the SEC staff to be looking for, and possibly comment as a matter of course on, disclosures of known trends and uncertainties, whether the company is located in the UK, has significant exposure to the UK economy or sterling (for example, through exports to the UK or as a result of significant operations in the UK that may need to be restructured and/or relocated to provide access to EU markets), or might otherwise be subject to shifts in macro conditions as a result either of the uncertainty surrounding Brexit or greater certainty around a particular course of action that is likely to have global ramifications.[2] The fallout from Brexit may well impact the timing of interest rate increases and other actions by the Federal Reserve and other central banks. And looking further ahead, the realization by the EU that steps need to be taken to reform itself combined with the expected absence of the UK voice as the EU sets policies and adopts internal rules could have a significant effect on the landscape relevant to businesses in or accessing the EU.

Brexit could impact revenue items, cost items, tax, goodwill impairments and liquidity, among others. The most obvious immediate impact will be the effect of foreign exchange fluctuations on revenue and cost items, as well as non-GAAP disclosures that present line items on a constant currency basis. Separate disclosure is required in the quantitative and qualitative disclosures about market risk (which includes foreign currency exchange risk).[3] Companies with UK operations will need to consider a range of potential changes, including, for example, trade arrangements, the ability to hire EU nationals and changes to employment rules, as part of their known trends and uncertainties. Financial services companies operating in the UK may have additional concerns due to the potential loss of the EU "passport," necessitating relocation of staff and operations, for example, to Amsterdam, Dublin, Frankfurt or Paris.

Risk Factors; Forward-Looking Statements

Once the relevant developments have been addressed in the MD&A, these same developments are likely to require changes to risk factors and possibly forward-looking statement risk factors. In drafting risk factors, companies should avoid the rush to add boilerplate disclosures. Courts have recognized repeatedly that risk factors, to be effective, need to be tied to specific facts and circumstances of the relevant company. In particular, for cautionary language to be meaningful for purposes of the Private Securities Litigation Reform Act, as one court has noted, it must be substantive, company-specific, "based on a realistic description of the risks applicable to the particular circumstances, not merely a boilerplate litany of generally applicable risk factors."

Going forward, Brexit-related risk factors should be evaluated on a regular basis to determine if new information warrants new, or modification of existing, risk factors. As courts have noted, risk factors that do not change over time are more likely to be boilerplate.

Disclosure for Capital Markets and M&A Transactions

Brexit may well change the landscape for financing and for acquisitions. Companies may need liquidity sooner than expected or may see opportunities to lock in funding at continued low interest rates, or they may continue to access the capital markets as they have in the past. Brexit may spur m&a activity as sectors consolidate or may prompt acquisitions as a means of obtaining an EU presence for "passporting" or for other purposes. In any event, activities that involve investment decisions require public disclosure, and that means that the foregoing disclosure considerations will be relevant to the extent they are to be incorporated by reference, or included, in offering documentation for capital raising exercises or in documentation (proxy statements, shareholder circulars, registration statements or prospectuses) relating to public m&a transactions. Due diligence exercises conducted by underwriters and m&a counterparties undoubtedly will include Brexit-related inquiries, which may prompt addressing discussions of plans that are yet to be fully developed.

Board; Disclosure Committee Focus

Depending on the materiality of the impact on any particular company, one can expect that the board of directors generally, as well as the audit committee and, if separate, the risk committee, will be focused on the shift in the risk landscape posed by a potential withdrawal of the UK from the EU, and disclosure themes will be an integral part of the discussion. Presumably, these issues will also form part of disclosure committee agendas.

Regulation FD

Domestic reporting companies need to be mindful of their obligations under Regulation FD. As companies with significant exposure to the EU market through the UK consider their contingency plans (which is a strategy an increasing number of companies are undertaking at this point), there could be significant pressure from shareholders and the market generally to explain what those plans could involve. There could be a fine balance between wanting to assure shareholders of a solution if Brexit becomes a reality and not presenting a plan that is a work-in-progress that could have a significant impact on employees and other stakeholders. Discussions on a selective basis of plans that could have a material impact (even if just in the short-term) could give rise to issues under Regulation FD.

UK Considerations

For dual registrants (US/UK), UK disclosure requirements will also be relevant. In March of this year, the Financial Reporting Council ("FRC"), in a letter to investors, noted that if a board considers Brexit to be a "principal risk," the company should disclose that fact to its shareholders. The FRC had also reminded audit committee chairs, in light of increased uncertainty and volatility due to the upcoming referendum, that (i) the strategic report (which forms part of the annual report) provides an opportunity to issue an update on prospects, (ii) key to understanding prospects will be disclosure of principal risks and (iii) financial reporting standards require disclosure of material post-balance sheet events including the estimated financial impact (or a statement that such estimate cannot be made). An FRC spokesperson in February had alerted directors to their obligations under the UK Companies Act to disclose "principal risks" to shareholders, which could include Brexit. In the UK, companies are required to consider materiality in reporting principal risks and uncertainties as part of their strategic reports and are encouraged to disclose the range of potential outcomes and (in contrast to SEC practice) any mitigating factors.

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Public disclosure forms but a part of the overall response by companies to the challenges so many will face as the highly uncertain process – with its political, economic, monetary and constitutional dimensions – unfolds over time. While serving to update shareholders and the market, disclosures on the part of UK companies, in particular, may serve an additional purpose, namely to help shape the debate over the ultimate nature of the relationship between the UK and the EU as the implications for businesses are laid out in unambiguous terms.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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[1] A useful example of these themes was the steep drop in oil prices a few years ago. At the point that depressed oil prices seemed not to be simply short-term in nature, the SEC staff expected issuers to re-evaluate their disclosures, particularly around asset impairment. SEC staff comments were not limited to oil and gas companies, but other industries as well that had significant exposure to oil and gas prices. The SEC staff was particularly focused on boilerplate language about the effects of potential or actual declines in oil prices without a corresponding discussion of material uncertainties and potential impairment estimates and judgments.

[2] Existing SEC guidance on MD&A (in the form of the various MD&A releases and SEC staff comment letters) should provide a sufficient basis for preparing the disclosure that the SEC staff and the market expect. The SEC, from time to time, has issued specific event-driven guidance on disclosure topics (for example, the 2010 interpretive release on climate change disclosures and the 2010 interpretive releases on liquidity and short-term borrowings) and, depending on the potential fallout from Brexit and the SEC staff's view of the adequacy of Brexit-related disclosures, might feel compelled to issue guidance.

[3] The SEC staff has issued specific reporting interpretations and guidance on foreign currency transactions.