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DISCLOSURE

Rules of the Road for the SEC's Corp Fin Review Process



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The primary contact of approximately 12,000 public companies with the Securities and Exchange Commission (Commission) is the Division of Corporation Finance. Known as Corp Fin, this Division is responsible for reviewing filings by public companies under the Securities Act of 1933 (the Securities Act) and the Securities Exchange Act of 1934 (the Exchange Act). From registration statements for public offerings of securities to annual, quarterly and current reports, these filings with the Commission are the basis for complying with the disclosure framework of the federal se-

curities laws. For decades, Corp Fin has administered this framework through a review process designed to protect investors while facilitating capital formation. Much is known about Corp Fin's positions on substantive legal and accounting issues. Yet, public companies and their advisors are often unclear about how to navigate the review process. These Rules of the Road are intended to provide guidance on the journey.

1. The Corp Fin Staff are people too. They are professionals just like you and should be treated with respect at all times. That is not to say that you can't disagree with the Staff, but it should be done in a professional manner. Simply put, that means treating the Staff in the same way that you would like them to treat you.

2. Plan ahead. If you know that you are going to have an issue, especially concerning the accounting treatment of a particular item, a pre-filing conference may be advisable. Both the Office of the Chief Accountant of Corp Fin (Corp Fin OCA) and the Office of the Chief Accountant of the Commission (OCA) have prescribed protocols to follow. Going in ahead of a filing can avoid delay from a lengthy comment process concerning that item once a filing is made. If you do decide to have a

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pre-filing conference, have all the players who will be involved in the process—including the appropriate committee of the board of directors (e.g., the audit committee for financial reporting or the compensation committee for executive compensation disclosure issues), members of management and representatives of the outside auditor as well as in-house and outside counsel—participate in preparing the submission to the Staff. Allow a reasonable period for the Staff to receive, analyze and respond to the request.

As with other rules of the road, written submissions should be supplemented by oral communication during the process. Do not expect either Corp Fin OCA or OCA to provide guidance without a written submission because the issues they handle are too complex and nuanced for that approach. And, if you receive informal guidance orally from the Staff on a no-names basis, don't expect the Staff to feel bound by that guidance with respect to a particular company that was not identified in the context of your question.

3. Documentation is important to have before the comment letter comes. The analysis that was done on an accounting issue, the documentation to back up a short cut derivative, the compensation committee analysis of a bonus program, how management viewed litigation, are some examples of what can be a much longer process if documentation has not been kept, or people's views of what occurred differ, or worse, conflict. Documentation can provide critical support for the analysis in the comment process.

4. Once the comment letter comes, take a deep breath and do not rush to respond, unless of course the comment is one which you have anticipated pursuant to Rule No. 3. Determine what kind of review the Staff has given you: a full review, which consists of legal and accounting comments on the filings referenced in the comment letter; an accounting only review, which consists of comments on the financial statements, MD&A and related areas of the filings referenced in the comment letter; or a limited review of one or more specific parts of a filing, such as executive compensation in a proxy statement. Distribute the comment letter to all interested persons: audit committee or compensation committee, depending on the nature of the comment; management; accounting and finance staff; disclosure committee; outside auditor; and in-house and outside counsel. Make sure the registrant's disclosure committee is informed of the letter. The internal auditor should also be included depending on the scope and nature of the comment letter, such as comments involving internal control over financial reporting or disclosure controls and procedures.

5. Select a project manager for the comment response process. This can be someone from accounting and finance or the general counsel's office or another member of management. But the critical point is that this person has to be able to: (a) coordinate between the different disciplinary areas; (b) understand the process and how to get it done; and (c) make decisions along the way. A senior person may want to serve in this position, but if that senior person is not going to be able to devote adequate time needed to get the job done, someone else should have responsibility for managing the process.

6. If you don't understand one or more comments, call the Staff and ask what the comment is driving at. It is easier to ask the Staff what it intended in giving the

comment than to misunderstand and go down a rabbit hole like Alice in Wonderland in the comment process.

7. If you need more time to respond, ask the Staff for an extension. Each comment letter has a date that the Staff has set for a response. If you cannot meet that date, call the Staff and discuss the issue—and have a date typically two weeks after the first date that you think you can respond and a specific reason for why the registrant needs more time. If you don't think that two weeks will be enough, discuss a longer period with the Staff, recognizing that the Staff will not be inclined to give a blank check for responding and is not inclined to give long periods to respond. Be prepared to confirm in writing to the Staff when you will respond and to submit that confirmation as a correspondence filing on EDGAR.

8. Check the precedent on the comments that you have through the Commission's system, but don't mindlessly follow the precedent. If the same Staff person has been giving the same type of comment to everyone else in your industry (such as a segment comment asking for more segments to be disclosed) look to see how the others in your industry have responded, with the possibility of checking with others as appropriate. But don't assume, merely because a similar comment response previously received favorable treatment from a particular Staff person or his or her supervisor, that you will necessarily receive the same favorable treatment with a similar response. There is no stare decisis in the review process. Precedent is helpful, it can even be a driver, but is rarely determinative, because each registrant's fact pattern is different.

9. Decide what your strategy is going to be in responding to the comment letter. Registrants will often just want to answer the question asked and not give a more complete answer. Others will assume (perhaps correctly, perhaps not) that the Staff understands the basis for a particular answer and therefore will not provide an in-depth response. The best response, especially for comments that have the potential to result in an amended filing, such as a restatement of financial statements, is to provide a complete discussion of the issue, the basis for management's position, both from their experience, the rules and regulations involved and from the perspective of the practice by comparable companies and industries.

Understand that, by following a comprehensive strategy, your response should fully address the comment without volunteering unnecessary information which can raise extraneous issues. For example, a Staff comment on the impairment of goodwill will require a response that often requires cognizance of the company's reporting units, which are generally one level down from the operating segments. As a result of this linkage, a response on goodwill impairment issues can result in the Staff questioning whether a registrant has the correct number of reportable segments or whether there should be more. Although the complete approach is the best way to address comments (and avoid becoming pen pals with the Staff under Rule No. 11), the registrant (management and the appropriate board committee) should confer with counsel to decide which strategy to follow.

10. Think ahead. The review process is much like playing chess in which you need to think several moves ahead. It is important for the registrant to understand that the Staff may be asking an initial question with

other questions in mind, depending on your answers to the initial comment. Sometimes, a registrant will just want to “get it over with” and not consider the consequences of the registrant’s initial response in terms of follow-up comments.

11. Don’t become pen pals with the Staff. If the response to the first comment letter results in more comments in the second letter than you received in the first, reconsider your strategy.

12. Although Emerson observed that “a foolish consistency is the hobgoblin of little minds,” consistency in the review process is anything but foolish. If you are inconsistent in your responses, either between comment responses in the same letter or in responses in more than one comment letter, expect the Staff to find the inconsistencies, rivet on them, and make a separate issue of those inconsistencies. For example, a shift in either your story or your numbers, or both, in a comment response can lead to a new comment relating to disclosure controls and procedures or internal control over financial reporting. See Rule No. 28.

13. Keep the appropriate board committee involved in the process. If the charter of the appropriate board committee already covers the response to comment letters, follow those procedures. If not, discuss the approach being taken with the chair of that committee, suggest having a meeting of the committee before sending the initial response to the Staff. Not only can early board committee oversight motivate a better initial response, but the board committee will not experience an unpleasant surprise when the Staff digs in its heels on a particular issue. Of course, this will also depend on the personalities of your directors and degree to which they expect to be involved in these types of matters. Some may want only a quick briefing from management and counsel, while others may provide detailed comments on the draft.

14. Keep your outside auditor involved throughout the process. This is not just for the engagement partner and his or her team, but if there is a need for national office participation, it is better to obtain it early in the process. It is not a good moment in your career when the national office representative starts a telephone call with the Staff, after they have rejected your initial position, with a statement like “I was just consulted on this matter yesterday.”

15. Don’t cite proposed rules or proposed legislation to the Staff in a comment response as something the Staff must follow, unless the release proposing the rule permits early adoption of the position being proposed.

16. If you are going to appeal a comment, go through the levels of the Staff, from the examiner through the Branch Chief and then the Assistant Director to the Associate Director (for non-accounting comments) or through the Accounting Branch Chief, then the Senior Assistant Chief Accountant before Corp Fin OCA and perhaps even OCA (for accounting comments). Appealing a comment should not be an emotional experience, especially when you have already gone through more than one comment letter. Typically, the review Staff will have already consulted with senior persons in a multiple comment letter situation. While they won’t necessarily tell you that, be prepared for it nonetheless.

If you believe that your position is the right one, however, an appeal may be warranted. This is especially the

case for comments that would result in filing financial statements or other disclosure that one or more of management, the audit committee, counsel or the outside auditor believe would not accurately describe the company’s real story. Thus, agreeing to the Staff’s position means that you are going to comply with that position and, if you are not able to do so in good faith, you may need to appeal.

17. Once you appeal, don’t think that the Staff will call you back immediately. An appeal outside of the office involved will typically involve other offices in the Division or in other parts of the Commission. Schedules have to be consulted and coordinated, documents sent, and meetings, conference calls held. All of that takes time.

18. If you appeal an issue, understand that supervisors may identify other issues in your response, your filing or fact pattern that can result in your not only losing the appeal but also having more comments to contend with. Having said that, remember in particular Rule Nos. 12, 13 and 14 during the appeal process.

19. With respect to futures comments, remember that the comment applies to the next filing. Often a company will agree to a futures comment and either forget or just not comply with the futures comment in the next filing. The Staff can easily come back and say, “You agreed to do X, your filing doesn’t do X, please amend your filing to do X.” Don’t expect sympathetic treatment from the Staff in that situation. The Staff’s use of the word “please” does not connote that compliance is voluntary.

20. Show the Staff that you “get it.” The comment process can be beneficial to the company, its management and counsel. It can be a process in which the registrant realizes that disclosure is not something to be gamed, that there really is someone who reads the filing and has questions about the disclosure in that filing.

21. When seeking to resolve a comment with the Staff, consider asking the Staff if they would review draft disclosure. And if the disclosure has not yet been written for the next filing (which is typically going to be the situation) ask if the Staff would review a draft of what the disclosure that was the subject of the Staff comment would have looked like if you had complied with the Staff comment in that filing. This approach can result in not just having a clear understanding of where the Staff is coming from on a comment, but ending the comment process, so that the Staff is not looking at your next filing to make sure that you “got it.”

22. Remember that your responses will become publicly available, and that your answers to questions can be reviewed by competitors as well as plaintiffs and by analysts. That should not mean that you pull any punches in your comment responses, but it should mean that you understand the different audiences that could see your responses. Often the Staff will ask a registrant to put the substance of an oral conversation about a comment into a comment response letter that is filed on EDGAR. Similarly, any communications with the Staff via email could find their way into the registrant’s correspondence file, which is subject to a FOIA request. You should assume that any communication with the Staff may become publicly available.

23. In light of Rule No. 22, consider a confidential treatment request (CTR). If you determine to submit a CTR, do so in a surgical fashion. Don’t ask for confidential treatment for more than is absolutely necessary.

Asking for confidential treatment for everything in a response, or even too much of the response, when you are only concerned about a discrete and limited number of items can: (a) aggravate the Staff; (b) result in delaying resolution of the comment process; (c) cause the Staff to think twice about the arguments you make in your response that do have merit; or (d) all of the above.

24. Don't have blinders on during the comment process. If events occur in the marketplace, at the Commission, FASB, the PCAOB, Congress or elsewhere that can affect your response to comments, or the Staff's response to your responses, take them into account as you go through the process. The comment process is not static.

25. If you get more comments "out of left field" near the end of the process, recognize that there is more than one person reviewing your responses, and that others may be weighing in. Although it is possible for the Staff to do this, it rarely happens. If this does occur, there may be an equitable argument available, which will depend on the nature of the new comment as well as on the specific facts and circumstances involved (such as the registrant commencing a public offering). In these situations, it may be helpful to approach the Staff and respectfully request that it reconsider the new comments. The thrust of the conversation, although not the exact words, is that the late comments are "a day late and a dollar short." Again, this is a topic for a conversation with the Staff.

26. If you are submitting a materiality analysis under SAB 99 in response to a comment, be sure to have a full discussion of the qualitative factors, rather than just asserting that you have them. Accountants typically think that they are done, once they give the quantitative presentation, but that is only part of the response. Pass the response by, or better yet, involve the legal staff (in-house and outside counsel) in the initial draft of the response. You can enhance the value of an SAB 99 memo if you can state that the merits of the issue were considered by management and the audit committee at the time that management prepared the financial statements and the auditor audited or reviewed them. See Rule No. 3.

27. Consider the Staff's schedule and factor it into your planning. If you are involved in a review, especially over a long period of time, ask the Staff person(s) involved in the review what their schedule is, in terms of vacations and when they may not be available. This is especially the case during the summer months when at any one time a large percentage of the review Staff may be on vacation. If the Staff person telecommutes certain days of the week, ask when is the best time for telephone calls.

28. The review Staff has real time access to many sources beyond newspapers. These include: press releases, such as earnings releases; research reports; live presentations or transcripts of your investor and analyst conference calls; the statements by your competitors, about themselves and you; interviews of your executives on CNBC, Bloomberg and the like; and court records. Another example is saying one thing to another governmental agency, such as the EPA, and a different thing in your filings with the Commission about environmental matters can result in conflicting statements to federal agencies.

It is not difficult for even an inexperienced examiner to compare your formal filings with the Commission to

informal sources of information and develop comments about inconsistencies, disparities or lack of complete discussion in your filing. Just think what an experienced examiner can do! The issue here goes beyond inconsistencies (see Rule No. 12). Instead, the Staff's concern is whether a registrant's periodic and current reports are full, accurate and complete. Do the registrant's reports tell investors the whole story about the registrant, or is there something missing that can be found only in other communications? The next step in the Staff's analysis is whether any differences, once identified, are material. For example, a comment may ask why non-GAAP financial measures in an informal communication portray the company's performance in one way, when the GAAP presentation described in the MD&A gives a materially different picture of the registrant's results of operations. Thus, the comment process can be used to identify inconsistencies, reconcile the registrant's overall disclosures with its Commission filings, and determine the reasons underlying any dissonance between the two.

29. Don't be surprised by, or shy away from, outside-the-box thinking. Even though there are training manuals, Dear CFO Letters, C&DIs, and other sources from which the Staff can issue comments, the examiner and the Staff accountant conducting the review have the ability to think outside the box. Sometimes these comments may appear off base, and other times they can result in a requirement that the registrant may have difficulty following. In the former category, when comments are off base, don't underrate the Staff — they don't know your company or client as well as you do. Your response should inform the Staff in an objective way. In the latter category, when a comment does hit close to home, understand that you may be in for a tussle to have your position prevail. But, in either event, remember that you need to convince the Staff of the merits of your position.

30. Sometimes the Staff uses the comment process to learn on you. What does that mean? In a new or emerging area—such as International Financial Reporting Standards (IFRS) in accordance with the International Accounting Standards Board (IASB)—the initial reviews by the Staff showed how they understood IFRS in accordance with the IASB even though they were not as conversant with it as they were with US GAAP.

31. The Staff can make a mistake — they are not infallible. Treat the Staff as you would like them to treat you when you goof up.

32. The Staff has a long memory. How you treat the Staff in one review can affect how the Staff views you in your next review. Every registrant, every law firm and every accounting firm has a "goodwill account" with the review Staff. During every review, each registrant, law firm, accounting firm or other professional adviser appearing before the Staff has the opportunity to either add to or subtract from that goodwill account. Even if the change in your goodwill account does not immediately affect your current review posture, it may well affect how the Staff perceives you in your next review. So remember, your goodwill account can become impaired or increased by how you treat the Staff during the review process.

33. Don't opinion shop. Once you are in review, don't take a comment on a no-names basis to another office or person in the Division or the Commission. If you don't agree with the comment, go through the per-

sons who are in charge of the review, rather than reaching out to a new person who is not connected with the review. If you do opinion shop, when the Staff finds out, you will be into Rule No. 32.

34. Having influential people you know from Congress or other agencies call senior people in the Commission or Commissioners to complain about the treatment you are receiving from the review Staff is dumb. This approach fundamentally misconceives the Staff's independence and the seriousness with which the Staff takes its mission of protecting investors. This approach will likely backfire and result in the Staff not being as flexible in addressing your meritorious arguments as they would have been. See also Rule No. 32.

35. Just because you resolved a comment in a prior review years ago doesn't mean that you must continue to comply with that comment today. Many registrants continue to comply with the comments that they received in the review of their IPO on Form S-1, reasoning that if they were ever called on it, they could say "the Staff made us do it." If compliance with an old comment no longer makes sense, then change your disclosure. If you are concerned about the matter, it may mean that you should continue to comply, but it may also mean that calling the Staff, explaining your changed circumstances and seeing what the Staff has to say is the better course of action.

36. Tell the Staff your schedule, especially with respect to the review of a registration statement under the Securities Act or a proxy statement under the Exchange Act. While the Staff will try to meet your schedule, it takes two to tango. If the Staff responds to you on an expedited schedule and you then take an inordinate amount of time to respond to any follow-up comments, the Staff may not be too willing to do it again. By the same token, if you have given the Staff your schedule and then the offering is delayed, it's a good idea to keep the review Staff updated on your revised schedule.

37. Coordination is key. This is especially the case when the filing being reviewed involves entities, law firms or accounting firms other than just the registrant.

Examples include: public offerings; mergers; tender offers, whether exchange offers or cash tender offers; proxy contests; and going private transactions. Be sure that the other parties understand who is going to talk with the Staff and under what circumstances. This is not to say that the lawyers for the other entities, such as underwriters' counsel or the financial advisor's counsel, cannot talk with the Staff about comments, especially those that affect the disclosure relating to their respective clients. But it does mean that there should not be a lone wolf in the review process.

38. When your filing involves third parties as described in Rule No. 37, it is important to discuss the responses to the comments and share drafts of the comment letter responses. Sending comment letters around after submission, rather than before, can result in the third parties disagreeing with positions being taken by the registrant which may result in an "oops" moment for the registrant in front of the Staff. See Rule No. 12.

39. Conference calls with the Staff must be well organized. The relevant persons who will participate should have a call (or meeting) before the conference call with the Staff. Bad rehearsals can result in good performances. Once on the conference call with the Staff, listen both to the words and the music being played for you by the Staff. Be attentive to how your statements can be perceived by the Staff as well as what you are trying to communicate. Expect the unexpected in terms of questions from the Staff. And, if a question is asked that neither you nor anyone else on the call knows the answer to, tell the Staff that you need to get back to them on that question, rather than trying to improvise your answer.

After the conference call with the Staff, have a debrief call in which you analyze the words and the music played for you by the Staff, develop answers to questions asked that need to be addressed and consider next steps.

40. Don't forget Rule No. 1.