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Responding To SEC Comments

The following is written by Laura Anthony, Esq., a going public attorney focused on OTC listing requirements, direct public offerings, going public transactions, reverse mergers, Form 10 and Form S-1 registration statements, SEC compliance and OTC Market reporting requirements.

Background

The SEC Division of Corporation Finance (CorpFin) reviews and comments upon filings made under the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act"). The purpose of a review by CorpFin is to ensure compliance with the disclosure requirements under the federal securities laws, including Regulation S-K and Regulation S-X, and to enhance such disclosures as to each particular issuer. CorpFin will also be cognizant of the anti-fraud provisions of the federal securities laws and may refer a matter to the Division of Enforcement where material concerns arise over the adequacy and accuracy of reported information or other securities law violations, including violations of the Section 5 registration requirements. CorpFin has an Office of Enforcement Liason in that regard.

CorpFin's review and responsibilities can be described with one word: disclosure!

CorpFin selectively reviews filings, although generally all first-time filings, such as an S-1 for an initial public offering or Form 10 registration under the Exchange Act, are fully reviewed. Forms 8-K reporting a change of auditor, a material acquisition, or a change in financial statements are almost always reviewed. Moreover, the Sarbanes-Oxley Act of 2002 requires that CorpFin review all public companies at least once every three years. Section 508 of the Sarbanes-Oxley Act specifies certain factors that the SEC should consider when scheduling reviews, including market capitalization, financial restatements, volatility of the company's stock price and the price/earnings ratio.

CorpFin does not publicly disclose the criteria it uses to identify companies and filings for review. Essentially, a publicly reporting company's filings may be reviewed at any time and periodic comment letters are a standard part of being a public company.

There are three basic levels of review. A review by CorpFin can be a "full review" in which CorpFin will review a filing from cover to cover, including both legal and accounting aspects and basic form for compliance with the federal securities laws. A partial review may include either legal or accounting, but generally a partial review is related to financial statements and related disclosures, including Management Discussion and Analysis of Financial Condition and Results of Operations, and is completed by CorpFin accounting staff. A review may also be a targeted review in which CorpFin will examine the filing for one or more specific items of disclosure. Moreover, although not a designated level of review, CorpFin sometimes "monitors" a filing, which is a term used for a light review.

Reviewers are appointed files based on industry sectors. CorpFin has broken down its reviewers into the following eleven broad industry sectors: healthcare and insurance; consumer products; information technologies and services; natural resources; transportation and leisure; manufacturing and construction; financial services; real estate and commodities; beverages, apparel and mining; electronics and machinery and telecommunications. Each industry office is staffed with an assistant director and approximately 25 to 35 professionals, primarily accountants and lawyers. Each filing has more than one reviewer with a frontline contact person and supervisor. A full review file will have an accounting and legal reviewer as well as a supervisor.

Neither the SEC nor the CorpFin evaluates the merits of any transaction or makes an assessment or determination as to whether a transaction or company is appropriate for any particular investor or the marketplace as a whole. The purpose of a review is to ensure compliance with the disclosure requirements of the securities laws. In that regard, CorpFin may ask for increased risk factors and clear disclosure related to the merits or lack thereof of a particular transaction, but they do not assess or comment upon those merits beyond the disclosure.

Comment Letters and Responses

Comment letters are based on a company's filings and other public information about the company. For instance, CorpFin will review press releases and a company's website, management communications and speeches, and conference presentations in addition to the company's filings with the SEC. In comment letters, CorpFin may ask that a company provide additional supplemental information to the staff (such as backup materials to justify factual information such as reference to reports, statistics, market or industry size, etc.), revise disclosure in the document, provide additional disclosure in the reviewed filing or provide additional or different disclosure in future filings. Where a change is requested in future filings, intended disclosures may be provided in the comment letter response for SEC advance approval.

A company generally responds to the particular comment letter with a responsive letter that addresses each comment and where appropriate, amended filings on the particular report(s) being commented upon. The response letter may refer to changes made in a filing in response to the comment or provide reasoning or explanations as to why a change was not made or in support of a particular disclosure. CorpFin then may issue additional comment letters either on the same question or issue, or additional questions or issues as it continues its review, and analyze the company's responses. The company should carefully consider its responses to comments that could open the door to additional review and comments. Comments related to accounting treatment and the flow-through to MD&A can be especially tricky and open the door to further review and changes.

Each comment response should clearly present the company's position on the pertinent issue in a way that will persuade CorpFin that it is the correct position. Comment responses should cite applicable SEC rules and guidance and accounting authority (as the comments themselves most often do). Responses should explain how the company's approach serves to satisfy the SEC's requirements while providing good disclosure to investors. Avoid conclusory or argumentative statements. If it is the company's position that the technical application of the rule will place too large of a burden on the company, explain how the company is burdened and how the alternative provided by the company will provide adequate disclosure for investors. The argument that technical compliance is overly burdensome rarely succeeds with CorpFin, but at times a middle ground can be reached if the company is convincing enough in its analysis.

The comment and response process continues until the staff has resolved all comments. CorpFin may request that the reasoning behind a disclosure be added to the SEC report itself, and so the company should consider whether it wants particular language included in public filings when drafting a response letter to a comment.

Although the basic process involves letters and responses, the CorpFin staff is available to discuss comments with a company and its legal, accounting and other advisors. The process can and often does involve such conversations. CorpFin will not give legal or accounting advice, but it will talk through comments and responses and discuss the analysis and adequacy related to disclosures. The initial comment letter received from CorpFin will have the reviewer's direct contact information. The back-and-forth process does not require a formal protocol other than the required written response letter. That is, a company or its advisors may engage in conversations regarding comments, or request the staff to reconsider certain comments prior to putting pen to paper.

Moreover, CorpFin encourages this type of conversation, especially where the company or its advisors do not understand a particular comment. The staff would rather discuss it than have the company guess and proceed in the wrong direction. Where the staff suggests that a company should revise its disclosure or its financial statements, the company may, and should as appropriate, provide the staff with a written explanation of why it provided the disclosure it did. This explanation may resolve the comment without the need for the requested amendment. A CorpFin review is not an attack and should not be approached as such. My experience with CorpFin has always been pleasant and involves a type of collaboration to improve company disclosures.

A company may also "go up the ladder," so to speak, in its discussion with the CorpFin review staff. Such further discussions are not discouraged or seen as an adversarial attack in any way. For instance, if the company does not understand or agree with a comment, it may first talk to the reviewer. If that does not resolve the question, they may then ask to talk to the particular person who prepared the comment or directly with the legal branch chief or accounting branch chief identified in the letter. A company may even then proceed to speak directly with the assistant director, deputy director, and then even director. Matters of legal disclosure or application of GAAP accounting principles are not an exact science, and discussions are encouraged such that the end result is an enhanced disclosure by the company and consistent disclosures across different companies. The SEC provides all of these individuals contact information on its website and will willingly engage in productive conversations with a company.

When responding to comment letters and communicating with SEC staff, it is important that a person who understands the process, such as SEC counsel, take the lead in communication. Responses should be consistent, both related to a particular comment letter and over time. A company that flip-flops on accounting treatment or disclosures will lose credibility with the SEC and invoke further review and comments.

CorpFin is also willing to provide a reasonable amount of extra time to respond to comment letters when requested. Most comment letters request a response within 10 days. CorpFin is usually willing to give an extra 10 days but will balk at much longer than that without a very good reason by the company for the delay.

If the reviewed filing is a Securities Act registration statement, such as an S-1, the CorpFin staff will verbally inform the company that it has cleared comments and the company may request that the SEC declare the registration statement effective. Where the reviewed filing is an Exchange Act filing that does not need to be declared effective, CorpFin will provide the company with a letter stating that it has resolved all of its comments.

Comment letters and responses are posted on the EDGAR database by CorpFin no earlier than 20 days after it has finished the review process.

The SEC generally requires an affirmative statement from the company acknowledging that the company cannot use the SEC's comment process as a defense in any securities-related litigation. This language is referred to as a "Tandy" letter. The Tandy portion of a response must be agreed to by the company itself, so if the response letter is on attorney letterhead, a signature line must be provided for the company or the company can submit a separate letter. The Tandy language for an Exchange Act filing is generally as follows:

The company acknowledges that:

- the company is responsible for the adequacy and accuracy of the disclosure in the filing;
- staff comments or changes to disclosure in response to staff comments do not foreclose the Commission from taking any action with respect to the filing; and
- the company may not assert staff comments as a defense in any proceeding initiated by the Commission or any person under the federal securities laws of the United States.

Tandy language for a Securities Act registration statement is generally as follows:

The company acknowledges the following:

- should the Commission or the staff, acting pursuant to delegated authority, declare the filing effective, it does not preclude the Commission from taking any action with respect to the filing;
- the action of the Commission or the staff, acting pursuant to delegated authority, in declaring the filing effective does not relieve the company from its full responsibility for the adequacy and accuracy of the disclosure in the filing; and
- the company may not assert staff comments and the declaration of effectiveness as a defense in any proceeding initated by the Commission or any person under the federal securities laws of the United States.

A company can stay prepared for comment letters, and responses, by making sure it has adequate internal controls and procedures for reporting. The company should also stay on top of SEC guidance on disclosure matters, which can be accomplished by ensuring that the company has experienced SEC counsel that, in turn, stays up to date on all SEC rules, regulations and guidance. Likewise, the company should retain an accountant that monitors up-to-date accounting pronouncements and guidance. The company should maintain a file with backup materials for any disclosures made, including copies of reference materials for third-party disclosure items. In responding to comments, it is helpful to review other companies' comment response letters and disclosures on particular issues. Where the SEC has requested changes in future filings, the company and its counsel must be sure to continuously monitor to be sure those changes are included. As mentioned, the SEC reviews public information on the company, including websites and press releases and accordingly, these materials should be reviewed for consistency in SEC reports. As CorpFin is only reviewing information provided by, or publicly available related to, a company, the completion of a review is not a guarantee as to the accuracy or adequacy of the information in the filing and cannot be used as a defense to claims of fraud or misrepresentations.

Although a full discussion of confidential treatment and requests are beyond the scope of this blog, a company may seek confidential treatment of materials and responses to comments under Rule 83. Rule 83 requires the company to respond to comments with two separate letters – one containing the confidential information and the other not. Unlike confidential treatment requests under Rule 406 and 24b-2, a confidential treatment request for a comment response letter does not require that the company provide a justification for such confidential treatment. However, if a Freedom of Information Act (FOIA) request is submitted by a third party related to such comment letter response, the SEC will inform the company and request justification for continued confidential treatment. Confidential treatment under Rule 83 expires after 10 years unless a renewal is requested. Both Rule 83 and other confidential treatment rules require very specific transmittal procedures, and the documents must all clearly indicate that confidential treatment is requested. In a future blog I will discuss confidential treatment requests and SEC review policies.

Conclusion

The very best way to handle comments and responses is to have a competent team in place that submits high-quality SEC reports in the first place and that is able to communicate with the SEC and understand the legal disclosure and accounting requirements, including interpretative changes over time. The topic of disclosures and disclosure requirements is in the forefront these days, and changes are being reviewed and considered by the SEC (see, HERE for example). Understanding the disclosure requirements for your particular company and industry will save substantial time and effort for a public company.

For a review of basic public company disclosures, see my blog HERE. For more information regarding officer and director liability associated with signing SEC reports, see my blog HERE.

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Securities Law Blog is written by Laura Anthony, Esq., a going public lawyer focused on OTC Listing Requirements, Direct Public Offerings, Going Public Transactions, Reverse Mergers, Form 10 Registration Statements, and Form S-1 Registration Statements. Securities Law Blog covers topics ranging from SEC Compliance, FINRA Compliance, DTC Chills, Going Public on the OTC, and OTCQX and OTCQB Reporting Requirements. Ms. Anthony is also the host of LawCast.com, the securities law network.

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