SEC Regulations Committee
September 25, 2013 - Joint Meeting with SEC Staff
SEC Offices – Washington DC

HIGHLIGHTS

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I. ATTENDANCE

A. SEC Regulations Committee

Melanie Dolan, Chair
Steve Meisel, Vice-Chair
Jim Brendel
Brad Davidson
Christine Davine
Jackson Day
Tom Elder
Greg Giugliano
Bridgette Hodges
Wayne Landsman
Jeff Lenz
Kevin McBride

Sandra Peters
Scott Pohlman
Amy Ripepi
Michelle Stillman

B. Securities and Exchange Commission

Division of Corporation Finance (Division)

Keith Higgins, Director (present for part of the meeting)
Mark Kronforst, Chief Accountant (present for part of the meeting)
Craig Olinger, Acting Chief Accountant
Nili Shah, Deputy Chief Accountant
Patricia Armelin, Associate Chief Accountant
Jill Davis, Associate Chief Accountant
Louise Dorsey, Associate Chief Accountant
Todd Hardiman, Associate Chief Accountant
Lindsay McCord, Staff Accountant (CF-OCA rotator)
Ryan Milne, Associate Chief Accountant
Leslie Overton, Associate Chief Accountant
Mark Shannon, Associate Chief Accountant
Johanna Losert, Special Counsel (present for part of the meeting)
Mark Green, Senior Special Counsel
John Fieldsend, Special Counsel (present for part of the meeting)
Eduardo Aleman, Special Counsel (present for part of the meeting)

Division of Enforcement

Charles Wright, Senior Legal Advisor (present for part of the meeting)
David Woodcock, Regional Director, Chairman of Financial Reporting and Audit Task Force (present for part of the meeting)

C. Center for Audit Quality

Annette Schumacher Barr

D. Guests

Keisha Hutchinson, KPMG
John May, PwC

II. DIVISION OF CORPORATION FINANCE PERSONNEL AND ORGANIZATIONAL UPDATE

Craig Olinger introduced Keith Higgins, the Director of the Division of Corporation Finance (the Division). Mr. Higgins addressed the group and conveyed that Mark Kronforst was appointed as Chief Accountant of the Division. Mr. Kronforst is currently Associate Director in the Division and previously served as a Deputy Chief Accountant in the Division. Mr. Higgins thanked Mr. Olinger and Ms. Nili Shah for their leadership during the past 2 years.

Mr. Olinger discussed a rotation program within the Division and noted that Lindsay McCord is currently participating in this program and will be in the group for one year, working on a variety of policy and practice issues.

III. CURRENT FINANCIAL REPORTING MATTERS

Financial Reporting Manual

On July 16, 2013, the Division staff updated the Financial Reporting Manual (FRM) Among the changes in the update were significant revisions to the staff's guidance on the financial statement requirements related to acquisitions of real estate operations (S-X Rule 3-14). The Committee discussed these revisions and informed the staff that the Committee has created a Real Estate Task Force that is compiling a list of questions and practice issues. The Real Estate Task Force plans to discuss these items with the staff to obtain clarification about the guidance. Louise Dorsey indicated that the staff has received a few informal questions related to calculating significance under the revised guidance.

The staff noted that the next update to the Division's Financial Reporting Manual (FRM) is expected to be issued in the ordinary course, with updates dated as of June 30, 2013.

[Note: On October 29, 2013, the Division's staff issued its quarterly update of the FRM with updates dated as of June 30, 2013.]

IV. CAPITAL FORMATION INITIATIVES

A. JOBS Act

During 2012 and 2013, the Division's staff published several Frequently Asked Questions (FAQs) designed to provide further guidance about how to implement certain provisions of the JOBS Act. The FAQs are posted on the JOBS Act section of the SEC's web site.

Ms. Shah indicated that the volume of questions regarding JOBS Act implementation has declined in recent months and reflect fact-specific issues rather than broad-based matters.

[Note: On October 29, 2013, the Division's staff updated the FRM to reflect changes arising from the JOBS ACT. The information in the updated FRM is intended to be consistent with the JOBS Act and the Division of Corporation Finance's Frequently Asked Questions on Title I of the JOBS Act, available at: http://www.sec.gov/divisions/corpfin/guidance/cfjjobsactfaq-title-i-general.htm.]

B. Recommendations by the SEC Investor Advisory Committee

Mark Green summarized the recommendations made at the July 25, 2013 meeting of the SEC Investor Advisory Committee as follows:

- The SEC should adopt a "Culture of Smart Disclosure" that promotes the collection, standardization, and retrieval of data filed with the SEC using machine-readable data tagging formats.
- The SEC should take steps designed to reduce the costs of providing tagged data, particularly for smaller issuers and investors.
- The SEC should give priority to the revision of certain existing forms to provide for the tagging of data that would provide increased transparency with respect to corporate governance.
- The SEC should explore relaxing the "bona fide nominee" rule embodied in Rule 14a-4(d)(1) promulgated in 1966 under Section 14 of the Securities Exchange Act of 1934 to provide proxy contestants with the option (but not the obligation) to use Universal Ballots in connection with short slate director nominations (in other words, where the candidates nominated by shareholders would, if elected, constitute a minority of the board of directors). In connection with that process, specific inquiry should be made as to whether all or only a portion of duly nominated candidates must or may appear on Universal Ballots.

The materials from the Investor Advisory Committee's July 25, 2013 meeting may be found at http://www.sec.gov/spotlight/investor-advisory-committee-2012.shtml. The Committee's recommendations may be found at http://www.sec.gov/spotlight/investor-advisory-committee-2012/data-tagging-resolution-72513.pdf and http://www.sec.gov/spotlight/investor-advisory-committee-2012/universal-proxy-recommendation-072613.pdf.

C. Recommendations by the SEC Advisory Committee on Small and Emerging Businesses

Johanna Losert indicated that at its September 17, 2013 meeting, the SEC Advisory Committee on Small and Emerging Companies invited individuals from Angel Capital Association, Latham and Watkins LLP and Cowen and Company to discuss the impact of the JOBS Act on capital formation as well as new ideas for capital formation. At the meeting, a recommendation to extend the comment period for the Commission's proposal to amend Regulation D, Form D, and Rule 156 under the Securities Act was unanimously approved by the members of the Advisory Committee present and voting.

Ms. Losert indicated that the SEC staff and the Advisory Committee members are currently considering the various recommendations made by the Advisory Committee. The current charter for the Advisory Committee expires in October 2013 and officials have taken steps to extend the Advisory Committee for an additional two year term.

On September 27, 2013 the SEC re-opened the comment period for the rule proposal referred to above for a period of 30 days. On October 2, 2013, the SEC announced that it has renewed the Advisory Committee's charter for an additional 2 year period.

The materials from the Advisory Committee's September 17, 2013 meeting may be found at http://sec.gov/info/smallbus/acsec.shtml.

V. SEC STAFF AND OTHER INITIATIVES

A. Rulemaking for Conflict Minerals and Extractive Industry Payments

On August 22, 2012, the SEC adopted two rules mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act. One rule requires certain companies with conflict minerals (tantalum, tin, gold and tungsten) in their products to disclose whether those minerals originated in the Democratic Republic of the Congo or an adjoining country and, if so, exercise due diligence and file a Conflict Minerals Report. The other rule requires resource extraction issuers to disclose certain payments made to the U.S. government or foreign governments in certain cases.

In May 2013, the SEC staff issued frequently asked questions (FAQs) and responses about complying with both the conflict minerals and resource extraction rules. The FAQs focused on areas such as applicability and scope of the rules, disclosure and reporting under the rules, how the rules apply in initial public offerings and the impact of noncompliance on Form S-3 eligibility. John Fieldsend stated that the SEC staff is still receiving interpretative questions about the conflict minerals rule, and he indicated that the staff is developing responses with the goal of providing additional guidance soon.

- **Conflict Minerals**

On July 23, 2013, the SEC's conflict minerals rule was upheld by the U.S. District Court for the District of Columbia (the Court) after challenges by industry groups. Mr. Fieldsend noted that plaintiffs have appealed the Court's decision. He noted that registrants are expected to comply with the May 31, 2014 filing deadline.

It was noted that a petition by a law firm asking for deferral of implementation of the conflict mineral rules is currently posted on the SEC web site. The Committee asked if the staff is planning on taking any actions regarding this petition. The staff noted that the petition is being reviewed in the same manner as all rulemaking petitions.

- **Extractive Industry Payments**

  On July 2, 2013, the U.S. District Court for the District of Columbia vacated the rule requiring disclosure of payments by resource extraction issuers. The staff stated that the Commission had not appealed the Court's decision. The staff indicated they will redraft the rule but a timetable for a new proposal has not yet been determined. In the meantime, the staff noted that the effect of the court's decision is that the rule has been vacated and registrants are not required to comply with the vacated rule.

B. COSO Revised Framework

In May, 2013 the Committee of Sponsoring Organizations of the Treadway Commission (COSO) released its updated *Internal Control – Integrated Framework* (2013 Framework).

The Committee noted that SEC Chief Accountant Paul Beswick recently said that the SEC staff plans to monitor the transition for issuers using the 1992 Framework to evaluate whether any staff or Commission actions become necessary or appropriate at some point in the future. Ms. Shah stated that the staff is currently referring users of the COSO 1992 framework to the following statements made on the COSO web site:

> "COSO believes that users should transition their applications and related documentation to the updated *Framework* as soon as is feasible under their particular circumstances. As previously announced, COSO will continue to make available its original *Framework* during the transition period extending to December 15, 2014, after which time COSO will consider it as superseded by the 2013 edition. During the transition period (May 14, 2013 to December 15, 2014) the COSO Board believes that organizations reporting externally should clearly disclose whether the original *Framework* or the updated *Framework* was utilized."

Exchange Act Rule 13a-15(c) requires management's evaluation of the effectiveness of internal control over financial reporting to be based on a framework that is "a suitable, recognized control framework that is established by a body or group that has followed due-process procedures…" In Release 33-8328, the SEC stated that " [t]he COSO Framework satisfies our criteria and may be used as an evaluation framework for purposes of management's annual internal control evaluation and disclosure requirements."

The staff indicated that the longer issuers continue to use the 1992 framework, the more likely they are to receive questions from the staff about whether the issuer's use of the 1992 framework satisfies the SEC's requirement to use a suitable, recognized framework (particularly after December 15, 2014 when COSO will consider the 1992 framework to have been superseded by the 2013 framework).

C. The Financial Reporting and Audit Task Force and the use of the Accounting Quality Model (AQM) to flag high-risk activities

In a speech on December 13, 2012, Craig M. Lewis, Chief Economist and Director, Division of Risk, Strategy, and Financial Innovation (subsequently renamed the Division of Economic and Risk Analysis), discussed a new tool, the "Accounting Quality Model" (AQM), being developed to evaluate registrant filings and search for potential areas of risk. According to Mr. Lewis, "This model is being designed to provide a set of quantitative analytics that could be used across the SEC to assess the degree to which registrants' financial statements appear anomalous," and "the AQM is a model that allows the SEC to discern whether a registrant's financial statements stick out from the pack, while taking into account the contemporaneous attributes of that pack. The goal is to facilitate comparison across firms within their industry while accounting for and illustrating industry differences as well."

In a press release on July 2, 2013, the SEC announced new initiatives to improve the Division of Enforcement's ongoing efforts to concentrate resources on high-risk areas of the market and introduce cutting-edge technology and analytical capacity in its investigations. One of these initiatives is the Financial Reporting and Audit Task Force (the Task Force), which is dedicated to detecting fraudulent or improper financial reporting. The Task Force will concentrate on financial statements, issuer reporting and disclosure, and audit failures. The goal of the Task Force will be fraud detection and increased prosecution of violations involving false or misleading financial statements and disclosures. The Task Force will focus on identifying and exploring areas susceptible to fraudulent financial reporting, including on-going review of financial statement restatements and revisions, analysis of performance trends by industry, and use of technology-based tools such as the AQM.

At the meeting, David Woodcock, Director of the Fort Worth Regional Office and Chairman of the Financial Reporting and Audit Task Force, indicated that Andrew Ceresney, Co-Director of Enforcement, and Mary Jo White, SEC Chair, are very interested in accounting fraud. He noted that over the past few years there has been a decrease in accounting fraud- and restatements-related investigations cases, and that currently there is a refocus on this area by the staff. Mr. Woodcock discussed how the SEC, particularly the Task Force and the Enforcement Division, will use the AQM. The AQM is an econometric regression model that looks at indicators and causes of accounting fraud, rather than performing a traditional company-by-company analysis. By integrating actual experiences, knowledge and other internal tools with the AQM, the staff can identify factors that indicate reporting outliers, which may then be used to assess whether particular accounting or reporting warrants further SEC attention.

Mr. Woodcock informed the Committee that the Task Force consists of six accountants and six attorneys who are focused on a number of different initiatives. He noted that one of the Task Force's goals is to be more proactive and find cases earlier than in the past. He indicated that the Task Force typically uses two broad

approaches: (1) an analytic approach such as the AQM that focuses on looking for outliers amongst companies and their industries; and (2) third party tools that provide insight into the quality of a Company's earnings.

The Task Force is collaborating with other groups within as well as outside the SEC, e.g., the PCAOB. It has already started these efforts and will continue to assess the benefits of this collaboration among the groups. Mr. Woodcock referred to the Task Force as the "incubator" for data and information to be provided to Enforcement staff.

The Task Force intends to focus on academic studies and is in the process of identifying academia with concrete ideas of where there may be problems (e.g., stock option backdating several years ago). Mr. Woodcock indicated that the first contact with registrants identified as outliers would not necessarily be a subpoena, but would probably be a call to registrants or a list of requests.

Mr. Woodcock indicated that while the role of the Task Force is not to set policies, it will work closely and communicate with other divisions and offices such as Corporation Finance and OCA. Enforcement leads will not be the Task Force's only output.

He added that, with the high degree of scrutiny provided by hedge fund analysts and others looking at the quality of registrants' earnings as well as the vigilance of whistleblowers, one would expect less accounting fraud. His hope is that the Task Force will be another means of deterring fraudulent financial reporting.

D. Request from Congressional Committee on Oversight and Government Reform for information on the Commission's implementation and enforcement of the Interactive Data Rule

The SEC requires that registrants provide U.S. GAAP financial statements to the Commission and on their corporate web sites in interactive data format using eXtensible Business Reporting Language (XBRL). The SEC's rules are intended not only to make financial information easier for investors to analyze, but also to assist in automating regulatory filings and business information processing. The SEC required the largest public companies to begin submitting their financial statements in XBRL in 2009. In a three-tiered implementation approach, the smallest companies were allowed to wait until 2011 before submitting for the first time.

In a letter to Chair White dated September 10, 2013, the Congressional Committee on Oversight and Government Reform asked the SEC to provide documents and prepare a briefing to explain how it uses information gathered through the requirement of all public companies to submit their financial statements in XBRL, and how it will enforce the quality of those filings.

Mr. Kronforst indicated that currently the staff does not have any comment on the letter.

VI. CURRENT PRACTICE ISSUES

A. Applying the interpretive guidance in FAQ # 3 of Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports-Frequently Asked Questions (revised September 24, 2007) to a business acquired through a merger of entities under common control

In the interpretive guidance in FAQ #3 of Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports-Frequently Asked Questions (revised September 24, 2007), the Division and OCA addressed the question of whether internal control over financial reporting (ICFR) for a business that was acquired in a "material purchase business combination" [emphasis added] must be included in management's report on ICFR for the fiscal year in which the business combination took place. The response to FAQ #3 states that, while the Division and OCA would typically expect management's report on ICFR to include controls at all consolidated entities, they acknowledge that it might not always be possible to conduct an assessment of an acquired business's ICFR in the period between the consummation date and the date of management's assessment. In such instances, they "would not object to management referring in the report to a discussion in the registrant's Form 10-K… regarding the scope of the assessment and to such disclosure noting that management excluded the acquired business from management's report on internal control over financial reporting."

The FAQ specifically addressed a business acquired through a material purchase business combination, but did not address a business acquired through a merger of entities under common control.

The Committee asked the staff whether a business acquired through a merger of entities under common control would be eligible for the temporary ICFR scope exception referred to in FAQ #3 if the other circumstances outlined in FAQ #3 are present. Mr. Olinger indicated that consistent with the concept in FAQ #3, in the case of a merger of entities under common control, if management is unable to conduct an assessment of ICFR for the transferred entity for the period in which the transaction was consummated, the same guidance would apply. Mr. Olinger noted that the key point is that management is unable to conduct an assessment of ICFR on the new entity. He noted however that where merged entities have a common parent and the parent and its subsidiaries have common processes, policies, and control environment and management of the parent oversees ICFR of each subsidiary, it might be more difficult to conclude that management is unable to conduct an assessment of ICFR.

B. Potential issues related to the FASB's proposals to permit private companies to apply alternative accounting principles

The FASB and its Private Company Council have undertaken a project to consider providing alternative recognition, measurement, disclosure, effective date or transition guidance for private companies reporting under U.S. GAAP. On August 7, 2013, the FASB issued an exposure draft that proposes a definition of a *public business entity* to be used in determining the scope of future accounting and reporting guidance. The proposed amendments would define a public business entity as a business entity meeting any one of the following criteria:

1. It is required by the SEC to file or furnish financial statements, or does file or furnish financial statements, with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).

2. It is required by the Securities Exchange Act of 1934, as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency.

3. It is required to file or furnish financial statements with a regulatory agency in preparation for the sale of securities or for purposes of issuing securities.

4. It has (or is a conduit bond obligor for) unrestricted securities that are traded or can be traded on an exchange or an over-the-counter market.

5. Its securities are unrestricted, and it is required to provide U.S. GAAP financial statements to be made publicly available on a periodic basis pursuant to a legal or regulatory requirement.

The Committee discussed with the staff potential practice issues that the proposed definition raises for registrants and auditors.

Regarding the proposed definition of a public business entity that includes "other entities whose financial statements or financial information are required to be or are included in a filing [with the SEC]", the basis for conclusions accompanying the exposure draft specifically references financial statements included in a filing with the SEC under S-X Rule 3-09. Additionally, this definition would appear to encompass financial statements or financial information provided, for example, under S-X Rules 3-05, 3-10(g), 3-14, 3-16, 4-08(g), 8-04, 8-06, 8-07 and 10-01(b)(1) as well as Article 11 and various SEC registration statement and proxy statement requirements (e.g., Item 17(b)(7) of Form S-4 and Item 14 of Schedule 14A).

Many of the reporting requirements cited above rely on the performance of significance calculations to determine if a specific rule applies. The Committee asked

the staff whether a registrant could use the financial statements of an "other entity" (e.g., acquiree or investee) that were prepared using private company alternatives when calculating significance or would the registrant be required to use financial statements prepared using public company requirements (even if they were prepared solely for the purpose of performing the significance test). The SEC staff noted it will continue to consider this and determine whether any further guidance is necessary (based on any final definition adopted by the FASB).

The Committee also discussed what transition alternatives might be available to a company that had historically prepared its financial statements in accordance with private company alternatives if that company is subsequently required to prepare its financial statements in accordance with the requirements of a public company. The changes required to adopt public company requirements (when financial statements had been previously prepared under private company alternatives) could be extensive. Mr. Olinger indicated the staff will continue to think about transition.

Another practice issue relates to Securities Act Section 7(a)(2)(B) (added by the JOBS Act) which states the following: "[an emerging growth company] may not be required to comply with any new or revised financial accounting standard until such date that a company that is not an issuer (as defined under section 2(a) of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7201(a))) is required to comply with such new or revised accounting standards, if such standard applies to companies that are not issuers." The Committee asked the staff whether an emerging growth company (EGC) would be permitted to use private company alternatives in filings with the SEC. The staff noted that the guidance in the Securities Act Section 7(a)(2)(B) only relates to the transition date for EGCs to comply with new or revised standards and not whether an EGC is altogether exempt from standards that apply to public companies. EGCs are considered public entities and they would not be able to use the private company alternatives in filings with the Commission.

C. Measuring significance of an acquired business using pro forma financial information following an IPO

A first-time registrant may apply SAB Topic 1J, *Application of Rule 3-05 in Initial Public Offerings* (SAB 80) to obtain relief from the requirements of Rule 3-05 of Regulation S-X in its initial registration statement if certain criteria are met. SAB 80 permits a registrant to measure significance of each acquired or to be acquired business based on pro forma financial information. Following effectiveness of its initial registration statement, the registrant may evaluate the significance of acquired businesses using the same pro forma financial information considered to apply SAB 80 until the registrant's next annual financial statements are filed (see FRM Section 2070.13).

Registrants may also utilize pro forma information to test significance applying the guidance in FRM Section 2025.3 as follows, "If the acquisition is made after reporting a previous significant acquisition or disposition on Form 8-K or non-IPO

registration statement that includes all information required by Form 8-K, the registrant may evaluate significance using registrant's pro forma financial information rather than historical pre-acquisition financial statements."

The Committee asked the staff whether it would allow a registrant that has not applied SAB 80 (including in a situation in which the use of SAB 80 would not have been permissible) in its initial registration statement and does not have pro forma financial information for a previous significant acquisition filed on Form 8-K or in a non-IPO registration statement to measure significance of a business acquired after the effective date of the IPO using pro forma financial information on file in its IPO registration statement (e.g., in the Form S-1). The staff indicated that registrants who did not apply SAB 80 cannot measure significance using pro forma financial information included in the IPO registration statement. The registrant should measure significance in the same manner that it did for that IPO S-1. The staff indicated that if a registrant has a situation that is anomalous or onerous, the registrant may discuss it with the staff.

D. Adoption of a New Accounting Standard that Requires Retrospective Application During an Interim Period and Application of Rule 3-09 of Regulation S-X in a Registration Statement During that Period

At its June 18, 2013 meeting, the Committee and the staff discussed whether the adoption of a change in accounting principle or a new accounting standard via retrospective application to previously issued financial statements would require the registrant to reassess the significance of equity method investees under Rule 3-09 of Regulation S-X with respect to those historical periods. The FRM contains guidance addressing the reassessment of significance under Rule 3-09 when historical financial statements are revised to reflect a discontinued operation. That guidance does not address a change in accounting principle or the adoption of a new accounting standard via retrospective application.

The Committee asked the SEC staff if the guidance in FRM Section 2410.8 about determining significance of equity method investees after a discontinued operation has been reflected in a registrant's financial statements (for purposes of complying with Rule 3-09 of Regulation S-X) would also be applicable when calculating significance after historical financial statements have been revised to reflect adoption of a change in accounting principle or a new accounting standard through retrospective application.

Committee members noted that re-performing the significance calculation can cause an equity method investee that was not significant to a registrant in an historical period to become significant, and vice versa. It can be difficult for registrants to obtain audited financial statements of an equity method investee when there was no expectation that the investee would be significant. Furthermore, retrospective application of a change in accounting principle or a new accounting standard can change the numerator and the denominator in the calculation.

Committee members also observed that some registrants might consider the effect of retroactive measurements of significance for equity method investees when deciding between alternative methods of transitioning to new accounting standards, such as in the case of the expected standard on Revenue Recognition. The staff acknowledged that there may be various transitional issues in connection with the expected Revenue Recognition standard and the staff will consider this matter as part of those issues.

[Note: On October 29, 2013, the SEC Staff updated FRM 2410.8 to clarify that the guidance applies in the case of retrospective changes in accounting.]

In a follow-up question the staff indicated that the guidance referred to above also applies to reassessing significance under Rule 4-08(g) of Regulation S-X in connection with the retrospective application of a change in accounting principle.