SEC REGULATIONS COMMITTEE
Joint Meeting with SEC Staff
March 4, 1997
SEC Headquarters—Washington, D.C.

HIGHLIGHTS

I. ATTENDANCE

A. SEC Regulations Committee

Robert H. Herz, Chairman
Mark Bagaason
Val Bitton
Rusty Brinkman
Mike Foley
Lee Graul
Jay Hartig
Rodney Liddle
Tom Milan
Eric Press
Arthur Radin
Keith Sandefur
Stuart Sandman
Bill Travis
Bill Yeates

B. Securities and Exchange Commission

Office of the Chief Accountant

Steve Swad, Deputy Chief Accountant
Scott Bayless, Assistant Chief Accountant
Donna Coallier
Brian Heckler
Mike Kigin
Bob Lavery
Tim McKay
Russ Mallett
Leslie Overton
Armando Pimentel
Cody Smith

Division of Corporation Finance

Robert Bayless, Chief Accountant
Kurt Hohl, Associate Chief Accountant
Doug Tanner, Associate Chief Accountant

C. Guests

Kenneth Chatelain, Coopers & Lybrand

II. Personnel Matters

Leslie Overton recently joined the Office of the Chief Accountant as an Assistant Chief Accountant. Leslie was previously an Assistant Chief Accountant in the Division of Corporation Finance.

III. **Derivatives** Disclosure Rules

Russ Mallett distributed a copy of a fact sheet describing the release titled, "Disclosure of Accounting Policies for Derivative Financial Instruments and Derivative Commodity Instruments and Disclosure of Quantitative and Qualitative Information About Market Risk Inherent in Derivative Financial Instruments, Other Financial Instruments, and Derivative Commodity Instruments." A copy of the fact sheet is attached. Russ briefly described the significant changes made to final rules based on comments received on the proposed rules. They are:

- The final rules permit different alternatives for reporting quantitative information about (I) trading and non-trading portfolios and (ii) different market risk categories (e.g., interest rate risk, foreign currency exchange rate risk, and commodity price risk).

- As an alternative to providing a sensitivity analysis or value at risk amount as of period end, the release allows registrants that choose those disclosure alternatives to disclose high, low, and average amounts during the period. This change was made in response to concerns about the potential of disclosing proprietary information about year end holdings.

- The effective date for the required disclosures about market risk was delayed to allow registrants time to respond to the new amendments.

For non-bank, non-thrift registrants whose market capitalization on January 28, 1997 exceeds $2.5 billion and all banks and thrifts, the new disclosures are required for filings with annual financial statements for periods ending after June 15, 1997. For non-bank, non-thrift registrants that do not meet the $2.5 billion market capitalization test, the disclosure requirements are effective one year later. Russ explained that the definition of "market capitalization" for purposes of determining when issuers must begin providing the new disclosures is the same as is used in the Form S-3 rules, except that the calculation for purposes of the derivatives disclosures includes the value of securities held by affiliates.

IV. Plain English Proposed Rules

Doug Tanner briefly discussed the proposed rules titled, "Plain English Disclosures," which would require portions of prospectuses to be written in plain English. Although plain English principles would not be required when preparing financial statements and related disclosures, the staff looks forward to working with registrants to develop plain English financial disclosures. The staff believes that plain English is consistent with the principle of full and fair disclosure.

V. Company Registration

Doug Tanner provided a status report on the concept release titled, "Securities Act Concepts and Their Effects on Capital Formation." A team of attorneys is working full time to analyze comments and draft proposed rules, which are expected to be sent to the Commission by late spring or early summer. Commentors expressed a wide variety of opinions on the company registration concept, although no summary of comments is available. The proposed rules are expected to be significant and to reflect the principles set forth by the Advisory Committee on Capital Formation and Regulatory Processes, although the decision about whether to implement company registration has not been made.

VI. Areas of Staff Focus for 1997 Reviews

The Division of Corporation Finance has no specific issues that it is targeting for reviews in 1997. However, certain matters always are important to reviewers. They include implementation of new accounting standards, financial instruments and related risk disclosures, industries that are undergoing significant changes (for example, public utilities), and basic accounting issues such as revenue recognition and cost deferral.

VII. Foreign Filings and Related Issues

Because of the departure of Wayne Carnall, the Division of Corporation Finance's Office of the Chief Accountant will be restructured. For now, questions regarding foreign filing matters should be directed to Robert Bayless. Wayne's role as the Office's principal representative on foreign filing issues may not be duplicated - those duties may be shared by several members in the office.

VIII. Staff Review and Updating of Financial Information

At times, the time delay in effectiveness of a registration statement or mailing of proxy materials because of the staff review process may cause the financial statements to become outdated. The staff is not inclined to grant waivers of the 45/135 day requirement for updating financial information because of the staff review process, even if comments are not issued within the targeted 30 day period. Issuers should plan for staff review when filing registration statements and proxy materials. Waivers generally will be granted only in the event of "catastrophic" staff failure. The staff may consider a waiver in the event of a lengthy staff review of a filing involving significant hardship, such as filings that include the financial statements of numerous entities (e.g., a roll-up of numerous partnerships). Registrants that anticipate problems with updating as a result of staff review should consider discussing significant reporting issues with the staff on a pre-filing basis.

IX. Trust Issued Preferred Securities

At the December 1996 SEC Conference, a staff member discussed the income statement treatment of dividends on Trust Issued Preferred Securities that are presented on the balance sheet as neither a liability nor permanent equity. In such cases, the staff requires a presentation of dividends that is consistent with the balance sheet presentation - in a manner similar to the presentation of minority interest rather than as interest expense. Non-debt presentations on the balance sheet and profit and loss statement are subject to special descriptive captioning. This should not be taken as an indication that the staff will not permit the classification of such securities as debt. The staff prefers that these instruments be treated as debt, consistent with a long-held view of Chief Counsel that in substance they are debt. When these instruments are presented as debt in the balance sheet, the dividends thereon should be classified in the income statement as interest expense.

X. Termination Fees

The staff recently revised its views as to the impact on the payment of a termination fee on future poolings. Payment of a termination fee should not prevent the payor from being a party to a subsequent pooling transaction, as long as the fee is a customary amount determined on an arms-length basis and paid in cash and is not otherwise entered into to circumvent the pooling rules. The staff will make a formal announcement of this view at the March 13 EITF Meeting.

XI. Securitization of Regulatory Assets

The staff recently addressed an issue involving the treatment of a proposed securitization by a public utility of cash flows from ratepayers. The staff concluded in this instance that FAS 125 does not apply because the regulatory assets are not financial assets. The staff also concluded that the proceeds received by the utility from a securitization represent either debt or deferred income. The staff is still considering the classification issue. The staff indicated that EITF 88-18 may provide some guidance in the determination of the appropriate classification of the proceeds. The staff noted that they are aware of two prior transactions for which sale treatment was afforded for securitizations of regulatory assets, but they are not necessarily prepared to treat these transactions as appropriate precedent. The staff will announce its views when this issue is resolved. Registrants are encouraged to discuss treatment of proposed securitizations of regulatory assets with the staff on a pre-filing basis.

XII. Preferred/Debt Convertible at a Discount

The SEC staff recently addressed issues involving the issuance of convertible preferred stock and convertible debt securities with a nondetachable conversion feature that is "in the money" at the date of issue (a "beneficial conversion feature"). These securities may be convertible into common stock at the lower of a conversion rate fixed at the date of issue or a fixed discount to the common stock's market price at the date of conversion.

The SEC staff believes that a beneficial conversion feature should be recognized and measured by allocating a portion of the proceeds equal to the intrinsic value of that feature to additional paid-in capital. This amount should be calculated at the date of issue as the difference between the conversion price and the fair value of the common stock into which the security is convertible, multiplied by the number of shares into which the security is convertible.

For convertible preferred securities, the staff believes that any discount resulting from an allocation of proceeds to the beneficial conversion feature is analogous to a dividend and should be recognized as a return to the preferred shareholders over the minimum period in which the preferred shareholders can realize that return.

For convertible debt securities, the SEC staff believes that any discount resulting from an allocation of proceeds to the beneficial conversion feature increases the effective interest rate of the security and should be reflected as a charge to interest expense. Because the security has been issued with beneficial conversion terms, the staff has presumed that the stated maturity date of the instrument is not substantive and, therefore, the amortization period should be from the date the security is issued to the date it first becomes convertible. If the issuer reasonably determines that a period other than the period to the first conversion date is substantive, the discount should be amortized over that period. In that circumstance, if the security is converted prior to full amortization of the discount, the staff believes the unamortized portion of the discount should be charged to interest expense in the period of conversion.

XIII. Pro Forma Adjustments for Cost Savings

The staff prefers that pro forma adjustments related to purchase business combinations be limited generally to the accounting effects of applying APB 16, financing the transactions, and other items directly attributable to the transaction. There was a discussion about whether anticipated cost saving adjustments meet the definition of a pro forma adjustment as contemplated in Article 11 of Regulation S-X. The determination of which adjustments meet this test is necessarily fact-specific. In several recent situations, the staff has challenged the appropriateness of presenting projections as pro forma adjustments to historical statements. Selective adjustment of certain historical revenues or expenses can result in an unbalanced or misleading presentation. Registrants are permitted to provide prospective financial information in lieu of pro forma financial statements. The Committee is aware of provisions under the Securities Litigation Reform Act that allow a safe harbor for forward looking statements under certain circumstances. Steve Swad suggested that the Filing Issues Task Force may wish to consider the issue of how disclosures concerning cost savings and similar forward looking statements could fall within that safe harbor.

XIV. Change in Fiscal Year End Following a Pooling

When an issuer enters into a business combination accounted for as a pooling, sometimes one of the pooled entities must change their fiscal year end to a period within 93 days of the other. Robert Bayless stated, if the issuer wishes to change its year end under these circumstances, the staff will permit the issuer to do so without filing the transition report that otherwise would be required. The registrant must make all notifications (such an Item 8 Form 8-K) on a timely basis and recast all years presented in future 1934 Act filings in accordance with the new year end. In some cases the staff has not objected to the presentation of financial information for the twelve month period corresponding with the new fiscal year in lieu of a transition period.