

COMMENT LETTER FOLLOW-UP

EXECUTIVE SUMMARY

The Office of Inspector General (Office) audited the Division of Corporation Finance's (Division) comment letter follow-up process. The purpose of the audit was to evaluate the effectiveness of the process in helping the Division accomplish its mission. The Office concluded that the Division's follow-up process was generally effective in helping the Division accomplish its mission.

To enhance the process, we recommend that the Division: consistently use the timeframes for registrant responses included in their operating procedures; request that registrants file amendments and supplemental information together; consult with the Office of Information Technology on improving the usefulness of EDGAR redlining; increase the distribution of the 10-K follow-up report to staff; and ensure that staff upload review documents to EDGAR.

SCOPE AND OBJECTIVES

The audit objective was to evaluate the effectiveness of the comment letter follow-up process in enabling the Division to accomplish its mission. We interviewed staff in the Division of Corporation Finance, the Office of Filings and Information Services (OFIS), and the Office of Information Technology (OIT). Also, we reviewed applicable documents and analyzed data related to comment letters issued in FY 2000.

We conducted the audit fieldwork between November 2000 and March 2001, in accordance with generally accepted government auditing standards.

BACKGROUND

The Division of Corporation Finance implements the Commission's Full Disclosure Program. The program's mission is to "...assure that investors are provided with material information and to prevent fraud and misrepresentation in the public offering, trading, voting, and tendering of securities...."¹The Division reviews filings as one means to accomplish its mission.

As a result of these filing reviews, the Division issues comment letters to registrants to identify disclosures needing improvement. In response to these comments, registrants

¹ Commission's Budget Estimate, Fiscal 2000, dated February 1999, page I-2.

generally send the Division a letter addressing each comment and an amended filing marked to identify the changes. The issuance of the comment letter starts a process of communication between registrants and the Division to resolve the disclosure issues raised in the comment letters (comment letter follow-up process)².

The Division uses a two-level review process for comment follow-up. The first level reviewers, staff accountants and attorneys, perform an in-depth review of the responses provided by the registrant. The first level reviewers determine whether the registrant provided a satisfactory response to the comments and propose disposition of the comments. The second level reviewers, senior accountants and attorneys, perform a generally less detailed review of the materials and the proposed dispositions of the comments. As a result of the review, the second-level reviewers may agree with the first level disposition, add their own comments, or waive certain comments.

If the Division is satisfied with the response, it will “clear” the comment. If it needs more information or further action on the comment, it will issue a request for information or re-issue the comment in another comment letter to the registrant. This process continues until the Division has no further comments or the registrant withdraws the filing. In cases where the registrant’s non-compliance appears material, the staff may contact the Enforcement Division for possible action.

The Division developed the comment letter follow-up process primarily for comments relating to 1934 Act reports (10-Ks, 10-Qs, 8-Ks, *etc.*). Registrants tended to resolve comments more quickly on 1933 Act registrations (and on 1934 Act reports reviewed in connection with these registrations) because they wanted the Division to allow their registrations to become effective in order to raise capital in the securities markets. The 1934 Act reports are not used to register securities offerings.

In FY 2000, the Division reviewed and issued comments on 2,435 new issuers and 1,535 reporting issuers. In FY 1999, the Division reviewed and issued comments on 1,755 new issuers and 2,550 repeat issuers. The Division still has a backlog of 10-Ks upon which to follow up. The recent slowdown in 1933 Act registrations, however, has allowed the Division to apply more of its review resources to 10-Ks.

The filing review workload of the Division continues to increase. The number of new public registrations increased approximately 39% from FY 1999 to FY 2000, from 1,755 to 2,435. These new public registrants will also be required to file 1934 Act reports such as 10-Qs (quarterly), 10-Ks (annually), and 8-Ks as the need arises, as long as they are registered with the Commission.

²The Division’s filing screening process may result in comment letter follow-up. During the screening process, the staff checks for comments from previous reviews that are pending resolution. If outstanding comments exist, the staff performs a “monitor,” a narrowly focused review, to follow-up on the comments.

Also, comment letter follow-up may result from information in the Division’s management reports. One management report lists 10-Ks with outstanding comments pending actions by either the registrant or the staff. Another management report lists 1933 Act registrations pending initial comments.

AUDIT RESULTS

Our Office concluded that the Division's comment letter follow-up process was generally effective in helping the Division accomplish its mission. We discuss our recommendations, intended to further enhance the follow-up process, below.

Comment Response Timeframes

The Division's operating procedures provide standard language for the staff to include in its comment letters requesting amendments. This standard language instructs registrants to provide amended filings within 10 business days of the date of the letter and to provide supplemental information within 15 business days. These procedures encourage registrants to respond promptly.

Division review staff, however, did not always include this language in their comment letters. Out of a judgment sample of 38 comment letters, 20 letters included language specifying when the registrant should file their amendments. Of the 20 letters that included this language, 4 letters provided a specific date within 10 business days of the date of the letter, 12 letters instructed the registrants to file amendments within 10 business days, and 4 letters instructed the registrants to file amendments within 15 business days.

Some staff members had not reviewed the procedures recently. As a result, over time, the language used to request amendments varied across the groups.

Also, as noted above, the staff requested that registrants file their amendments five business days before the supplemental information. Requesting that registrants file amendments and supplemental information together would enable the staff to receive all the response information at one time from the registrant.

Recommendation A

The Division should remind its staff to require registrants to file amendments and supplemental information within the timeframes provided in the operating procedures.

Recommendation B

The Division should consider requesting that registrants file amendments and supplemental information at the same time instead of five days apart.

EDGAR “Redlining”

The staff reviews amendments to evaluate the registrants’ responses to the accounting and disclosure issues raised in the comment letters. This review is one of the most important steps in the comment follow-up process.

To facilitate the staff’s review of amendments, Commission rules required registrants to mark the changes in their amended filings “...clearly and precisely....”³To comply with the rule, registrants sent the review staff paper copies of amendments with the changes underlined.

The EDGAR system was supposed to facilitate the amendment review process by allowing the staff to more quickly identify and review changes in electronic filings. To accomplish this, the Commission required registrants to “redline,” or highlight, the amended text in their EDGAR filings by inserting the appropriate “tags” or codes.

EDGAR redlining, however, appears to hinder rather than facilitate the staff’s review of amendments. The EDGAR rules require that filers place redlining codes at the beginning and end of paragraphs instead of at the beginning and end of the specific amended information.⁴ The Commission required this placement of the redlining codes because the EDGAR system inserted spaces where it removed the codes from the filings for public dissemination, indicating where information was amended in the filing. As a result, the EDGAR system redlines entire paragraphs, often obscuring, instead of clearly marking, the amended information.

The review staff often avoids using these redlined documents. Instead, the staff obtains paper copies of the amendments from the registrant with the specific changes clearly marked, as was done before EDGAR implementation. The manual review of paper documents adds more time to the follow-up process.

In May 1999, the Commission amended the EDGAR rules to allow filers to redline specific information in amendments submitted in HTML (HyperText Markup Language)⁵. The EDGAR filer manual, however, was not updated to reflect the change in the rule. Since filers followed the guidance in the EDGAR manual, they continued to redline entire paragraphs.

³ 17 C.F.R. 230.472(a), 240.14a-6(h)

⁴ 17 C.F.R. 232.310, revised as of April 21, 1993.

⁵ 17 C.F.R. 232.310, revised as of May 21, 1999. The rule still requires that registrants place redlining codes at the beginning and at the end of paragraphs in documents submitted in ASCII (American Standard Code for Information Exchange) format.

In connection with the EDGAR modernization project, the Office of Information Technology (OIT) has attempted other software solutions to facilitate review of amended information in electronic filings. These efforts have had limited success. One proposed solution involved software to compare an amended document with a previous version to identify changes. Another solution involved using the document compare function in the Microsoft Word software.

Recommendation C

The Division of Corporation Finance should consider whether the benefits to the review staff of providing specific redlining in amended ASCII EDGAR filings outweigh the risk of disseminating the filings with spaces where EDGAR removed the redlining codes. If Division determines that the benefits outweigh the risks, it should recommend that the Commission amend the EDGAR rules to allow filers to redline specific information in ASCII filings.

Recommendation D

The Office of Filings and Information Services should update the EDGAR filing manual to reflect the change in the EDGAR rules concerning the use of redlining codes in HTML documents.

Actions Taken

The Office of Filings and Information Services indicated that the version of the EDGAR system in use after May 1999 did not properly recognize the redlining codes in HTML documents. In the newest version of EDGAR⁶, however, the deficiency was corrected. The Office of Filings and Information Services indicated that the filer manual would be revised to reflect the May 1999 change in the EDGAR rules concerning redlining.

Expand 10-K Follow-up Report Distribution

The Division developed the 10-K follow-up report to monitor the status of 10-K filings with either no registrant response within 15 days or no staff action on a registrant response within 15 days. Staff members indicated that this report covers only filings with material comments. This report includes information such as the company name, staff members assigned to the review, and the number of days pending.

Most groups gave the report to a designated senior accountant to track the status of 10-K follow-up. The first-level review staff, however, rarely saw these reports. They

⁶ EDGAR version 7.5, implemented in June 2001.

generally relied on their records and memory to keep track of the 10-Ks that they processed.

Also, in at least 7 out of a judgment sample of 41 pending items in the follow up report, the 10-Ks were cleared, but were still listed on the report as pending. Because of the volume of registration statements last year, the staff had little time to update the report. The accuracy of the follow-up report, however, affects its reliability as a management tool.

Recommendation E

The Division should periodically distribute to each review accountant and attorney the portion of the 10-K follow-up report that includes their filings for their review and update.

Upload Documents

The accountants' and attorneys' filing review reports and comment letters are uploaded to the EDGAR system. During comment follow-up, the staff retrieves the uploaded documents to compare to the registrant's response. We noted in several instances, however, that documents were not uploaded. This made it more difficult and time-consuming for staff to follow-up on comments, especially those comments issued by former Division staff.

The Division's operating procedures require that the staff upload accounting and examination reports as soon as the staff submits the reports for review, and upload comment letters to EDGAR promptly after the material is mailed or faxed.

Recommendation F

The Division should remind the review staff to follow their operating procedures for uploading documents to EDGAR.

Recommendation G

The Division should periodically check a sample of companies reviewed to ensure that staff members upload documents.