December 18, 2017

By email: rule-comments@sec.gov

U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: File Number S7-08-17: *FAST Act Modernization and Simplification of Regulation S-K;* Release Nos. 33-10425; 34-81851; IA-4791; IC-32858.

Dear Office of the Secretary:

The Center for Audit Quality ("CAQ") is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high quality performance by public company auditors; convenes and collaborates with other stakeholders to advance the discussion of critical issues requiring action and intervention; and advocates policies and standards that promote public company auditors' objectivity, effectiveness, and responsiveness to dynamic market conditions. Based in Washington, D.C., the CAQ is affiliated with the American Institute of CPAs. This letter represents the observations of the CAQ but not necessarily the views of any specific firm, individual, or CAQ Governing Board member.

The CAQ appreciates the opportunity to share our views and provide input on the Securities and Exchange Commission's ("Commission" or "SEC") Proposed Rule, *FAST Act Modernization and Simplification of Regulation S-K* (the "proposal" or the "Proposed Rule*")*.[1]

Because auditors play an important role in enhancing the quality, rigor, and reliability of financial information disclosed in Commission filings, the profession has a strong interest in the modernization of disclosure requirements. Additionally, we are required under our professional standards to read the other information presented in a document with the audited financial statements and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements.[2] Therefore, we provide our comments through the lens of the public company audit profession.

[1] *FAST Act Modernization and Simplification of Regulation S-K*, Release Nos. 33-10425; 34-81851; IA-4791; IC-32858; File No. S7-08-17, October 11, 2017.

[2] PCAOB Auditing Standard 2710, *Other Information in Documents Containing Audited Financial Statements,* paragraph 4.

Consistent with the Commission's views, we believe that parts of Regulation S-K require amending to streamline disclosure requirements and modernize how users may access information by incorporating the use of technology. While we agree with several of the proposed amendments, we encourage the Commission to improve the clarity of the disclosure objectives in each item of Regulation S-K as it continues to consider other possible rules to amend. We also believe that the Proposed Rule may not fully consider the impact some of the proposed amendments, such as incorporation by reference and hyperlinks, would have on the auditor in complying with the auditing standards of the Public Company Accounting Oversight Board (PCAOB). Our observations focus on aspects of the Proposed Rule that we believe require further consideration by the Commission.

Disclosure Framework and Materiality Considerations

Certain of the amendments in the proposal use the concept of materiality and require preparers to consider whether a specified disclosure is material or otherwise could be omitted. We agree the primary consideration for all disclosures should be materiality. Materiality has been well defined in the federal securities laws,[3] and we believe materiality is always a factor in disclosure and should be based on those concepts of the federal securities laws for applying materiality – e.g., the "reasonable investor" concept.

The materiality concept helps to ensure the information that is disclosed is tailored to the specific facts and circumstances of the registrant. Having both materiality as the overarching principle and clearly stated disclosure objectives, it is unnecessary to embed any explicit materiality reference within the respective disclosure requirements. Accordingly, we recommend the specific criteria for omitting information about the third year referred to in the proposed amendments to Instruction 1 of Item 303(a) of Regulation S-K that refers to materiality be eliminated. We are concerned that this instruction could be challenging to apply in practice and may not achieve the intended streamlining of Management's Discussion and Analysis (MD&A).

If a registrant does not understand the intended goal of the disclosure requirement, the concept of materiality may be misapplied, resulting in disclosure of too much, too little, or unnecessary information. Clearly stated disclosure objectives are necessary for the registrant to properly consider the appropriate extent of the discussion based on its circumstances. As previously suggested in our comment letter to SEC Release No. 33-10064, *Business and Financial Disclosure Required by Regulation S-K*[4] (SEC Release No. 33-10064), clear and understandable disclosure objectives articulated within each item of Regulation S-K would help to elicit more meaningful, complete and focused disclosure. While disclosure objectives were not part of the proposal, we recommend that as the Commission considers additional improvements to Regulation S-K, that it consider establishing disclosure objectives in the various sections as appropriate. To illustrate, we recommend the SEC revise S-K Item 303 to clearly identify its disclosure objectives, many of which are currently embedded within the instructions to S-K Item 303 and were expressed in the Commission's December 19, 2003 Interpretive Release. These objectives should be fundamental and sufficiently broad to apply across industries and remain relevant over time, and could include:

- Providing a narrative explanation through the eyes of management necessary to understand the registrant's financial condition, changes in financial condition and results of operations;
- Providing the context within which the financial statements should be analyzed; and

[3] Rule 405 of the Securities Act of 1933 and Rule 12b-2 of the Securities Exchange Act of 1934.

[4] CAQ comment letter on *Business and Financial Disclosure Required by Regulation S-K,* SEC Release No. 33-10064, July 21, 2016, page 2.

- Discussing the quality and variability of earnings and cash flows, from operations and outside sources, and the likelihood that past performance will not be indicative of future performance based on known events and uncertainties.

Management's Discussion and Analysis

The Proposed Rule allowing a registrant to omit the discussion in MD&A of the earliest of the three years when the discussion (i) is not material to an understanding of the registrant's financial condition, changes in financial condition and results of operations and (ii) has been included in the registrant's prior year Form 10-K on EDGAR, is consistent with the Commission's objectives to discourage repetition, limit disclosures that are not currently material, and modernize and simplify Regulation S-K. However, we believe it unnecessary to include the first condition of the proposed two-part test that would require consideration of whether discussion of the earliest of three years is *material* because materiality is an overarching concept (as discussed above). Furthermore, the second condition of the test does not eliminate the requirement for a discussion of the earliest of three years; it only allows the discussion to be located in a different filing. As long as the rules require three years of MD&A, these conditions in combination may create unnecessary complexity in determining whether the earliest MD&A should be repeated.

In addition, we do not believe that the occurrence of an event that affects a registrant's financial statements, such as a retrospective change in accounting, correction of an error, or reorganization of entities under common control, affects the above analysis for a current Form 10-K. The Proposed Rule is intended to simplify the mechanics of complying with the three-year requirement while encouraging registrants to take a fresh look at their approach to MD&A. A registrant would need to consider whether or not the prior discussion based upon the original financial statements needs to be updated in light of events that have affected the financial statements. As a result, we do not believe a Form 10-K filed with the revised financial statements for the earlier years should be required to include a discussion of the earliest year (i.e., the third year back) in its revised MD&A if the registrant believes the nature and impact of the changes do not warrant revision.

As long as the Commission requires a three-year MD&A discussion, we recommend the Commission expand the second condition to allow a registrant to omit from its current Form 10-K the discussion of the earliest of the three years not only if it was previously filed in its prior Form 10-K but also if it was previously filed in **any** SEC filing on EDGAR made by that registrant under the Securities Act of 1933 (Securities Act) or the Securities Exchange Act of 1934 (Exchange Act), such as Form S-1, Form S-4, Form 10 and Form 8-K.[5] We recommend that a registrant disclose in its Form 10-K the form (and its filing date) that includes the MD&A that discusses the earliest of the three years. Similarly, when it meets the conditions, we believe a registrant should be allowed to omit the MD&A discussion of the earliest of the three years in all filings other than initial registration statements. If the Commission concludes that complete discussion of the earliest of the three years be retained and instead allows hyperlinking to the prior year's annual report or other filing for that discussion, we request that the Commission consider our observations on hyperlinking included in a separate section of this letter.

Furthermore, we support the Commission's proposal to revise Instruction 1 to Item 303(a) of Regulation S-K to eliminate the reference to (i) year-to-year comparisons and (ii) five-year selected financial data. We believe

[5] A registrant may file a Form 8-K to include retrospectively revised financial statements and MD&A covering three years as a result of a retrospective accounting change (e.g., a change in segment presentation under ASC 280, reporting of a discontinued operation under ASC 205-20, and accounting changes resulting from the adoption of newly issued standards).

these changes in combination with the suggestions above that focus on disclosure objectives will encourage companies to take a fresh look at MD&A and re-evaluate their disclosures of prior year information, collectively assisting the Commission in achieving its objective to enhance the overall quality of MD&A and omit or reduce disclosure that is no longer material or relevant.

Lastly, we agree with the proposed conforming changes to Form 20-F for foreign private issuers (FPIs).

Cross-referencing and Incorporation by Reference

Financial Statements

While we support the Commission's objective of improving the effectiveness of disclosure by streamlining information included in documents filed with the SEC using mechanisms such as cross-referencing, we do not believe any benefits would result from amending the Commission's rules or forms to clarify or expand when financial statement disclosure may be used to satisfy other disclosure requirements. We are not aware of concerns from registrants regarding their use of financial statement disclosures to satisfy other SEC disclosure requirements. In our view, it is unlikely current practice would change as a result of this proposed amendment. Overall, the forms do not need to be this explicit and clarification and expansion of the rules or forms would be unnecessarily exhaustive and require continuous monitoring and maintenance.

In addition, we support the Commission's proposed amendment prohibiting registrants from incorporating or cross-referencing information outside of the financial statements into their financial statements unless otherwise specifically permitted or required by the Commission's rules. However, it is not clear why the Commission is proposing to amend rules under the Securities Act, the Exchange Act and the Investment Company Act of 1940 (Investment Company Act) in addition to certain forms and why certain forms were proposed to be amended and other forms were not (e.g., Form S-3 but not Form F-3). It would seem that this objective, which is a prohibition against incorporation by reference, could be accomplished by amending just the applicable rules, such as Securities Act Rule 411, as proposed; it is not necessary to also amend the applicable forms.

Foreign Private Issuers (FPIs)

It is not uncommon for FPIs to use their home country annual report as the basis for the annual report on Form 20-F. While we support the proposal to prohibit cross-referencing from the financial statements, we understand that there are certain standards within International Financial Reporting Standards (IFRS) (e.g. IFRS 7, *Financial instruments: Disclosures*) that permit certain disclosures that are part of the audited financial statements to be located outside the related notes with a cross-reference in the notes to the financial statements that identifies this information. Similar to the proposed amendments that permit cross-referencing when permitted by SEC rules, we suggest the SEC consider permitting cross-referencing when expressly permitted by the accounting standards, such as IFRS or by law, regulation or by the primary securities regulator in the FPI's home country jurisdiction or market. Should the SEC permit certain disclosures to reside outside the financial statements, we further recommend that the SEC consider requiring disclosure to identify any information which has been cross-referenced in the financial statements as an integral part of the audited financial statements.

Registered Investment Companies

In the Proposed Rule, the Commission inquired as to whether investment companies raise special considerations related to the rules governing incorporation by reference. The proposed amendments to Rule

0-4 do not appear to address existing guidance concerning financial reporting practices for master/feeder arrangements. As previously noted by the SEC staff,[6] the annual and semiannual reports for feeder funds contain the financial statements of their master fund. The Commission may wish to clarify whether the SEC staff guidance continues to be relevant and, if so, whether this practice should be codified within the final rule. Alternatively, if the Commission intends for a change in practice, clarification may be warranted.

Forms

We do not believe it is necessary to change the information that may be incorporated by reference into a prospectus under any of the Commission's forms. It is important for the Commission to consider professional standards when an auditor is associated with "other information" contained in a document that includes the independent auditor's report. PCAOB Auditing Standard (AS) 2710, *Other Information in Documents Containing Audited Financial Statements*, addresses the auditor's responsibility with respect to other information in documents containing audited annual reports required under the Exchange Act and the related auditor's report, or other documents to which the auditor, at the registrant's request, devotes attention. With respect to other information, PCAOB AS 2710.04 states the following:

> "The auditor's responsibility with respect to information in a document does not extend beyond the financial information identified in his report, and the auditor has no obligation to perform any procedures to corroborate other information contained in a document. However, he should read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements."

In addition, paragraph .02 of PCAOB AS 4101, *Responsibilities Regarding Filings Under Federal Securities Statutes,* states that an auditor's responsibility regarding registration statements containing their audit report is in substance no different from that involved in other types of reporting. If the auditor's reading of the document uncovers other information materially inconsistent with information, or the manner of its presentation, appearing in the financial statements, then the auditor is required to determine whether the financial statements or the auditor's report require revisions; if no revision to the financial statements or auditor's report is required, then the auditor should request the client to revise the other information.

Due to these auditor responsibilities, if the Commission were to consider changes to the information that may be incorporated by reference, we recommend the Commission propose a separate rule and request for comment.[7] If the Commission agrees and moves forward with this approach, we encourage the SEC to coordinate with the PCAOB as it considers expanding what information may be incorporated by reference into a prospectus under any of the Commission's forms. Such coordination is necessary to enable the PCAOB to timely amend auditing standards involving auditor responsibility for other information in documents containing audited financial statements. If the auditor's responsibilities with respect to other information under the auditing standards are not aligned with any changes that the SEC may make concerning information that may be incorporated by reference into a prospectus, then the Commission's goal to streamline information included in documents filed with the SEC and enhance the navigability of information for users may be delayed or not achieved.

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[6] Dear Chief Financial Officer Letter, SEC Division of Investment Management, December 30, 1998.

[7] The PCAOB's research agenda includes a project on the auditor's role regarding other information, PCAOB Standard-Setting Update, September 30, 2017, pages 5 – 7.

Hyperlinks

We continue to support the Commission's objective to improve the quality of disclosures and to increase the readability and navigability of documents filed with the SEC. We acknowledge the wide use of hyperlinks in today's world, their ability to provide efficient and effective access to information, and also the value they may provide to an investor or other user of a document filed with the SEC. However, if the Commission moves forward with requiring or permitting hyperlinks for any information incorporated by reference into a document filed with the SEC if that information is available on EDGAR, we offer the following observations:

- We agree with the Commission that a description of the location of the information incorporated by reference should be provided. This is critical in order for the auditor to understand what the "other information" is and his/her professional responsibility and what constitutes "a document" as referred to in PCAOB AS 2710.04.
- Consistent with our recommendation above regarding auditor responsibilities, we encourage the SEC to coordinate with the PCAOB as it further explores and evaluates appropriate uses and unintended consequences of hyperlinking in SEC filings. While the profession stands ready to expand its role as necessary to protect the evolving needs of the investor, it can only respond within its professional capacity.

As we noted in a previous letter[8] commenting on proposed hyperlinks to exhibits, it is our understanding that providing hyperlinks for exhibits does not expand the liability or the responsibility of the auditors with respect to the hyperlinked exhibits. We recommend that the Commission confirm this in the final rule.

Corporate Governance

We support the proposed amendment to Item 407(d)(3)(i)(B) of Regulation S-K to refer to the "applicable requirements of the PCAOB and the Commission rules." As noted by the Commission, auditing standards governing audit committee communications have changed over the years, and using history as an indication of the future, these standards will continue to evolve as necessary to promote investor protection. Therefore, amending the existing requirements to more broadly refer to the PCAOB's and Commission's rules effectively accommodates potential changes to audit committee communication requirements.

Risk Factors

We agree that revising the risk factor requirements as proposed may encourage registrants to take a fresh approach to informing investors of the relevant risk factors and present them in a manner they determine to be most meaningful and representative of their business. However, consistent with recommendations provided above, we believe providing clear disclosure objectives in lieu of examples may be more helpful in improving the quality of disclosures.

We previously shared our observations on this topic in our comment letter on SEC Release No. 33-10064.[9] Specifically, we believe risk factor disclosures would be more meaningful to investors if risk factors were required to be listed based on management's view of priority as well as encouraging disclosure on how the particular risk is addressed. Prioritizing risk factors will direct investors to what management believes to be the key risks of the business. In addition, voluntary disclosure of how those risks are managed provides

[8] CAQ comment letter on *Exhibit Hyperlinks and HTML Format*, SEC Release Nos. 33-10201; 34-78737, October 5, 2016.
[9] CAQ comment letter, July 21, 2016, pages 6 – 7.

investors with the opportunity to evaluate registrants on how effective they are at managing those risks and encourages registrants to provide specific and tailored, rather than generic, disclosure.

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We appreciate the opportunity to comment on the questions raised in the proposal. As the Staff and Commission gather feedback from preparers, users and other interested parties, we would be pleased to discuss our comments or answer any questions that the Staff or Commissioners may have regarding the views expressed in this letter.

Sincerely,

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Executive Director
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cc:

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