UNIVERSITY OF MARYLAND SCHOOL OF LAW
FIFTH ANNUAL BUSINESS LAW CONFERENCE:
THE FALL AND RISE OF FEDERAL CORPORATION LAW

OCTOBER 13 2006

RECENT REGULATORY DEVELOPMENTS AFFECTING CORPORATE FINANCE

AS OF SEPTEMBER 22, 2006

By:
John F. Olson
Jonathan C. Dickey
Stephen I. Glover
Brian J. Lane
Bradford P. Weirick
Ronald O. Mueller
Scott J. Calfas
Amy L. Goodman
James J. Moloney
Paul J. Collins
Gillian McPhee
Peter W. Wardle
Ari B. Lanin

GIBSON, DUNN & CRUTCHER LLP

©2000, 2001, 2002, 2003, 2004, 2005, 2006 by John F. Olson.
Portions of this outline may be used for other programs.
The authors gratefully acknowledge the assistance of William Adkerson, Mari Anzai, Sally Avitsian, Candice Choh, Patrick Dykstra, Shawn Domzalski, David Egdal, Frisco Fayer, Andrew Hirsch, Elizabeth Ising, Phil Kenny, David Lee, Farshad More, Michael Scanlon, Eric Scarazzo, Meredith Shaughnessy and Ashley Wright in the preparation of this outline.

TABLE OF CONTENTS

Recent Developments in Federal Securities Regulation of Corporate Finance

I. Introduction

This outline reviews recent cases, no-action letters, releases and other information promulgated by the Securities and Exchange Commission (the "**SEC**" or "**Commission**"), including under the Sarbanes-Oxley Act of 2002 (the "**Sarbanes-Oxley Act**"), and actions taken by the major securities exchanges and the Public Company Accounting Oversight Board (the "**PCAOB**") and addresses many recent and proposed changes to the federal securities laws, the related rules and regulations and the Commission's practices.

II. Current Issues

A. Amendments to Executive Compensation, Related Party and Independence Rules

1. Overview and Compliance Periods

On August 29, 2006, the Commission issued new rules comprehensively revising the disclosure requirements for executive and director compensation, related party transactions, director independence and other corporate governance matters. The final rules also modify the requirements for disclosing executive compensation actions and arrangements on Form 8-K. With a few notable exceptions, the final rules as adopted are substantially similar to the SEC's proposal from January 2006.

The new rules are effective for fiscal years ending on or after December 15, 2006, and therefore apply to disclosures of 2006 compensation in calendar-year companies' 2007 proxy statements. The new rules applicable to disclosure of executive compensation arrangements on Form 8-K become effective on November 7, 2006, 60 days after the new rules' publication in the Federal Register, applying to executive compensation events that occur on or after that date. Early adoption is not permitted with regard to any of the new rules, including the amended Form 8-K rules, prior to the date of November 7, 2006.

After November 7, 2006, early adoption is permitted, subject to certain requirements. In its Executive Compensation and Related Person Disclosure Transition Questions and Answers, the SEC provided the following example to clarify when and how companies may adopt the rules ahead of schedule. Should a company's fiscal year end on September 30, 2006 and it files its Form 10-K on December 14, 2006, the company may choose to comply with the new rules or the old rules. If it chooses to comply with the new rules, its Form 10-K would include a Summary Compensation Table (as defined below) under the new rules with only the last year of compensation, as the new rules' transition provision provides that a company will not be required to restate compensation or related person transactions disclosure for fiscal years for which the company previously was required to apply the old rules. If the company chooses to comply with the new rules, however, it must comply with *all* of the rules. Using the same example, if the company files a Form S-1 on

December 14, 2006 to register its initial public offering under the Securities Act, the company may choose to comply with the new rules or the old rules. Similarly, if the company chooses to comply with the new rules on its Form S-1, it must comply with *all* of the rules.

Among the significant aspects of the rule changes that require companies' attention in light of the new rules are the following:

- The SEC adopted the new requirement for a Compensation Disclosure and Analysis ("**CD&A**"). The CD&A is intended to differ significantly from the former Board Compensation Committee Report on Executive Compensation by comprehensively addressing the design and bases for a company's compensation of each of its named executive officers. The CD&A will need to describe the operation and material features of each element of named executive officer compensation and the interaction of each of those elements (or lack of interaction) with one another. The CD&A is company disclosure that is covered by the CEO's and CFO's certifications; yet, the board's compensation committee will need to remain closely involved in the preparation and review of this disclosure. It is likely that most companies will not be able to use the Board Compensation Committee Report as a model for drafting the CD&A and that the CD&A drafting process will necessitate extensive and careful coordination between the human resources and legal departments with the input of the board's compensation committee. Companies will need to determine who are their named executive officers and will need to prepare drafts of the tabular and narrative compensation disclosures required under the rules in order to be best positioned to draft the CD&A.

- The characterization, presentation and calculation of some forms of compensation differ significantly from the present rules and are not always intuitive. For example, some annual bonuses will no longer be reported in the Bonus column of the Summary Compensation Table but instead will be reported as Stock Awards or as Non-Equity Incentive Plan Compensation. Careful review is necessary to determine how and where to report various forms of compensation.

- It may be necessary to retain outside actuaries and consultants to perform some of the calculations required under the new rules. Companies should make arrangements with those outside advisers now.

- Careful descriptions and calculations of benefits payable under severance and change of control arrangements will be necessary. Companies should begin now to identify each form of benefit and triggering event encompassed by this disclosure requirement and to determine whether any of these arrangements should be revised before the end of their fiscal year. Given the extensive disclosure that will be required at some companies, companies should begin now to evaluate how to most clearly present the required benefit amounts and narrative descriptions.

- Revised related party and director independence disclosure rules reinforce the need to have procedures in place to monitor on a current basis transactions between a company and its directors, executives and immediate family members of directors and executives. Companies that do not have written procedures for identifying and approving or ratifying related party transactions should consider adopting them. Companies also need to revise their director and officer questionnaires.

- Amendments to Form 8-K generally reduce the number of executive compensation related events that trigger Form 8-K filings and eliminate the need for Form 8-K reports on most director compensation related matters, but there are also some new Form 8-K triggering events that will go into effect in the near future. Companies should revise their disclosure controls to ensure that reportable events are timely identified.

2. Compensation Disclosure

(a) Executive Compensation Disclosure

As noted above, the new rules delete the current requirement for a Board Compensation Committee Report on Executive Compensation and require instead a CD&A. SEC officials have emphasized that the CD&A is intended to provide a dramatically different perspective on executive compensation than the existing Board Compensation Committee Report. The CD&A is intended to provide an overview of material aspects of the objectives, implementation and factors underlying named executive officers' compensation overall as well as information on the operation of each material element of compensation. The discussion is required to describe the following:

- the objectives of the company's compensation programs;

- what the company's compensation programs are designed to reward;

- each element of compensation;

- why the company chooses to pay each element;

- how the company determines the amount (and, where applicable, the formula) for each element to pay; and

- how each compensation element and the company's decisions regarding that element fit into the company's overall compensation objectives and affect decisions regarding other elements.

The rules list fifteen examples of topics that, to the extent applicable and material, may need to be addressed in the CD&A.[1] However, as a principles-based disclosure regime, CD&A

---

[1] While the material information to be disclosed under the CD&A will vary depending upon the facts and circumstances, examples of such information may include, in a given case, among other things, the following:

- the policies for allocating between long-term and currently paid out compensation;
- the policies for allocating between cash and non-cash compensation, and among different forms of non-cash compensation;
- for long-term compensation, the basis for allocating compensation to each different form of award (such as the relationship of the award to the achievement of the registrant's long-term goals, management's exposure to downside equity performance risk, correlation between cost to registrant and expected benefits to the registrant);
- how the determination is made as to when awards are granted, including awards of equity-based compensation such as options;
- what specific items of corporate performance are taken into account in setting compensation policies and making compensation decisions;
- how specific forms of compensation are structured and implemented to reflect these items of the registrant's performance, including whether discretion can be or has been exercised (either to award compensation absent attainment of the relevant performance goal(s) or to reduce or increase the size of any award or payout), identifying any particular exercise of discretion, and stating whether it applied to one or more specified named executive officers or to all compensation subject to the relevant performance goal(s);
- how specific forms of compensation are structured and implemented to reflect the named executive officer's individual performance and/or individual contribution to these items of the registrant's performance, describing the elements of individual performance and/or contribution that are taken into account;
- registrant policies and decisions regarding the adjustment or recovery of awards or payments if the relevant registrant performance measures upon which they are based are restated or otherwise adjusted in a manner that would reduce the size of an award or payment;
- the factors considered in decisions to increase or decrease compensation materially;
- how compensation or amounts realizable from prior compensation are considered in setting other elements of compensation (e.g., how gains from prior option or stock awards are considered in setting retirement benefits);
- with respect to any contract, agreement, plan or arrangement, whether written or unwritten, that provides for payment(s) at, following, or in connection with any termination or change-in-control, the basis for selecting particular events as triggering payment (e.g., the rationale for providing a single trigger for payment in the event of a change-in-control);
- the impact of the accounting and tax treatments of the particular form of compensation;

disclosures should not be drafted as simply responses to these questions, nor should the CD&A be limited to the topics listed in the examples if there are other material factors that have affected a company's compensation of its named executive officers. Instead, the CD&A should explain and place in context the compensation disclosures in the proxy statement, encompassing the topics covered in the rule's examples to the extent material. Unlike the current Board Compensation Committee Report, the CD&A should specifically address the compensation of each of the named executive officers and be sufficiently precise to identify material differences in compensation policies and decisions among them, but the named executive officers' compensation can be discussed as a group where the policies and decisions affecting their compensation are materially similar.

As is also the case currently, the rules do not require companies to disclose target levels of specific quantitative or qualitative performance-related factors considered by the board's compensation committee or any other factors or criteria involving confidential trade secrets or confidential commercial or financial information, if disclosure of those factors or criteria would result in competitive harm for the company. However, if a company relies on this exception, the CD&A must discuss how difficult or likely achieving the factor or criteria is believed to be. SEC officials have stated that they intend to review and comment on the CD&A to enforce this standard of disclosure.

The CD&A is disclosure by the company – not by the board's compensation committee – that is "filed" rather than "furnished," and thus is subject to certification by a company's principal executive officer and principal financial officer. Accordingly, companies' disclosure controls should be sufficient to ensure that the CD&A accurately sets forth all required information. Likewise, before a company files its proxy statement, there should be a disclosure committee review that encompasses not only the tabular compensation and related party disclosures in the proxy but also the CD&A.

In addition to the CD&A, companies are required to furnish a compensation committee report that is similar to the audit committee report currently required in proxy statements. This new report of the board's compensation committee consists of a brief statement on whether the compensation committee reviewed and discussed the CD&A with management and, based on that review and discussion, whether the committee recommended to the company's board of directors that the CD&A be included in the company's proxy statement and annual report on Form 10-K. To the extent that board compensation committees wish to express their views or philosophy on the company's executive compensation, those statements may be included in the report by the compensation committee.

- the registrant's equity or other security ownership requirements or guidelines (specifying applicable amounts and forms of ownership), and any registrant policies regarding hedging the economic risk of such ownership;
- whether the registrant engaged in any benchmarking of total compensation, or any material element of compensation, identifying the benchmark and, if applicable, its components (including component companies); and
- the role of executive officers in determining executive compensation.

i. Determination of the Named Officers

The "named executive officers" ("**NEOs**") for whom compensation disclosure is required under the new rules are:

- any person who served during the year as the principal executive officer;
- any person who served during the year as the principal financial officer;
- three other most highly compensated executive officers, other than the principal executive officer and the principal financial officer, who were serving as executive officers at the end of the fiscal year; and
- up to two additional persons who served as executive officers during, but not at the end of, the fiscal year, whose "total compensation" is higher than that of any of the three other most highly compensated executive officers described above.

To determine who are the most highly compensated executives, companies total the amounts reportable for the year under each column of the Summary Compensation Table for each executive, other than amounts that would be reported as above-market earnings on deferred compensation and the actuarial increase in pension benefit accruals. Significantly, large severance payments to departing executives may cause them to be NEOs in the year they cease to be employed with a company because amounts that were paid or accrued in connection with a termination of employment during the fiscal year generally are counted in determining whether a former executive's "total compensation" is higher than that of any of the three most highly compensated executive officers were serving at the end of the fiscal year.

This new definition of NEO can significantly affect companies' planning strategies for complying with the provisions for deductibility of compensation in excess of $1 million under Section 162(m) of the Tax Code. This is because Section 162(m) applies to the principal executive officer and the four individuals who were serving as executives at year-end who were the highest paid executive officers (other than the principal executive officer) determined pursuant to the SEC's executive compensation disclosure rules. Companies that arranged Section 162(m) compliance for 2006 based on who they expected to have the highest salaries and bonuses may discover that their highest paid executive officers differ for proxy disclosure and Section 162(m) compliance purposes. Moreover, in the event the principal financial officer (who now is treated as an NEO for proxy disclosure purposes regardless of compensation levels) is not one of the four highest paid executive officers (other than the principal executive officer), Compensation paid to an individual who does not appear as a named executive officer in the proxy statement may be subject to Section 162(m).

ii. Revised Executive Compensation Tables

The new rules require most companies to set forth six tables disclosing various aspects of NEO compensation. As under the current rules, companies can omit columns to the extent they are not applicable.

Phase-In of New Disclosures; No Pre-2006 Disclosure

Eventually, the Summary Compensation Table will require disclosure of compensation in each of the three most recent fiscal years, as is currently the case under the existing rules. However, the new Summary Compensation Table disclosures "phase-in" over the next three years: in the first year, only fiscal year 2006 disclosure is required. Thus, companies will not be required to recalculate or report compensation for fiscal years that were covered in previously filed proxy statements.

Summary Compensation Table

The Summary Compensation Table reports amounts paid during the fiscal year, equity awards that were granted during the year and other benefits that accrued during the fiscal year, together with a Total column that sums all of these disparate elements.

Summary Compensation Table

Name and Principal Position (a)	Year (b)	Salary ($) (c)	Bonus ($) (d)	Stock Awards ($) (e)	Option Awards ($) (f)	Non-Equity Incentive Plan Compensation ($) (g)	Change in Pension Value and Nonqualified Deferred Compensation Earnings ($) (h)	All Other Compensation ($) (i)	Total ($) (j)
NEOs									

- Amounts of compensation are to be reported in the applicable column, even if some of the compensation was deferred.

- Cash payments are reported in the Bonus column only if they were paid under an arrangement that either (i) did not involve pre-established performance criteria that were communicated to the executive, or (ii) was not "substantially uncertain." Thus, a payment that is based on an end-of-year assessment of performance or a payment that is guaranteed under an employment agreement is reported in the Bonus column. In contrast, annual cash payments based on performance criteria that are "substantially uncertain" at the time established (a term that applies under the Tax Code for awards intended to qualify as "performance-based" under Section 162(m)) and that are communicated to executives in advance are reported in the Non-Equity Incentive Plan Compensation column.

- The Stock Awards and Option Awards columns report a dollar value equal to the grant date fair value computed under Statement of Financial Accounting Standards No. 123 (revised), Share-Based Payment ("**SFAS 123(R)**"). In calculating the value of these awards, a company must use the same assumptions that it applies for financial statement reporting purposes. Additional details about awards shown in these columns are presented in the Grants of Plan-Based Awards Table in the same year they are reported in the Summary Compensation Table.

- If a company has adjusted or amended the exercise price of options or stock appreciation rights ("SARs") or otherwise materially modified outstanding options or SARs, the incremental fair value of the amended award must be included in the Option Awards column.

- An annual or long-term award or arrangement that is payable in company stock (even if denominated in dollars or payable in cash or stock at the company's or participant's election) is treated as an equity-based incentive plan award because these types of arrangements are typically subject to SFAS 123(R). Therefore, this type of award or arrangement is reported in the Stock Awards column at grant, based on its grant date value.

- Dividends and dividend equivalents on stock and option awards are not reported in the Summary Compensation Table (or elsewhere) if the value of expected dividends was taken into account in calculating the SFAS 123(R) grant date fair value of those awards.

- Amounts that have been earned based upon performance under a Non-Equity Incentive Compensation Plan are reported in the Summary Compensation Table when the performance conditions are satisfied, even if amounts are deferred or remain subject to a continued service vesting condition. These amounts are not thereafter reported when actually paid.

- Amounts are reported as Earnings on Non-Qualified Deferred Compensation in the Summary Compensation Table only if they are "above-market" earnings, as defined in the rules.

- When calculating the annual increase in an NEO's pension benefits for purposes of determining the amount reported in the Change in Pension Value column, companies must apply the same actuarial and other assumptions used for financial statement reporting purposes. The amount reported ties to the year-over-year difference of the amounts required to be reported in the new Pension Benefits Table discussed below. The Change in Pension Value column must show zero if the amounts otherwise would be negative.

- The Summary Compensation Table is to be accompanied by extensive footnote disclosure of matters such as the assumptions used in valuing stock awards and option awards.

Narrative disclosure accompanying the Summary Compensation Table and the Grant of Plan-Based Awards Table (which is discussed below) must describe any material information necessary for understanding the information in these tables. This narrative should provide a specific context to the quantitative disclosure in these tables, explaining, for example:

- the relationship between amounts disclosed and any employment agreements;

- the material terms of awards reported, such as performance conditions, vesting conditions and formula or criteria used to determine the amount payable;

- where applicable, whether dividends or dividend equivalents accrue on stock awards and the applicable dividend rate; and

- any performance-based conditions and any other material conditions applicable to the award.

Companies should examine the assumptions used for valuing equity awards and pension benefits before they are finalized for financial reporting purposes to determine whether it would be appropriate to refine those assumptions as they relate to benefits provided executives. For example, companies that apply the same SFAS 123(R) assumptions for all employee stock options may wish to segregate options granted to executive officers if it would be appropriate to apply different assumptions in valuing those options for financial statement and proxy reporting purposes.

The All Other Compensation Column and Perquisite Disclosure

The All Other Compensation column includes any other element of compensation unless it is reportable in another column of the Summary Compensation Table or there is a specific instruction indicating that the particular element of compensation is not reportable in the Summary Compensation Table. Examples of compensation to be included in this column are:

- perquisites valued in the aggregate at $10,000 or more;

- all tax gross-ups or other amounts reimbursed during the fiscal year for the payment of taxes, including tax gross-ups on perquisites;

- the amount paid or that becomes due to any NEO in connection with any termination of employment or change in control of the company;

- company contributions or other allocations to tax-qualified and non-tax qualified defined contribution plans (whether or not vested);

- the dollar value of any insurance premiums paid by, or on behalf of, the company during the fiscal year with respect to life insurance for the benefit of an NEO; and

- the dollar value of dividends or other earnings paid in stock or option awards, when those amounts were not factored into the grant date fair value required to be reported in the stock or option awards.

Amounts not reportable in this column include:

- the value realized upon exercise of options or vesting of restricted stock;

- dividends and dividend equivalent payments on stock awards and options, unless the value of those dividends was not taken into account when determining the grant date fair value of the stock awards and options; and

- benefits paid pursuant to defined benefit pension plans unless the payment is accelerated due to a change in control.

Footnotes to the All Other Compensation column are required to identify and quantify any item reported in this column whose value exceeds $10,000, other than perquisites. Perquisites received by an NEO must be separately identified if their aggregate incremental cost exceeds $10,000 and must be separately quantified to the extent their incremental cost exceeds the greater of $25,000 or 10% of the value of all perquisites received by the NEO. The rules also require footnote disclosure of the methodology a company uses for computing the aggregate incremental cost of perquisites.

The SEC reiterated and elaborated on the standard it applies in determining whether an item is a perquisite or other personal benefit. Under the SEC's two-step analysis:

- an item is not a perquisite or personal benefit if it is integrally and directly related to the performance of the executive's duties.

- otherwise, an item is a perquisite or personal benefit if it confers a direct or indirect benefit that has a personal aspect, without regard to whether it may be provided for some business reason or for the convenience of the company, unless it is generally available on a non-discriminatory basis to all employees.

The SEC explained that if an item is integrally and directly related to the performance of duties, then the fact that it also confers a personal benefit or is not generally provided to others does not make the item a perquisite. For example, if an NEO is permitted to travel in Business Class on a flight from the company's headquarters to a business meeting, that travel is not a perquisite even if others are required to travel in Coach class. Likewise, a larger office in the corporate headquarters is not considered a perquisite.

In contrast, if a benefit is not integrally and directly related to an executive's job, the fact that it has a business purpose or facilitates the executive's job performance does not prevent it from being a perquisite. Likewise, a benefit's characterization or treatment under tax rules is not determinative of whether it is a perquisite. Thus, the SEC states that perquisites include commuting benefits (whether or not for the company's convenience or benefit), personal use of planes, boats or automobiles owned or leased by the company, payment of housing or living expenses and security provided at a personal residence or during personal travel. If a benefit is a perquisite, the incremental cost of the benefit is required to be reported. Thus, for example, while club memberships not used exclusively for business entertainment purposes are viewed by the SEC as perquisites, companies must disclose only the incremental cost of the non-business use.

Grants of Plan-Based Awards Table

The Summary Compensation Table is accompanied by a Grants of Plan-Based Awards Table that provides additional detail regarding stock options and other equity awards (such as restricted stock and restricted stock units) granted during the last fiscal year and amounts payable under other compensation plans (such as long-term incentive awards that are payable in cash or stock).

Grants of Plan-Based Awards in Fiscal Year 200x

		Estimated Future Payouts Under Non-Equity Incentive Plan Awards			Estimated Future Payouts Under Equity Incentive Plan Awards			All Other Stock Awards: Number of Shares of Stock or Units (#)	All Other Option Awards: Number of Securities Underlying Options (#)	Exercise or Base Price of Option Awards ($/Sh)
Name	Grant Date	Threshold ($)	Target ($)	Maximum ($)	Threshold (#)	Target (#)	Maximum (#)			
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)	(k)
NEOs										

- Each grant of an award made to each NEO under each plan must be disclosed on a separate line.

- The Grant Date column is required to be completed only for equity-based awards.

- Amounts reported in the Estimated Future Payouts Under Non-Equity Incentive Plan Awards column for a particular year are not reported in the Summary Compensation Table for that year, except that if the award is based on annual performance the actual amount earned under the award is reported in the Summary Compensation Table in the same year the award is reported in this table. In contrast, awards reported in any other column in this table also are reported in the Summary Compensation Table at their grant date fair value for the same year in which they appear in this table.

In response to recent concerns about stock option grant practices, the Grants of Plan-Based Awards Table "expands" in certain circumstances to include additional information applicable to equity awards. Specifically:

- if the date on which the compensation committee takes action or is deemed to take action to grant an equity-based award is different from the date of grant as determined under SFAS No. 123(R), a column must be added between columns (b) and (c) to disclose the date action was taken to authorize the action; and

- if the exercise price of options reported in the Grants of Plan-Based Awards Table is less than the closing market price of the underlying security on the grant date (for example, if the exercise price is the average of the high and low stock price on the grant date), an additional column must be added after column (k) showing market price on the grant date.

Outstanding Equity Awards at Fiscal Year-End Table

The Outstanding Equity Awards at Fiscal Year-End Table presents information on each outstanding equity award held by companies' NEOs at the end of the last fiscal year, including the number of securities underlying both exercisable and unexercisable portions of each stock option as well as the exercise price and expiration date of each outstanding option.

<u>Outstanding Equity Awards at 200x Fiscal Year-End</u>

	Option Awards					Stock Awards			
Name (a)	Number of Securities Underlying Options (#) Exercisable (b)	Number of Securities Underlying Unexercised Options (#) Unexercisable (c)	Equity Incentive Plan Awards: Number of Securities Underlying Unexercised Unearned Options (#) (d)	Option Exercise Price ($) (e)	Option Expiration Date (f)	Number of Shares or Units of Stock That Have Not Vested (#) (g)	Market Value of Shares or Units of Stock That Have Not Vested ($) (h)	Equity Incentive Plan Awards: Number of Unearned Shares, Units or Other Rights That Have Not Vested (#) (i)	Equity Incentive Plan Awards: Market or Payout Value of Unearned Shares, Units or Other Rights That Have Not Vested ($) (j)
NEOs									

- Information on option holdings must be presented on a grant-by-grant (instead of aggregate) basis, but (in contrast to what has been required) a company is not required to present a single line "total" that aggregates the number and value of all options held by an NEO.

- The number of shares subject to outstanding Stock Awards and their aggregate value may be reported on a single line, as can the number of shares subject to and the aggregate value of Equity Incentive Plan Awards.

- Footnote disclosure is required to state the vesting dates for each option and for stock awards and equity incentive plan awards reflected in this table.

- If options or stock awards are subject to performance conditions, they are reported in column (d) or columns (i) and (j), respectively. If the performance conditions have been satisfied but the awards remain subject to forfeiture or service-based vesting conditions, then the awards remain in this table but are shifted into columns (b) and (c) or columns (g) and (h) until they are exercised or vest.

- The number of shares subject to performance-based incentive plan awards valued or payable in stock reported in column (i) and the payout value of those awards reported in column (j) generally is determined based on achieving threshold performance goals. However, if the previous fiscal year's performance has exceeded the threshold, the amount disclosed should be based on the next higher performance measure (target or maximum) that exceeds the previous fiscal year's performance. If the award provides only for a single estimated payout, that amount should be reported. If the target amount is not determinable, companies must provide a representative amount based on the previous fiscal year's performance.

- This table includes awards that have been gifted or transferred other than for value, and footnote disclosure is required to provide information about the nature of the transfer.

Option Exercises and Stock Vested Table

The Option Exercises and Stock Vested Table shows amounts realized by NEOs on each option that was exercised and each stock award that vested during the last fiscal year.

<u>Option Exercises and Stock Vested in Fiscal Year 200x</u>

	Option Awards		Stock Awards	
Name (a)	Number of Shares Acquired on Exercise (#) (b)	Value Realized on Exercise ($) (c)	Number of Shares Acquired on Vesting (#) (d)	Value Realized on Vesting ($) (e)
NEOs				

- In contrast to what the SEC proposed, companies are not required to disclose the SFAS 123(R) grant date value of awards reported in this table.

- Footnotes to the Option Exercises and Stock Vested Table are required to include information quantifying the amount and terms of any amount deferred upon exercise of an option or vesting of a stock award.

Pension Benefits Table

The Pension Benefits Table discloses the actuarial present value of each NEO's accumulated benefit under each pension plan, assuming benefits are paid at normal retirement age based upon current levels of compensation.

<u>Pension Benefits for the 200x Fiscal Year</u>

Name (a)	Plan Name (b)	Number of Years of Credited Service (#) (c)	Present Value of Accumulated Benefit ($) (d)	Payments During Last Fiscal Year ($) (e)
NEOs				

- A separate line is required to report each pension plan or defined benefit-type plan or arrangement in which the NEO participates that provides for retirement payments and benefits primarily following retirement, including but not limited to tax-qualified defined benefit plans, cash balance plans and supplemental executive retirement plans.

- The value of benefits are calculated based on normal retirement age (or if a plan does not specify normal retirement age, the earliest age at which benefits become payable without reduction), calculated as of the same measurement date the company uses for financial statement reporting purposes and using the same assumptions that the company uses for financial statement purposes.

- The benefit amount reported in this table is the same used to calculate the year-to-year Change in Pension Value in the Summary Compensation Table.

- Footnotes are required to report any additional years of credited service and the resulting dollar value of the benefit augmentation if there is a difference between an NEO's number of years of credited service and the NEO's actual years of service.

- In the narrative section following this table, the company must include the valuation and material assumptions applied when quantifying the present value of the current accrued benefit of pension benefits. This disclosure may be satisfied by reference to the discussion of the assumptions in the company's financial statements, footnotes to the financial statements, or the discussion in the MD&A.

- The narrative description must also disclose the material factors necessary to understand each plan reflected in this table, including:

    - the material terms and conditions of payments and benefits available under the plan;

    - if any NEO is currently eligible for early retirement, the identity of the NEO and the plan, the plan's early retirement payment and eligibility standards;

    - the specific elements of compensation included in applying the payment and benefit formula;

    - if a company has multiple plans, the different purposes for separate plans; and

    - any policies with respect to granting extra years of service.

Nonqualified Deferred Compensation Table

The Nonqualified Deferred Compensation Table discloses annual executive and company contributions under non-qualified defined contribution and other deferred compensation plans, as well as each NEO's withdrawals, "earnings" and fiscal-year end balances in those plans.

Nonqualified Deferred Compensation for the 200x Fiscal Year

Name (a)	Executive Contributions in Last Fiscal Year ($) (b)	Registrant Contributions in Last Fiscal Year ($) (c)	Aggregate Earnings in Last Fiscal Year ($) (d)	Aggregate Withdrawals/ Distributions ($) (e)	Aggregate Balance at Last Fiscal Year-End ($) (f)
NEOs					

- This table covers only deferred compensation that is not provided under a tax-qualified plan.

- While not defined or described by the SEC, "earnings" presumably reflect the difference in the account balance between the beginning and end of the year, less any executive or company contributions and plus any amounts withdrawn or distributed.

- Footnotes to this table are required to quantify the extent to which amounts reported as contributions or earnings are also included in the amounts reported as compensation in the last completed fiscal year in the Summary Compensation Table. Footnote disclosure is also required to quantify the extent to which amounts reported in the Aggregate Balance at the Last Fiscal Year-End column were reported as compensation to the NEOs in the company's Summary Compensation Table for prior years, although it is unclear whether this footnote is to include only deferred amounts reported as compensation in the Summary Compensation Table of the current year's proxy, all deferred amounts reported in the Summary Compensation Table of all past years' proxy statements or simply the aggregate amount of employee contributions to the plan for all years.

- Following this table, a narrative description should be included describing any material factors necessary to understand each plan covered by this table. Examples of material factors include:

    - the types of compensation permitted to be deferred, and any limitations on the extent to which deferral is permitted;

    - the measures for calculating interest or other plan earnings, quantifying interest rates and other earnings measures applicable during the company's last fiscal year; and

    - material terms with respect to payouts, withdrawals and other distributions.

ii. Extensive Disclosure of Termination and Change in Control Payments

The rules require companies to describe any arrangement that provides for payments or benefits to any NEO at, following, or in connection with a change in control of the company, a change in an NEO's responsibilities, or an NEO's termination of employment, including resignation, severance, retirement or constructive termination. The disclosure must explain the specific circumstances that would trigger payment or the provision of benefits and how the payment or benefit levels are determined in each circumstance. In addition, companies must quantify the amount that would have been payable to each NEO under each of the foregoing triggering events, assuming that the triggering event had occurred as of the end of the last fiscal year. Any benefits that are valued based on stock price likewise are to be quantified based on that price as of the end of the last fiscal year. If uncertainties exist as to whether benefits are payable or the amount or value of such benefit, companies are required to make a reasonable estimate (or a reasonable estimated range of amounts) of the payment or benefit and disclose material assumptions underlying such estimates or estimated ranges in its disclosure. For an NEO who has terminated employment during the last fiscal year, only the actual benefits paid or payable must be reported.

The disclosure must also:

- describe and explain any material conditions or obligations applicable to the receipt of payments or benefits, including but not limited to non-compete, non-solicitation, non-disparagement or confidentiality agreements, including the duration of such agreements and provisions regarding waiver of breach of such agreements; and

- describe any other material factors regarding each such contract, agreement, plan or arrangement.

For many companies, this new disclosure standard will be the most burdensome and time-consuming aspect of the new rules. Companies must carefully review all of their employment agreements, benefit plans and compensation arrangements to identify each triggering event and the amounts and benefits payable. Companies with slight variances in terms among their different benefits (such as different definitions of "change in control") might wish to amend some of their arrangements to conform the terms. The required disclosure may necessitate quantifying current pension benefits (which, unless an NEO is retirement-eligible, may involve a calculation that is different from the one used to prepare the Pension Benefits Table) and the value of "golden parachute tax" gross-ups, each of which likely will require complex calculations that may best be performed by outside consultants.

Companies will also need to carefully consider how to most clearly present the required information, including whether to arrange the presentation by triggering event or by NEO, and the extent to which tabular presentations can be used to facilitate making the required disclosures. Because the amounts reported typically will be based on hypothetical circumstances, companies will also want to adequately explain (and disclaim) that amounts payable upon a triggering event could differ, perhaps materially, from those reported in the proxy statement.

(b) Directors' Compensation Disclosure

Director compensation for the last fiscal year is reported in a tabular format based on the form of payment. A separate line must be provided for each director, except that directors may be grouped in a single row if all of the elements and amounts of their compensation are identical.

<u>Director Compensation in Fiscal 200x</u>

Name (a)	Fees Earned or Paid in Cash ($) (b)	Stock Awards ($) (c)	Option Awards ($) (d)	Non-Equity Incentive Plan Compensation ($) (e)	Change in Pension Value and Nonqualified Deferred Compensation Earnings (f)	All Other Compensation (g)	Total ($) (h)
Directors							

- The All Other Compensation Column covers the same items reported for NEOs in the All Other Compensation column of the Summary Compensation Table, with the same $10,000 thresholds for itemizing elements of All Other Compensation and the same $10,000 *de minimis* exception to the disclosure of perquisites. In addition, All Other Compensation includes:
  - all consulting fees; and
  - the annual cost of payments and promises of payments pursuant to director legacy programs or charitable awards programs.
- Footnotes are required to accompany the Stock Awards and Option Awards columns to report the aggregate number of stock awards and option awards outstanding at fiscal year end.
- Narrative disclosure accompanying this table should describe director compensation arrangements (such as fees for retainer, committee service, service as chair of the board or a committee, and meeting fees) and any other material factors necessary to the understanding of this table.

3. Stock Option Grant Practices

- In response to recent concerns about stock option grant practices, the rules and adopting release address disclosure requirements focusing on the timing of option grants in coordination with the release of material non-public information and the determination of exercise prices that differ from the stock price on the date of grant. These rules are discussed in Section II(C) below.

4. Related Party Transactions

The rules revise the related party transaction disclosure requirements in subtle but significant ways. The SEC noted that the purpose of these rules remains unchanged: to elicit disclosure of transactions and relationships with related persons and the independence of directors and director nominees. The rules eliminate a number of "bright-line" standards on relationships that were not required to be disclosed, focusing instead on the materiality standard, which should be "determined on the basis of the significance of the information to investors in light of all the circumstances."

(a) Disclosure Standards for Related Party Transactions

Item 404(a) of Regulation S-K continues to set forth a general disclosure requirement for related party transactions: disclosure is required of any transaction (or proposed transaction) since the beginning of the company's last fiscal year, in which (i) the company was a participant, (ii) the amount involved exceeds $120,000, and (iii) any related person had or will have a direct or indirect material interest. The threshold dollar value of transactions to be considered has been increased from $60,000 to $120,000, but the SEC has emphasized that transactions over this threshold are reportable only if they satisfy the materiality standard. The SEC has emphasized that the scope of what constitutes a "transaction" is broad and includes both compensatory relationships and indebtedness.

The definition for "related person" covers:

- any person who served as an executive officer or director at any time during the previous fiscal year (regardless of whether they held that position at the time of the transaction) or (for proxy statements) is a director nominee;

- any person who was a greater than 5% securityholder at the time of a transaction or while the transaction was continuing; and

- any child, stepchild, parent, stepparent, spouse, sibling, mother-in-law, father-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law of any of director, executive, director nominee or securityholder, the foregoing related persons, as well as any other person (other than a tenant or employee) sharing the household of any such related person. The scope of this "immediate family" definition is broader than previously applied under Item 404(a) because it includes stepparents, stepchildren and others living in an executive's or director's household.

The rules retain a number of "bright line" exclusions on relationships that are not reportable and confirm that compensation of executive officers who are not NEOs will not generally be reportable. Thus, companies need not report any transaction:

- with an entity in which the related person's interest arises solely from being a director or less than 10% stockholder of the other party to the transaction, or from being both a director and less than 10% stockholder; or

- involving compensation to an executive officer who is not an NEO, provided that the executive officer is not an immediate family member of a related person and the compensation has been approved by the company's compensation committee or other independent directors.

On the other hand, the revisions eliminate an important exception that in the past was relied upon as a basis for not disclosing *de minimis* transactions with companies at which directors are executive officers. Specifically, the SEC has replaced Item 404(b), which required disclosure of transactions with entities where a director or director nominee served as an executive officer, with a new rule (discussed below) adopting stock exchange listing standards for evaluating director independence. This has the effect of eliminating companies' ability to rely upon a well-established SEC staff interpretation that related person disclosure was not required under Item 404(a) of any business dealings that were not disclosable under Item 404(b). While companies may still conclude that many such transactions or business relationships do not need to be disclosed, that conclusion will be dependent on a facts-and-circumstances analysis of the transaction and a determination of whether the director has a direct or indirect material interest in the transaction under general Item 404(a) standards. Also, in light of the elimination of the Item 404(b) standards for disclosure of transactions with entities where a director or director nominee served as an executive officer, the SEC has amended the definition of "Non-Employee Director" under Rule 16b-3 to drop this element from the definition and to provide safe harbor procedures for determining whether a director qualifies as a "Non-Employee Director" for purposes of that rule.

(b) Approval of Related Party Transactions

New Item 404(b) requires companies to describe their policies and procedures for the review and approval or ratification of transactions with related persons. The rule provides the following examples of aspects of the policies and procedures that may need to be discussed:

- the types of transactions that are covered by such policies and procedures;
- the standards to be applied pursuant to such policies and procedures;
- the persons or groups of persons on the board of directors or otherwise who are responsible for applying such policies and procedures; and
- a statement of whether such policies and procedures are in writing and, if not, how such policies and procedures are evidenced.

Companies will need to disclose whether any related party transactions that are required to be disclosed under Item 404(a) were not subject to the company's policies for approval or ratification.

We expect that these rule changes will lead many companies to reinforce their procedures for timely identifying potential related party transactions and to clarify and formalize their procedures relating to approval of related party transactions.

5. Corporate Governance Disclosures

New Item 407 of Regulation S-K consolidates existing disclosure requirements relating to directors' board and annual meeting attendance and shareholder communications with directors and nominating and audit committees. The rules also include new disclosure standards relating to director independence and compensation committee operations. The revisions eliminate the need to periodically attach the audit committee's charter to the proxy statement, and instead all committee charters may instead be posted on a company's website and cross-referenced in the proxy statement.

The new Item 407 rules regarding independent directors require companies to:

- identify each person who served as a director during any part of the year and each director nominee who is "independent," using the independence standards applied under the securities market where the company's stock trades;

- identify any member of the audit, nominating or compensation committees of the board who is not independent, and describe the listing standard exemption relied upon for having a non-independent director; and

- describe in reasonable detail on a director-by-director basis each category or type of transaction, relationship or arrangement that is not disclosed as a related party transaction but that was considered by the company's board when determining that a director and director nominee is independent.

The new Item 407 rules regarding compensation committees require companies to describe the compensation committee's processes and procedures for the consideration and determination of executive and director compensation. If director compensation is not set by the compensation committee, then corresponding disclosure must be provided with respect to the committee or group of directors that are responsible for establishing directors' compensation. The disclosure must address:

- the scope of authority of the compensation committee;

- the extent to which the compensation committee may delegate any of its authority to others, specifying what authority may be so delegated and to whom;

- any role of executive officers in determining or recommending the amount or form of executive and director compensation; and

- any role of compensation consultants in determining or recommending the amount or form of executive and director compensation, including:

    - identifying the compensation consultants,

    - stating whether the consultants are engaged directly by the compensation committee, and

    - describing the nature and scope of the consultant's assignment, and the material elements of the instructions or directions given to the consultants with respect to the performance of their duties under the engagement.

6. Form 8-K Reporting Requirements

The new rules revise and significantly narrow the Form 8-K reporting requirements applicable to compensation-related information. As noted above, compliance with the changes to Form 8-K is required for triggering events that occur 60 days or more after publication of the adopting release in the Federal Register. The rules:

- remove compensation related plans, agreements and arrangements as reportable events under Items 1.01 and 1.02 of Form 8-K. Although compensation-related events are no longer reportable as "material agreements" under the Form 8-K rules, they continue to be treated as "material agreements" under the rules enumerating exhibits that are required to be filed with registration statements and Forms 10-K and 10-Q.

- add to and expand the executive compensation-related events that require a Form 8-K report under Item 5.02 of Form 8-K. That item formerly applied only upon appointment or upon resignation or severance of a director, principal executive officer, president, principal financial officer, principal accounting officer, principal operating officer, or person performing similar functions. In addition to events that formerly triggered a Form 8-K under Item 5.02, that item now also is triggered:

  - whenever a company enters into, adopts, commences or materially modifies or amends a material compensatory plan, contract or arrangement (whether written or not) in which a principal executive officer, principal financial officer or person identified as a NEO in the company's most recently proxy statement participates; and

  - whenever a company makes or materially modifies a material grant or award under any plan, contract or arrangement to or with any principal executive officer, principal financial officer or person identified as a NEO in the company's most recently proxy statement, <u>unless</u> the grant or award (or modification thereto) is "materially consistent with the previously disclosed terms of such plan, contract or arrangement," and the grant, award or modification is disclosed when required in the company's next proxy statement (or other filing reporting compensation of NEOs under Item 402 of Regulation S-K).

As with the case when compensatory plans or arrangements were reported under Item 1.01, the failure to timely file a Form 8-K reporting one of the foregoing two types of triggering events will not impair a company's eligibility under Form S-3, as long as the event is reported in the Form 10-Q or Form 10-K filed after the end of the quarter in which the triggering event occurred.

- In addition, under amendments to other provisions of Item 5.02, a Form 8-K must be filed:

  - whenever a company calculates the amount of an NEO's salary or bonus for the previous fiscal year if that amount was not reported in the company's previously filed proxy statement (or other filing reporting compensation of NEOs under Item 402 of Regulation S-K) for that fiscal year; and

  - whenever a person identified as an NEO in the company's most recently filed proxy statement (or other filing reporting compensation of NEOs under Item 402 of Regulation S-K) retires, resigns or otherwise terminates employment.

- The rules set forth more clearly the information required to be described when a company appoints a new principal executive officer, president, principal financial officer, principal accounting officer, principal operating officer, or person performing similar functions. In addition to describing any employment agreement with the newly appointed executive, companies must describe: (i) any material plan, contract or arrangement (whether or not written) in which the newly appointed executive participates that is materially amended in connection with the executive's appointment; and (ii) any grant or award that is made to the newly appointed executive in connection with the appointment.

- Significantly, events relating to establishing or amending director compensation are not required to be reported on a Form 8-K, except that if a company appoints a new director, the Form 8-K filed in connection with that appointment must describe: (i) any material plan, contract or arrangement (whether or not written) in which the newly appointed director participates that is entered into or materially amended in connection with the director's appointment; and (ii) any grant or award that is made to the newly appointed director in connection with the appointment.

- Companies are not required to file a Form 8-K to report compensation-related events that relate only to executives who are not NEOs except for (i) the triggering events discussed above that apply upon the appointment or termination of a principal executive officer, president, principal financial officer, principal accounting officer, principal operating officer, or other person performing similar functions; and (ii) events that trigger disclosure under other Form 8-K items such as plan trading "black outs" that are reportable under Item 5.04 of Form 8-K and plans of termination that involve a material charge and therefore are reportable under Item 2.05 of Form 8-K.

7. Other Requirements

(a) Security Ownership of Directors and Officers

The rules require disclosure of the number of shares owned by management that are subject to a pledge.

(b) Performance Graph

The SEC retained the requirement for the stock performance graph, but the graph is not required to appear in the proxy statement but instead is called for under the rules setting forth requirements applicable to companies' annual report to stockholders.

(c) Plain English

The rules require companies to present most of this information in plain English.

(d) Disclosure of Other Employees' Compensation

The SEC did not adopt its proposal to require disclosure of the compensation paid to non-executive employees whose compensation exceeds that paid to any of the NEOs. However, the SEC has sought additional comment on a revised version of this proposal, under which companies that are "large accelerated filers" would be required to disclose the total compensation of up to three employees (i) who are not executive officers but who have significant policy-making powers either within the company or within a significant subsidiary, principal business unit, division or function of the company; and (ii) whose compensation exceeds that of any of the NEOs listed in the Summary Compensation Table. Companies wishing to submit comments on this proposal must do so before October 23, 2006.

B. Nasdaq Becomes National Securities Exchange

On August 1, 2006, the Nasdaq Stock Market began operating as a national securities exchange for Nasdaq-listed securities, following the SEC's approval of its application to convert from an interdealer quotation system earlier this year. Nasdaq intends to begin operating as an exchange for other exchange-listed securities as of October 1, 2006.

The impact of these changes on listed companies is minimal. Securities listed on Nasdaq must now become registered under Section 12(b) of the Exchange Act rather than Section 12(g). Ordinarily, such a conversion would require each Nasdaq-listed company to have to file a registration statement with the SEC. However, as a result of negotiations between Nasdaq and the SEC, Nasdaq was permitted to file a global application on behalf of all Nasdaq-listed companies to register their securities under Section 12(b). The SEC also granted Nasdaq-listed companies that were exempt from Section 12(g) registration an exemption from the registration requirements of Section 12(b) through August 1, 2009, thereby allowing members, brokers and dealers to trade in these unregistered securities without violating Section 12(a). After August 1, 2009, these companies will have to register under Section 12(b).

The 1934 Act registration numbers of listed companies will remain unchanged. Although exchange-listed companies typically have a different prefix (001-XXXXX), the SEC has decided to leave Nasdaq registration numbers (000-XXXXX) unchanged, due to the large number of affected companies.

Going forward, listed companies will need to indicate in their Exchange Act reports that their securities are registered under Section 12(b). For example, Nasdaq-listed companies will now need to check a different box on the Form 10-K cover page, indicating "Securities registered pursuant to

Section 12(b) of the Act." Since both Section 12(b) and 12(g) securities are "registered" for purposes of the 1934 Act, the reporting obligations of listed companies should generally not be affected. In an August 1, 2006 No-Action Letter the Commission stated that issuers' obligations under the federal securities laws to file information with Nasdaq would be satisfied "by the filing of such information electronically with the Commission through . . . [EDGAR] pursuant to Regulation S-T and the applicable Nasdaq Exchange rules."[2] Nasdaq also changed the names of the Nasdaq National Market to Nasdaq Global Market and the name of the Nasdaq Small Cap Market to the Nasdaq Capital Market. It also created a new market tier known as the Nasdaq Global Select Market with very stringent initial financial listing standards. There are no substantive differences between the listing requirements of the Nasdaq National Market and the Nasdaq Global Market

C. Stock Option "Backdating" and Other Problematic Option Grant Practices

1. Overview

In recent months, option grant practices have come under heightened scrutiny over allegations that executives have been manipulating the dates of their option grants in order to increase their value. In November 2004, the SEC began investigating option grant practices at several technology companies. At that time, the director of the SEC's Division of Enforcement publicly stated that he believed that it was problematic, and perhaps illegal, for a company to grant options at a time when the company was aware of material non-public information. While the SEC's investigations of option grant practices at a number of companies has been on-going for more than a year, interest in companies' option practices exploded following a March 18, 2006 article by the Wall Street Journal focusing on grant practices at six companies. Currently, more than 100 public companies have disclosed criminal, regulatory or internal investigations into their option grant practices.

2. Problematic Option Grant Practices

A core issue for most, but not all, option grant practices that are being reviewed arises from the issue of when exactly an option "grant" is deemed to occur. The issue arises because an option's exercise price is typically derived from the stock's price on the date the option is granted, and because the date of grant can have accounting, tax, securities law and corporate law implications. Generally, though, the issues being addressed include the following:

a. Intentional Backdating

Intentional backdating occurs when an option's grant date, or the date that otherwise is used to set the option's exercise price, is recorded as occurring in the past; typically as of a date when the company's stock price (and thus the option's exercise price) was lower.

---

[2] The NASDAQ Stock Market LLC, SEC No-Action Letter (Aug. 1, 2006), *available at* http://www.sec.gov/divisions/marketreg/mr-noaction/nasdaq080106.htm.

b. Unintentional Backdating or “Misdating”

Option grants may be unintentionally backdated or “misdated” as a consequence of corporate actions and policies that result in an option’s grant date being recorded as occurring on a date that is different than (and typically earlier than) when it is deemed to have been granted under an applicable accounting or legal standard. This may arise in a variety of circumstances, including, for example, a company may record the date of grant on the date the written consent authorizing the grants was sent to its directors, whereas under some states’ corporate law or under accounting or tax standards, the grant date may not be deemed to occur until the date that every signature was obtained on the written consent.

c. Inadequate Grant Date Documentation

Some companies do not possess adequate documentation to substantiate the date the options were granted. A common scenario occurs where a senior executive (typically the CEO or head of HR) has been delegated authority to grant options under a stock plan, and there is no concurrent documentation to demonstrate when a particular option was granted. For example, the CEO may have orally stated that an option was to be granted, but there is no concurrent email or other documentation of that authorization, and the grant agreement or notification may not have been completed and distributed until the end of the month. In other cases, grants may have been concurrently documented, but the authority of the person who made the grant is not properly documented.

d. Spring-Loading

“Spring-loading” refers to a practice in which a company sets the grant date and exercise price of an option just prior to the release of material nonpublic information that is expected to increase the company's stock price (e.g., issuing options a day prior to public announcement of FDA approval of medical devices).

e. Other Practices

A variety of other practices have been uncovered in the course of option grant practice reviews. For example, one internal review revealed that certain employees may have backdated exercise dates for options in order to reduce the employees’ taxable income upon exercise and to establish an earlier capital gains holding period. Other practices include allowing employees to pay for option exercises with promissory notes that were not enforced and substantial delays (as much as two years) from the date the employee options were approved by the board of directors to the date such option grants were communicated to individual employees.

3. Legal Implications of Problematic Option Grant Practices

Granting options with an exercise price that is below the fair market value of the stock on the date of grant is not in itself illegal. However, the practices described above can have accounting, tax, securities law and corporate law implications.

a. Accounting Issues

Prior to the implementation of FAS 123R, under APB 25, companies were required to record an accounting expense from the grant of an option if the option's exercise price was below the stock's market price on the "measurement date," which was generally viewed as being the date that the number of shares subject to the option and the option exercise price were fixed. If an option's exercise price is below the stock's market price on the measurement date – which could occur because of intentional backdating or unintentional misdating – accounting rules require the company to record the difference as an expense, which is recognized over the vesting term of the option. As a result of the typical multi-year vesting terms applicable to options, the accounting implications of backdated options thus can impact the accuracy of financial statements for a number of years following the options' grant. While the accounting standards applicable under APB 25 appear to be unclear, some commenters have suggested that the absence of valid authorizations for, or delays in documentation of, option grants may result in a measurement date that could differ from the reported grant date. On September 19, 2006, however, the Commission's Chief Accountant's office issued a letter clarifying some of the issues relating to APB 25.[3] The letter expresses the following views of the Office of the Chief Accountant, among others:

- dating a stock award document as of a date prior to the date the terms of the award are determined does not affect the measurement date under APB 25;

- if a company acted as if the terms of its awards were not final prior to the completion of all required granting actions, the company should conclude that measurement date for all awards (granted using similar philosophies) would be similarly delayed;

- in situations where questions have arisen as to whether an option can be accounted for as a fixed option with a definite measurement date where uncertainty exists as to the validity of the grant, in certain circumstances, the mutually understood substantive arrangement should serve as the basis for the company's accounting decisions;

- in situations where the compensation committee approved an aggregate number of options for a group of employees and provided management with discretion in determining the number of options to be granted to certain individual employees, the measurement date can not occur for such options prior to the date on which the allocation to the individual employee was finalized;

[3] Letter from the Office of the Chief Accountant of the Securities and Exchange Commission, *available at* http://sec.gov/info/accountants/staffletters/fei_aicpa091906.htm (Sept. 19, 2006).

- if the original terms of an option provided for a reduction to the exercise price if a specified future event occurred (such as a fluctuation in exercise price based on market price), variable accounting is required from the award approval date until the date uncertainty is resolved. If, however, the award does not include terms that would cause an automatic adjustment, but the exercise price is nonetheless reduced after the approval date nevertheless, a repricing will have occur; and

- in situations where documentation of an option grant is incomplete or cannot be located, a default to variable accounting is not necessarily required. In this case a company should use "all available relevant information" to form a reasonable conclusion as to the most likely option granting actions that occurred.

b. Tax Issues

Tax rules applicable to incentive stock options define the “date of grant” as occurring “when the granting corporation completes the corporate action constituting an offer of stock for sale to an individual under the terms and conditions of a statutory option. A corporate action constituting an offer of stock for sale is not considered complete until the date on which the maximum number of shares that can be purchased under the option and the minimum option price are fixed or determinable.” It is likely the IRS will apply this same definition for all purposes under the tax laws.

In order for a company to be entitled to deduct the “spread” on options that are exercised by the company’s CEO and four next most highly compensated executive officers, the option must qualify as “performance-based compensation” under Section 162(m) of the Internal Revenue Code. The most common basis relied upon for an option to qualify as “performance-based compensation” is for the option to have an exercise price equal to the stock’s fair market value on the date the option was granted. Thus, if an option’s exercise price is below the stock’s fair market value on the grant date – which could occur because of intentional backdating or unintentional misdating – then years later, if the optionee is subject to Section 162(m) at the time the option is exercised, the company may not be entitled to deduct the entire spread realized by the optionee upon exercise of the option. If such an option has already been exercised and the company has already claimed a deduction for it, the company may need to refile its income tax returns. For companies that are not current taxpayers due to net operating losses, the loss of a deduction affects how quickly they use up their net operating losses.

In addition, there can be adverse tax consequences for optionees if they are granted options with an exercise price below the stock’s fair market value on the date the option is deemed to have been granted for tax purposes. Subject to certain transition rules, these options are treated as giving rise to deferred compensation under new Section 409A of the Internal Revenue Code to the extent they first become exercisable after December 31, 2004. Under Section 409A, the spread on an option that was granted with a below fair market value exercise price is taxable to the optionee once the option vests, whether or not it is exercised at that time. The optionee also is subject to additional excise taxes imposed upon deferred compensation under Section 409A. Finally, if an option’s exercise price is below the stock’s fair market value on the date the option was granted, the option can not qualify for favorable tax treatment as an “incentive stock option” (also known as an ISO).

c. Securities Law Issues

The main securities law implications of inappropriate option grant practices are derivative from the accounting and tax consequences; if a company has not properly accounted for grants of options or for the tax treatment of option exercises, then financial statements included in its SEC filings may be inaccurate and, if material, require restatement. However, there are other potential collateral implications. The grant practices may result in a violation of the "books and records" provision of the securities law, which require companies to "make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions … of the issuer" and to "devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in conformity with generally accepted accounting principles." In addition, the practices may not be consistent with statements that have been made in companies' proxy statements and other filings, such as statements that all options are granted with an exercise price equal to the fair market value on the date of grant (proxy disclosure rules require that the chart reporting option grants to executive officers reflect whether the options have an exercise price that is below the grant date stock price) and statements that options are deductible under Section 162(m). For more recent years, the practices may indicate a deficiency in companies' internal control over financial reporting and thus affect the company's ability to provide internal control certifications.

Spring-loading poses different securities law issues than the other practices, primarily relating to whether the practice constitutes a form of illegal insider trading. In this regard, the traditional view has been that it does not constitute insider trading when directors who are aware of material nonpublic information authorize the grant of options, since there is no deception when they are fully informed of the inside information. Nevertheless, the SEC's enforcement division has been pursuing cases that may test the limits of insider trading theory by asserting that spring-loading is unlawful. One company, Analog Devices, has announced that it agreed to settle an SEC investigation into the practice rather than litigate over the issue.

Additionally, pursuant to the new executive compensation rules adopted by the Commission on August 29, 2006, issuers are now required to include disclosure in the new Compensation Disclosure and Analysis regarding option grant practices, when necessary for a material understanding of the issuer's compensation policies. With respect to both the timing of stock options and any programs under which option exercise prices are set at an amount below the closing market price of the stock on the grant date, companies must, where applicable, answer questions such as:

- does the company have a program or practice in place to time option grants to executive officers with the release of material non-public information (or to set exercise prices in coordination with such release)?
- how does that program or practice fit into the context of the company's program or practice, if any, with regard to option grants to employees generally?
- what was the compensation committee's role in approving and administering that program or practice?
- what was the role of executive officers in the company's program or practice?

- does the company plan to time, or has it timed, the release of material non-public information in order to affect the value of executive compensation?

This disclosure is in addition to the various forms of tabular and footnote disclosure relating to option grant practices described in greater detail throughout Section II(A) above.

d. Corporate Law Issues

Option grant practices can raise corporate law concerns as to whether particular options were duly authorized, either because they were granted under an equity compensation plan (typically, a plan approved by stockholders) that requires options to have an exercise price equal to the stock's market price on the date of grant, or because the person purporting to make grants was not at the time authorized to do so (or the authorization was not appropriately documented and can not be demonstrated). These situations can raise difficult questions as to whether outstanding options are valid obligations of the company and, if a company seeks to ratify past grants, whether the "ratification" is effectively a new grant that requires a new option exercise price.

3. Other Developments

The controversies over option grant practices have lead to a number of other developments:

- Most companies have undertaken at least an internal review of their past option grant practices to determine the extent to which they can document the timing and authorization of option grants. While it is not yet clear what procedures audit firms may implement in reviewing clients' past accounting for options, it appears that some of the firms have developed a list of clients that are viewed as having possibly problematic practices. On July 28, 2006, the Public Company Accounting Oversight Board issued an Audit Practice Alert Regarding Timing and Accounting for Stock Option Grant. The alert provides guidance on auditor reviews of accounting for option grants.

- Many investment analysts have sought to identify companies that may be at risk of having questionable option grant practices and have advised their clients that investments in such companies may be at risk if an option accounting scandal results in financial restatements or termination of key executives who participated in the practices. There are reports that hedge funds have used the threat of an option accounting rumor as a basis for trying to extract some form of concession from companies. Companies often have not been able to respond to such allegations, either because they are in the process of conducting internal reviews of the option grant practices, or because of Regulation FD concerns over privately discussing the status of such internal reviews.

- SEC and Department of Justice investigations and civil securities class-action lawsuits have been commenced against many companies, often based solely on a news or analyst report suggesting that the company's option grant practices appear suspect.

- The SEC's new rules on executive compensation disclosure, adopted on July 26, 2006, include expanded disclosures about stock options:

  - Companies must address matters relating to executives' option compensation in the new Compensation Discussion and Analysis section, including the timing of grants and how exercise prices are determined.
  - Grants of stock options must be disclosed in the Summary Compensation Table at their fair value on the date of grant, as determined under FAS 123R.
  - The grant date of option awards must be disclosed in a new "Grants of Plan-Based Awards" table.

- A number of institutional investors have used the controversy over option backdating as a further basis for criticizing executive compensation. It can be expected that the issue will remain a source of discussion and rhetoric for the coming proxy season. A number of institutional investors have written companies asking them to take a number of steps to address perceived option grant abuses. For example, the California Public Employees Retirement System (CalPERS) urged directors at certain companies to:
  - Conduct an independent investigation into backdating allegations.
  - Publicly disclose all findings from both internal and external investigations.
  - Develop and disclose in public financial statements and proxy statements a new board policy for the determination of all option grant dates.
  - Refrain from using any company resources to satisfy the tax and legal liability for executives implicated for wrongdoing related to the backdating of options.
  - Commit to have the company's selection of its external auditor ratified by shareowners annually.

- As institutional investors press companies to overhaul their option grant policies, Institutional Shareholder Services recommends the following best practices for shareholders and boards to consider:
  - Adopt "blackout" periods to preclude stock grants when company executives have material, non-public information in hand.
  - Adopt fixed grant date schedules that provide for grants on a periodic basis (monthly, quarterly, or annually), along with rules for the establishment of option exercise prices on such grant dates.
  - Refrain from making grants on these fixed dates when executives have market-moving news.
  - Disclose the rationale for grants on a certain date, explaining why the compensation committee chose that date over other possible dates.

- o File Form 4 reports on option grants promptly with the SEC, since the failure to file these reports within the required two business days may suggest documentation problems.

D. Changes to the Registered Offering Process under the Securities Act of 1933

On June 29, 2005, the Commission voted unanimously to adopt major amendments to the registered offering framework under the Securities Act of 1933, as amended (the "**Securities Act**"), in the areas of offering communications, registration procedures, the timing of disclosures provided to investors and liability issues.[4] The amendments dramatically changed the securities offering process and particularly for a new category of large, already public companies that will be categorized as "well-known seasoned issuers" ("**WKSIs**").

1. Overview

The amendments modernize certain aspects of the regulation of securities offerings under the Securities Act, and address three main areas:

- permissible communications before and after the filing of a registration statement and clarification of associated liability;
- timely delivery of information to investors without imposition of regulatory delays through mandatory delivery of information; and
- improvement of registration and other procedures in the registered offering process.

The amendments categorize issuers into four groups:

- "Non-Reporting Issuers" are issuers that are not required to file reports pursuant to Sections 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended (the "Exchange Act");
- "Unseasoned Issuers" are issuers that are required to file reports pursuant to Sections 13(a) or 15(d) of the Exchange Act, but do not satisfy the requirements of Forms S-3 or F-3 for primary offerings of their securities;

---

[4] Securities Offering Reform, Release Nos. 33-8591; 34-52056; IC-26993, (June 29, 2005), *available at* http://www.sec.gov/rules/final/33-8591.htm. On September 15, 2005 and November 30, 2005, the SEC staff issued guidance on the offering reform rulemaking in the form of questions and answers. *See* Securities Offering Reform Transition Questions and Answers, *available at* http://www.sec.gov/divisions/corpfin/transitionfaq.htm and Securities Offering Reform Transition Questions and Answers, *available at* http://www.sec.gov/divisions/corpfin/faqs/securities_offering_reform_qa.pdf, respectively.

- "Seasoned Issuers" are issuers that are eligible to use Forms S-3 or F-3 for primary offerings of their securities; and

- WKSIs constitute a new class of issuers that are eligible to register primary offerings of their securities on Forms S-3 or F-3 and have either (1) $700 million of public common equity float or (2) issued $1 billion of registered debt during the preceding three years.

Blank check companies, shell companies, penny stock issuers, financially-distressed issuers and issuers that have violated the anti-fraud provisions of the federal securities laws will not be permitted to avail themselves of WKSI status or other benefits of the amendments. In addition, investment companies and business development companies, as well as merger and acquisition transactions, are not covered by many of the amendments, as they are subject to separate regulatory frameworks.

2. Communications and Associated Liability

In recognition of the fact that issuers communicate in a variety of ways on an ongoing basis (including through electronic communications), the amendments significantly relax the prohibition on "gun-jumping" - offers prior to the filing of the registration statement and written communications during the "waiting period" or "quiet period" that begins after the filing of the registration statement and ends when the registration statement is declared effective. Generally, the amendments allow communications to be made before and during the registered offering process and subject these communications to liability under Section 12(a)(2) of the Securities Act, but not Section 11 liability (that is, liability for material misstatements or omissions will attach only to the person who offers or sells the security, such as the issuer, and is subject to a defense if that person did not and could not reasonably have known of the untruth or omission).

The amendments related to "gun-jumping" have the following effects:

- WKSIs are permitted to engage at any time in oral and written communications, including use at any time of a "free writing prospectus", defined as any written offer that is not a Section 10(a) statutory prospectus, subject to enumerated conditions (including, in specified cases, filing with the Commission);

- all reporting issuers are permitted, at any time, to continue to publish regularly released factual business information and forward-looking information;

- non-reporting issuers are, at any time, permitted to continue to publish factual business information that is regularly released to persons other than in their capacity as investors or potential investors;

- communications by issuers more than 30 days before filing a registration statement will not be considered prohibited offers so long as they did not reference a securities offering;

- a broader category of routine communications regarding issuers, offerings, and procedural matters, such as communications about the schedule for an offering or about account-opening procedures, are allowed without the communications being deemed a prospectus;

- the exemptions for research reports will be expanded.

After filing of the registration statement, all issuers and offering participants can use free writing prospectuses, so long as certain conditions are satisfied. These conditions include the filing of (1) any free writing prospectus provided by the issuer, (2) information provided by the issuer about the issuer or its securities that is contained in any other person's free writing prospectus and (3) any broadly disseminated free writing prospectus provided to potential investors by an underwriter or other offering participant. Other types of underwriter free writing prospectuses are not required to be filed.

Electronic roadshows do constitute free writing prospectuses and generally are required to be filed unless the issuer makes at least one version of an electronic roadshow available in electronic form to an unrestricted audience. Note, however, that the release indicates that all "live" conferences with investors, including roadshows, are not deemed oral communications only, and thus will not be subject to prospectus liability.

With respect to issuers that are not WKSIs or otherwise already reporting companies, the statutory prospectus must accompany or precede the free writing prospectus if the issuer or an offering participant prepares or pays for the dissemination of the free writing prospectus.

Any free writing prospectus used by any person (whether or not it is filed) is subject to Section 12(a)(2) liability and the antifraud provisions of the federal securities laws. However, a free writing prospectus will not be part of the registration statement and thus will not be subject to Section 11 liability.

3. Liability Timing Issues

The amendments codify the SEC's interpretation of Section 12(a)(2) and Section 17(a)(2) as meaning that, for purposes of assessing whether information that is conveyed to an investor at the time of sale by or on behalf of a seller can result in liability (*i.e.*, includes a material misstatement or omits to state a material fact necessary in order to make the statements in light of the circumstances under which they were made not misleading), only information conveyed to the investor at or before the time of an investment decision should be taken into account. Information conveyed to the investor only after the time of the contract of sale (*i.e.*, a subsequently-filed prospectus or prospectus supplement) cannot be used to avoid liability.

Under the amendments, all prospectus supplements will be deemed a part of the registration statement, thus subjecting them to potential Section 11 liability. In addition, the amendments establish that Section 11 liability may arise for the issuer -- but not for directors, executives or auditors -- at the time of any prospectus filing reflecting a takedown of securities from a shelf registration statement.

4. Improvement of Registration and Other Procedures

a. Modernization of the Shelf Registration Procedure

The amendments have the following effects on all shelf registration-eligible issuers:

- the amendments codify, in one rule, the information that can be excluded from the base prospectus of a shelf registration statement at effectiveness and included in later filings;
- the current requirement that the issuer register an amount of securities that is reasonably expected to be offered or sold within two years was replaced with a requirement that the issuer update the registration statement with a new registration statement that is filed every three years;
- restrictions on Rule 415(a)(4) "at-the-market" offerings were eliminated;
- immediate takedowns from registration statements are permitted, eliminating the so-called "48 hour" waiting period for using a shelf registration statement once it becomes effective;
- selling securityholders can be added to a registration statement by a prospectus supplement;
- prospectus supplements are permitted to include material changes to the plan of distribution contained in the base prospectus; and
- seasoned issuers with a $75 million public float are allowed to identify selling securityholders in prospectus supplements (rather than post-effective amendments) where the securities to be sold are outstanding when the registration statement is filed.

b. Automatic Shelf Registration

For WKSIs, more flexible shelf registration will be available ("**Automatic Shelf Registration**"):

- Automatic Shelf Registration provides for automatic effectiveness of the WKSIs' registration statements upon filing and allows WKSIs to register unspecified amounts of different types or classes of securities on the automatically effective Form S-3 or Form F-3 without having to allocate between primary and secondary offerings;

- WKSIs can add different classes of securities and eligible majority-owned subsidiaries as registrants after the automatic registration statement is effective;

- more information can be excluded from the base prospectus than was previously allowed; for example, the base prospectus no longer needs to include the plan of distribution; and

- filing fees can be paid in advance or on a "pay as you go" basis at the time of each offering.

c. Incorporation by Reference into Forms S-1 and F-1

The amendments allow Exchange Act reporting issuers that are current in their Exchange Act filings to incorporate previously filed Exchange Act reports into Forms S-1 and F-1. Accordingly, the SEC eliminated Forms S-2 and F-2 as no longer necessary.

d. Access Equals Delivery Model for Final Prospectuses

Filing a final prospectus and meeting other conditions now constitutes delivery of the final prospectus for purposes of Section 5. Accordingly, physical delivery of the final prospectus will not be required if the applicable conditions are met. Moreover, to preserve an investors' ability to trace securities to a registered offering, there is a requirement to notify investors that they have purchased securities in a registered offering.

e. Additional Disclosure Requirements in Exchange Act Reports

The amendments require that additional disclosures be provided in Exchange Act periodic reports:

- risk factors are required in Form 10-K;

- disclosure is required regarding whether issuers are "voluntary filers" under the Exchange Act; and

- for accelerated filers, as defined in Rule 12b-2 and WKSIs, disclosure in Form 10-K is required regarding written SEC staff comments that were issued more than 180 days before the end of the fiscal year to which the Form 10-K relates where the comments are unresolved at the time of filing of the Form 10-K and the issuer believes that the comments are material.

E. De-registration for Foreign Issuers

On December 14, 2005, the SEC announced that it was proposing amendments to rules under the Exchange Act which, if adopted, would liberalize the de-registration process for many foreign private issuers, allowing them to terminate their on-going reporting obligations under the Exchange Act and remove them from the burdens of the Sarbanes-Oxley Act. In addition to providing relief to existing registrants, the SEC believes the proposals should encourage foreign private issuers to access the U.S. public markets in light of the relaxation of the de-registration process.

Though the public comment period was scheduled to close on February 28, 2006, the Commission continues to accept additional comments and has apparently taken no further action on the changes.[5] On August 2, 2006, the SEC announced in a press release that discussion of the changes is part of the SEC-CESR Dialogue's on-going agenda as a "general information point."[6] The next meeting of the SEC-CESR Dialogue is tentatively scheduled for the second half of 2006.

1. Existing De-registration Requirements

Registration under the Exchange Act is a prerequisite to any U.S. stock exchange listing (including Nasdaq), and, as a result of that registration, the issuer becomes subject to the ongoing reporting requirements of the Exchange Act as well as most provisions of the Sarbanes-Oxley Act. De-listing a class of securities of a foreign private issuer from a U.S. stock exchange, a process which removes the securities from trading on that exchange, is relatively straightforward. Under the current rules, however, de-registration is not.

Under the existing Exchange Act rules, a foreign private issuer may de-register under the Exchange Act only if it establishes that it has less than 300 (or 500 for certain small companies) U.S. resident holders of record, after making inquiry as to the number of U.S. residents for whom securities are held by brokers, dealers, banks or nominees. In addition, under the current rules, any such issuer which successfully de-registers under the Exchange Act merely suspends its registration, and does not permanently de-register. The foreign private issuer is required to resume its registration obligations under the Exchange Act (including its ongoing reporting obligations and the requirements of the Sarbanes-Oxley Act) for any fiscal year if, at the end of the preceding year, it then had more than 300 U.S. resident holders of record.

2. New Proposal

Under proposed Exchange Act Rule 12h-6, any eligible foreign private issuer with a class of equity securities registered under the Exchange Act will be able to de-register that class of securities if it either satisfies the existing de-registration standards or if its U.S. resident shareholder base and, in certain cases, U.S. trading volume fall below either of the following standards:

- Any foreign private issuer, including a WKSI, may de-register a class of its equity securities under the Exchange Act if it determines that U.S. residents hold no more than 5% of the issuer's world wide public float; or

---

5 Comments on the proposed rule changes *available at* www.sec.gov/rules/proposed/s71205.shtml.

6 SEC and CESR Launch Work Plan Focused on Financial Reporting (Aug. 2, 2006), *available at* http://www.sec.gov/news/press/2006/2006-130.htm. The press release does not provide a timetable for further SEC action on the proposed rule changes.

- Any WKSI may de-register that class of equity securities if it determines that:
  - its U.S. daily trading volume has been no greater than 5% of the average daily trading volume of the securities in their primary market over the preceding 12 months, and
  - U.S. residents hold no more than 10% of the issuer's world wide public float.

Separate benchmarks for the de-registration of a class of debt securities will be proposed.

To be eligible to seek such de-registration of its securities pursuant to proposed Rule 12h-6, a foreign private issuer will need to have been an Exchange Act reporting company for the prior two years and filed or furnished all reports in such period (including at least two annual reports), must not have directly or indirectly sold its securities, with certain exceptions, in the U.S. in a registered or unregistered offering during the preceding 12 months and will need to have maintained a public listing on an exchange in its home market for the preceding two years which constitutes the primary trading market for the securities. Under the proposal, once a foreign private issuer terminates its registration under the Exchange Act, it will be permanently de-registered, unless it subsequently seeks to list a class of securities on a U.S. securities exchange or Nasdaq or if it subsequently makes a U.S. public offering of a class of its securities.

Further, under the proposed rule, in determining the number of U.S. resident security holders and the number of securities held by U.S. residents, foreign private issuers will be permitted to limit their inquiry of brokers, dealers, banks and nominees to such entities in the U.S., the issuer's jurisdiction of incorporation and the principal trading market, if different. Issuers will also be permitted to rely in good faith on independent sources of such information.

F. Proposed Amendments to the Tender Offer Best-Price Rule

On December 14, 2005, the SEC voted to approve proposed amendments to the best-price rule set forth in Exchange Act Rules 14d-10(a)(2) and 13e-4(f)(8)(ii), applicable to third-party tender offers and issuer tender offers, respectively. The public comment period closed February 21, 2006, and the Commission has yet to take further action on the proposed changes.

The best-price rule provides that the consideration offered and paid to any security holder in a tender offer must be equal to the highest consideration paid to any other security holder in the offer. Using this rule, plaintiffs have challenged retention agreements, golden parachutes and similar arrangements with target company executives by characterizing such compensation as separate tender offer consideration that violates the best-price rule. The proposed revisions address a split among federal courts as to whether the best-price rule in fact applies to such employment and compensation arrangements. This uncertainty regarding the application of the best price rule has led many acquirors to shy away from conducting a tender offer when engaging in a business combination transaction.

Specifically, the proposed revisions address this issue by:

- Exempting from the third-party tender offer rule the "negotiation, execution or amendment of an employment compensation, severance or other benefit arrangement," so long as the consideration paid under the agreement relates *solely* to past or future services, severance, or a non-competition agreement, and *not* the number of shares owned or tendered by an employee or director of the target company.

- Clarifying that the best-price rule applicable to both issuer and third-party tender offers is limited to the payment for securities tendered in a tender offer, and *not* consideration paid for other compensatory purposes.

- Providing a general safe harbor covering arrangements approved by an independent compensation committee or a committee of the board of either the target or the bidder depending on the entity entering into the arrangement.

- Clarifying that the best-price rule is not limited solely to the period when a tender offer is pending.

G. The Public Company Accounting Oversight Board's Auditing Standard No. 2

The Sarbanes-Oxley Act created the PCAOB, empowered to oversee public company auditors and the audit process for public companies and companies offering securities to the public.

On June 17, 2004, the SEC approved PCAOB Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting ("**Auditing Standard No. 2**"). Auditing Standard No. 2 provides professional standards and related performance guidance for independent auditors to attest to, and report on, management's assessment of the effectiveness of internal control over financial reporting under Section 404 of the Sarbanes-Oxley Act.[7]

Under Auditing Standard No. 2, the auditor must evaluate whether management's assessment process has an appropriate basis for its conclusion and whether the design and operation of the internal control is effective for supporting management's conclusion. For this evaluation, Auditing Standard No. 2 provides guidance for identifying significant deficiencies and material weaknesses.

The auditor must issue two opinions pursuant to Auditing Standard No. 2: (i) an opinion as to whether management's assessment on the effectiveness of financial reporting at the end of the most

---

[7] Public Company Accounting Oversight Board; Order Approving Proposed Auditing Standard No.2, Release No. 34-49884 (June 17, 2004), *available at* http://www.sec.gov/rules/pcaob/34-49884.htm. Auditing Standard No. 2 was adopted by the Public Company Accounting Oversight Board on March 9, 2004, and submitted to the SEC for approval on March 11, 2004, pursuant to Section 107 of the Sarbanes-Oxley Act of 2002 and Section 19(b) of the Securities Exchange Act of 1934.

recent fiscal year is fairly stated and (ii) an opinion as to the effectiveness of the issuer's internal control over financial reporting at the end of the most recent fiscal year.[8]

Auditing Standard No. 2 also establishes thresholds that the auditor must apply when determining whether there are "significant deficiencies" or "material weaknesses" in the issuer's internal control over financial reporting:

- "Significant deficiencies" exist when a control deficiency, or a combination of control deficiencies, adversely affects the company's ability to initiate, authorize, record, process, or report external financial data reliably in accordance with generally accepted accounting principles ("**GAAP**"), such that there is more than a remote likelihood that a misstatement of the company's annual or interim financial statements that is more than inconsequential will not be prevented or detected.[9]

- "Material weaknesses" exist when there is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.[10]

The SEC and the PCAOB staffs have both continued to release guidance, in the form of frequently asked questions and policy statements, regarding Auditing Standard No. 2. [11]

Some of the issues upon which the SEC staff has provided guidance include:

- *Recent acquisitions, consolidations, and equity investments.* For acquisitions within the last fiscal year where the registrant is unable to conduct an assessment of the acquired business's internal controls, management's report should note the exclusion and, either in management's report or elsewhere in the annual report, indicate the financial significance of the acquired business. In addition, management's report on internal control over financial reporting should include the controls of all consolidated entities, regardless of the basis of consolidation. However, in a situation where an entity existing prior to December 15, 2003 is consolidated by virtue of Interpretation 46 and the registrant lacks the legal or contractual right to assess the internal control of

---

8 *Id.*

9 Proposed Auditing Standard, PCAOB Release No. 2004-002 (Mar. 9, 2004), *available at* http://pcaobus.org/rules/Release-20040308-2.pdf.

10 *Id.*

11 The PCAOB guidance documents are available at http://www.pcaobus.org/Standards/Standards_and_Related_Rules/Auditing_Standard_No.2.aspx; the SEC guidance documents are available at http://www.sec.gov/divisions/corpfin.shtml, under the heading "FAQs and Staff Statements."

the entity, the registrant's management report on the internal control over financial reporting should contain disclosures regarding the entity. For equity investments, the registrant must have control over the recording of amounts in the consolidated financial statements by considering the selection of accounting methods, the recognition of equity method earnings and losses, and its investment account balance.

- *Qualification on internal controls and transition periods.* Management may not conclude that a registrant's internal control over financial reporting is effective if a material weakness exists. Moreover, the registrant is obligated to identify and publicly disclose in its report all material weaknesses. Transition reports should be filed subject to transition provisions applied to the transition period as if it were reported for the end of the fiscal year.

- *Timeline for foreign subsidiaries.* If a registrant has foreign subsidiaries and is thus subject to a lag in reporting financial results, then it may consolidate the operations of its foreign subsidiaries, which have an earlier year-end, for the purpose of an internal control assessment.[12]

The PCAOB guidance addresses, among others issues, the following areas:

- *Independence.* An auditor may not accept an engagement to perform any internal control-related service without pre-approval by the audit committee. If an internal control-related engagement was pre-approved prior to the effective date of Auditing Standard No. 2 in a manner that would not satisfy the new requirement, and the services are ongoing, then the auditor should request a subsequent evaluation from the audit committee as to the appropriateness of the internal control-related engagement.

- *Scope and Extent of Testing.* The auditor's evaluation and testing of controls applies to a company's financial statements and notes as presented in accordance to GAAP, but does not include the preparation of MD&A or other such financial information. The PCAOB also stressed that in order to complete an audit and render an opinion, the auditor must test controls directly, regardless of the company's own assessment. However, if management of the company fails to fulfill its responsibilities of evaluating the effectiveness of its internal control, then the auditor must disclaim an opinion, and the audit cannot be completed.

---

[12] Management's Report on Internal Control Over Financial Reporting and Disclosure in Exchange Act Periodic Reports Frequently Asked Questions (June 22, 2004), *available at* http://www.sec.gov/info/accountants/controlfaq0604.htm, as updated October 6, 2004. The answers in the report reflect the views of the staffs of the Office of the Chief Accountant and the Division of Corporation Finance, but have not been approved by the SEC.

- *Evaluating Deficiencies.* When evaluating whether a significant deficiency or material weakness exists, the auditor should consider the deficiencies both in isolation and in their aggregate. That includes the consideration of compensating controls. The PCAOB also noted that individual controls do not have to operate perfectly at all times to be considered effective. Hence, all control testing exceptions should not be immediately deemed control deficiencies.

- *Multi-Location Issues.* Although Auditing Standard No. 2 provides that an auditor needs to test controls over a "large portion" of the company's operations, there is no specific target percentage. However, when a company has multiple locations or business units, the auditor must select a representative sample, either statistically or non-statistically, such that it would be representative of the entire population. If the SEC has allowed management to exclude certain entities from the assessment, the auditor must include disclosure regarding the exclusion in the report.

- *Using the Work of Others.* The auditor is allowed to use the work of others when the work has been tested for its quality and effectiveness. The auditor need not test every single account in which he or she plans to use another's work. However, the testing of another's work does not count towards the "principal evidence" used to support the auditor's own work. For work that has been performed by another regarding the prevention and detection of fraud, the auditor is allowed to consider the results of the work to make his or her own assessment for additional tests.[13]

On May 16, 2005, the SEC and PCAOB each issued important policy statements, and accompanying guidance, regarding application of their respective internal control requirements.[14] These coordinated policy statements and staff clarifications were intended to respond to many of the concerns that have been voiced about the internal control over financial reporting regime and, in particular, PCAOB Auditing Standard No. 2.

Important clarifications in the communications include: positive statements urging auditors to use their professional judgment in applying Auditing Standard No. 2 and noting that auditors have a great deal of latitude in several areas under Auditing Standard No. 2; additional support for a risk-

---

[13] Staff Questions and Answers, Auditing Internal Control Over Financial Reporting (June 23, 2004), *available at* http://www.pcaobus.org/QA_Staff_Internal_Control.pdf, as updated October 6, 2004. The answers in the report reflect the staff's opinion, but have not been approved by the PCAOB.

[14] The policy statements issued by the SEC, and the guidance issued by the SEC staff, are available at http://www.sec.gov/news/press/2005-74.htm (SEC policy statement), and http://www.sec.gov/info/accountants/stafficreporting.pdf (SEC staff guidance). The PCAOB policy statement and PCAOB staff Q&As are both available under the "News and Events" heading at http://www.pcaobus.org.

based approach to the internal control process; and emphasis that reasonable assurance, while a high-level of assurance, does not mean absolute assurance.

The communications are also notable, in part, for what they do not do: amend Auditing Standard No. 2. As a result, the definitions of material weakness and significant deficiency remain unchanged, and auditors are still required to give an opinion on management's assessment, as well as a separate opinion on the effectiveness of the company's internal controls.

On May 17, 2006, the SEC and PCAOB each issued a press release detailing plans to improve further the implementation of their internal control reporting requirements.[15] The SEC noted that, among other things, it planned to issue a "Concept Release" (as discussed in more detail below in Section II.G.6) for public comment in order to solicit views on the process of assessing internal controls and specifically noted that it will place a particular focus on providing guidance to smaller public companies. The SEC declined to accept the recommendation from its own advisory committee that smaller public companies be exempted from the Section 404 requirements. The PCAOB noted that, among other things (discussed in detail in subsection 5, below), it will consider amendments to Auditing Standard No. 2. Neither entity provided a timetable for such matters. Until such guidance is issued and revisions are approved, the 2005 policy statements and other current guidance should be followed.

Though the SEC declined to exempt smaller public companies from Section 404's requirements, on August 9, 2006, the SEC proposed rule changes that would extend the deadline for compliance with Section 404's internal control over financial reporting requirements for non-accelerated filers. Under the proposed rules, management's assessment will first be required in the annual report for the fiscal year ending on or after December 15, 2007 (formerly July 15, 2007), and the auditors' attestation report will be required in annual reports for fiscal years ending on or after December 15, 2008.[16] Thus, these companies would only be required to provide one of the two reports in their first year of compliance. The Commission's stated intent in staggering the requirements is to help smaller companies minimize the cost spike associated with becoming 404-compliant.[17]

The proposed rule changes would also provide newly public companies with a one-year exemption from Section 404's reporting requirements. Under the proposed rules, newly public

---

[15] The SEC press release is available at http://sec.gov/news/press/2006/2006-75.htm. The PCAOB press release is available at http://www.pcaobus.org/News_and_Events/News/2006/05-17.aspx.

[16] On August 9, 2006, the SEC also issued a final rule extending the deadline for requiring an auditor's attestation report from foreign private issuers that are accelerated filers, but not large accelerated filers. The affected foreign issuers will now have to provide the auditor's attestation report beginning with their annual reports filed for the first fiscal year ending on or after July 15, 2007.

[17] *See* John W. White, Director, Division of Corporate Finance, U.S. Securities and Exchange Commission, Speech by SEC Staff: SOX 404—Moving Forward (Sept. 12, 2006) *available at* http://www.sec.gov/news/speech/2006/spch091206jww.htm.

companies will be allowed to file their first annual report with the SEC free of any internal control over financial reporting reports. As of their second filed annual report, newly public companies will have to fully comply with Section 404.

On July 11, 2006, the SEC published the Concept Release Concerning Management's Reports on Internal Control over Financial Reporting requesting public comment on Section 404's requirements.[18] The SEC's intent is to use the public input to draft rules providing "additional guidance to assist management in its performance of its assessment of internal control over financial reporting." The SEC acted in response to complaints that the limited nature of the SEC guidance currently available had resulted in Auditing Standard No. 2 driving management's implementation and assessment efforts. The Concept Release requested comment on three topics: Risk and Control Identification, Management's Evaluation, and Documentation to Support the Assessment.

1. SEC Policy Statement and SEC Staff Guidance

In its 2005 policy statement, the SEC touched upon several overarching principles that should help reshape the focus of the internal control over financial reporting process. In particular, the SEC noted that it is management's responsibility to determine the form and level of controls appropriate for each company, and that auditors, in turn, should recognize that there is a "zone of reasonable conduct" by companies that should be recognized as acceptable. Building on this core principle, the SEC articulated several broad themes that should flow through the internal control process:

- *Top-down, Risk-based Approach*. The SEC urged management and auditors to bring "reasoned judgment and a top-down, risk-based approach" to the internal control process. As has been emphasized in the past, the SEC underscored that there is no "one-size-fits-all" approach, and that companies and their auditors should tailor implementation efforts to the nature and size of the company. The SEC staff reiterated this point in its guidance, noting that companies should devote resources to the areas of greatest risk and avoid giving all significant accounts and related controls equal attention.

- *Integration of Audits*. The SEC expressed its belief that compliance costs likely can be trimmed if the internal control audit is integrated more effectively with the financial statement audit, and urged auditors to work toward this end.

- *Auditor Communications*. Aiming to dispel concerns that Auditing Standard No. 2 limits an auditor's ability to confer with its client concerning accounting and internal control matters, the SEC noted that discussion with auditors regarding internal controls will not, itself, be deemed an internal control deficiency. In addition, the SEC noted that "as long as management determines the accounting to be used and does not rely on the auditor to

[18] Concept Release Concerning Management's Reports on Internal Control over Financial Reporting, Rel. No. 34-54122, http://www.sec.gov/rules/concept/2006/34-54122.pdf (July 11, 2006).

design or implement the controls, we do not believe that the auditor's providing advice or assistance, in itself, constitutes a violation of our [auditor] independence rules." The SEC staff also clarified that management should not feel constrained in providing draft financial statements to its auditor, even if the financial statements are incomplete, and that errors in the drafts, in and of themselves, should not form the basis for a determination that a deficiency exists.

In addition to amplifying on the broad themes noted by the Commission, the SEC staff provided the following guidance:

- *Reasonable Assurance.* Section 404 requires management to assess whether the company's internal control over financial reporting is effective in providing reasonable assurance over the reliability of financial reporting. The staff emphasized that while "reasonable assurance" connotes a high level of assurance, it does not mean absolute assurance. In the Section 404 context, the staff noted that the "reasonableness" concept does not imply a single conclusion or methodology, but rather encompasses the full range of potential conduct, conclusions or methodologies upon which an issuer may reasonably base a decision. To this point, the staff stated that "[w]hile [the] zone [of reasonableness] is not unlimited, the staff expects that it will be rare when there is only one acceptable choice in implementing Section 404 in any given situation."

- *Timing of Management's Assessment.* To address a concern that management's testing of controls would only be deemed acceptable for purposes of the effectiveness assessment if the testing occurred "as of" the company's year end, the SEC staff clarified that, for a substantial number of controls, effective testing and assessment does not have to be as of the end of the fiscal year.

- *Evaluating Internal Control Deficiencies.* The SEC staff noted that once an internal control deficiency is identified, it is appropriate to undertake both qualitative and quantitative analyses when determining if the deficiency is a significant deficiency or material weakness, including such elements as the nature of the deficiency; its cause; the relevant assertion the control was designed to support; its effect on the control environment; and whether other compensating controls are effective. The staff also noted that neither Section 404 nor the Commission's implementing rules require that a material weakness be found to exist in every case where a restatement is the result of an error.

- *Disclosures About Material Weaknesses*. The SEC staff took this opportunity to reiterate that three elements should be reflected in disclosures regarding the existence of a material weakness: (1) the nature of the material weakness; (2) its impact on financial reporting and the control environment; and (3) management's current plans for remediating the material weakness. The SEC staff highlighted the desirability of providing disclosure that allows investors to distinguish between material weaknesses that may have a pervasive impact on internal control from those that do not.

- *Information Technology ("IT") Controls*. The staff clarified that for purposes of Section 404 compliance, companies should document and test relevant general IT controls, in addition to appropriate application-level controls, that are designed to provide assurance that financial information generated from a company's IT system can be relied upon. Testing of general IT controls that do not pertain to financial reporting, however, is not required.

- *IT System Implementation and Upgrades*. The staff declined to provide an exception (similar to the exception for material business combinations) that would allow issuers to exclude from management's assessment new IT systems and upgrades implemented in the latter part of a fiscal year.

2. SEC Press Release

In its May 17, 2006 press release, the SEC announced a series of actions it intends to take to improve the implementation of the Section 404 internal control requirements based on extensive analysis and commentary from investors, companies, auditors and others. The SEC plans to take the following actions:

- *Guidance for Companies*. The SEC will issue additional guidance for management on how to complete its assessment of internal control over financial reporting and intends to ensure that such additional guidance is helpful to companies of all sizes. The SEC will issue a Concept Release and provide an opportunity for public comment covering a variety of issues that will serve as guidance for management and the appropriate role of outside auditors in the process. The SEC will also consider additional guidance from the Committee of Sponsoring Organizations of the Treadway Commission ("**COSO**") that pertains specifically to smaller public companies in completing their Section 404 assessments and will determine if it needs to issue its own guidance to further aid smaller public companies. The SEC also plans to issue guidance to assist management in the performance of a top-down, risk-based approach to assessing internal controls.

- *PCAOB revisions to Auditing Standard No. 2*. The PCAOB announced in its press release that it intends to propose revisions to Auditing Standard No. 2 (which are subject to SEC approval). The SEC will work closely with the PCAOB to ensure that the proposed revisions are in the public interest and consistent with the protection of investors.

- *Inspection of PCAOB's efforts to improve Section 404 oversight*. As part of its oversight responsibility for the PCAOB, the SEC announced that it plans to review the PCAOB's 2006 inspection process for registered public accounting firms. In particular, the SEC noted that its review will include an inquiry into whether the PCAOB inspections have been effective in encouraging audit firms to implement principles characterized as "cost-saving efficiencies" that the PCAOB outlined in its 2005 guidance.

- *Extension of Compliance Deadline for Non-Accelerated Filers (But Not Exemption from Section 404 Compliance).* The SEC said that it expects to issue a "short postponement" of the effective date for the Section 404 rules for non-accelerated filers in order to permit those companies to have the guidance that the SEC intends to issue and the opportunity to evaluate and implement the revisions to Auditing Standard No. 2. The press release did not contain an exact date. As discussed below, the SEC has subsequently proposed rules to postpone the effectiveness of the Section 404 rules for non-accelerated filers.

3. PCAOB Policy Statement and Staff Q&As

The PCAOB’s 2005 policy statement focuses on many of the same themes identified in the SEC 2005 policy statement but, as would be expected, focuses primarily on the auditor’s role. The PCAOB staff provides additional specifics on several of these topics.

- *Integrated Audit Concept*. Like the SEC, the PCAOB contemplates that greater integration can be achieved between the audits of internal control over financial reporting and the financial statement audit. The PCAOB views the processes as mutually reinforcing as the auditor’s findings during the internal control audit can help in planning and conducting the financial statement audit.

- *Importance of Professional Judgment*. The PCAOB states that Auditing Standard No. 2 “does not prescribe detailed audit programs” and that auditors should use their own audit plans and judgment to address the nature and complexity of the audit client. The PCAOB’s statement critiques some auditors for having used a one-size-fits-all audit plan in the first year of implementation, and characterizes this as a “disappointing development indicative of poor training and audit planning.” It should be noted, however, that the detailed standards set forth in Auditing Standard No. 2 and the guidance issued by the PCAOB staff in fall 2004 were not issued until companies and auditors were underway with the Section 404 process in order to meet the compliance deadlines. The PCAOB also encourages auditors to exercise professional judgment in determining how to apply the standard to different clients, but also to exercise judgment to focus their work on areas that pose higher risks of misstatement.

- *The Top-down Approach and Risk Assessment*. The PCAOB clarifies that Auditing Standard No. 2 is designed to be a top-down approach, and thus auditors should focus first on company-level controls and then on significant accounts and, finally, on individual controls. The PCAOB also encouraged auditors to consider the risk related to each significant account to determine the nature, timing and extent of testing required. This approach should allow auditors to “eliminate from further consideration accounts that have only a remote likelihood of containing a material misstatement.” Another important statement made by the PCAOB is that “strong company-level controls should lead the auditor to do less work than he or she otherwise would have performed or [to] rely to a greater degree on the work of others."

- *Using the Work of Others.* The PCAOB states that Auditing Standard No. 2 provides auditors with "considerable flexibility to use the work of others," and that the "principle evidence" requirement in Auditing Standard No. 2 is not in conflict with this considerable flexibility. This clarification is helpful and should increase the efficiency of the internal control audit process, but significant uncertainty likely will remain regarding application of the principal evidence requirement. Expanding on the flexibility that the auditor has to rely on the work of others, though, the PCAOB notes that: (1) the auditor should perform more work directly in high-risk areas and seek to use the work of others in areas of lesser risk; and (2) in evaluating whether the auditor has met the principal evidence test, the auditor should ascribe more weight to the work he or she performs in high-risk areas.

- *Board Approach to Oversight of Auditing Standard No. 2 Implementation.* The PCAOB noted that it intends to use its upcoming inspections to evaluate how accounting firms have conducted the first round of audits under Auditing Standard No. 2, and noted that it expected their inspections to drive improvements in the effectiveness and efficiency of internal control audits. In this process, the PCAOB presumably will conduct its inspection reviews applying the guidance and standards in place at the time the audits were conducted, rather than attributing the benefit of hindsight and this most recent guidance from the SEC and PCAOB to the audit firms. On a more positive note, the PCAOB also underscored that in the course of its inspections, it "[does] not intend to second-guess good faith audit judgments."

In a series of 17 Q&As, the PCAOB staff provided additional detail on the points highlighted in the PCAOB's policy statement.

- *Risk Assessment.* As a core principle, the PCAOB staff repeatedly notes that there is a direct relationship between the degree of risk that a material weakness could exist in a particular area and the amount of audit attention that should be devoted to that area. Applying this principle, the PCAOB staff noted that there is essentially a sliding scale as to the nature, timing and extent of testing that must be performed. For example, as the risk associated with a control decreases, the persuasiveness of the evidence that the auditor needs to obtain for that control also decreases. The converse would be true as the risk associated with the control increases. Likewise, as to the timing of testing, as the risk associated with a control decreases, the testing may be performed farther from the fiscal year "as of" date. But, as the risk associated with the control increases, the testing should be performed closer to the as-of date.

- *Key Controls.* The PCAOB staff noted that the auditor is not required to test all controls that management has identified as "key" or "significant" controls. Rather, the auditor should first focus on assertions that are relevant to significant accounts and then focus on the controls for the relevant assertions over the significant accounts. The PCAOB staff emphasized that "the auditor need test only those controls that the auditor identifies as controls over relevant assertions related to significant accounts."

- *Prior Year Testing.* Although Auditing Standard No. 2 indicates that "each year's audit must stand on its own," the PCAOB staff clarified that prior year audits can be used to inform risk assessment decisions in the current audit, including, for example, to reduce the sample size for controls tested if the prior-year audit produced a favorable outcome.

- *Benchmarking for Testing Automated Application Controls.* The PCAOB staff provided helpful guidance in clarifying that benchmarking strategies can be used to test automated application controls.

- *Auditor's Use of Management's Self-Assessment of Controls.* Even though Auditing Standard No. 2 provides that the auditor should not use management's "self-assessment" process as evidence to support its opinion, the PCAOB staff suggests that the "self-assessment" concept has taken on a broader meaning in the implementation context than it intended, such that this phrase now is used to refer to numerous different procedures performed by various parties. In this regard, the auditor should evaluate the nature of the "self-assessment" process that it intends to rely on. If the process is not one in which the assessment is made by the same person who is responsible for the control, then it is permissible for the auditor to use the self-assessment as part of its evidence.

- *Auditor Responsibilities with Respect to Section 302 Certification.* The PCAOB staff confirmed that the procedures the auditor is required to perform on a quarterly basis are limited to "inquiry and observation and an evaluation of the implications of any misstatements identified by the auditor during the auditor's required review of interim financial statement." The PCAOB staff emphasized that Auditing Standard No. 2 does not require the auditor to perform a quarterly internal control audit.

4. PCAOB Report on the Initial Implementation of Auditing Standard No. 2

On November 30, 2005, the PCAOB issued a report discussing issues identified in the course of its monitoring of the implementation of Auditing Standard No. 2.[19] The PCAOB found that both firms and issuers faced enormous challenges in the first year of implementation. The most common reasons given by the PCAOB in the report for why audits were not as efficient or effective as the PCAOB expects include the following:

---

[19] The report may be viewed at http://www.pcaobus.org/Rules/Docket_014/2005-11-30_Release_2005-023.pdf.

- not enough integration of audits of internal control with audits of financial statements;
- not enough application of a top-down approach;
- not enough tailoring of the nature, timing, and extent of testing to reflect the level of risk;
- inefficient walkthroughs of major classes of transactions by using different transactions to test each control, rather than walking a single transaction through the entire process;
- not enough use of the work of others to the extent permitted by Auditing Standard No. 2;
- in the face of identified control deficiencies, often discovered late in the audit process, failure to sufficiently evaluate the adequacy of compensating controls; and
- insufficient testing of the most important controls related to preparing financial statement disclosures.

The report also clarifies aspects of Auditing Standard No. 2 and amplifies the guidance issued by the PCAOB in May 2005 as follows:

- The term "more than remote," which appears in the definitions of "significant deficiency" and "material weakness," means "at least reasonably possible." These definitions are designed to lead to a determination as to whether there is a deficiency such that a prudent official does not have reasonable assurance that transactions are recorded to prepare financial statements in conformity with GAAP.
- Circumstances identified in Auditing Standard No. 2 as "strong indicators" of a material weakness are not automatically material weaknesses; rather, they require heightened scrutiny to determine whether a material weakness exists.
- An audit in accordance with Auditing Standard No. 2 should not be designed to detect deficiencies that, individually or in the aggregate, are less severe than a material weakness.
- When the auditor identifies control deficiencies, Auditing Standard No. 2 requires the auditor to evaluate the existence and effectiveness of any compensating controls, which may mitigate the effects of the deficiencies.
- In performing an integrated audit of internal control and the financial statements, the auditor may perform tests of controls that simultaneously satisfy the objectives of both audits.

5. PCAOB Press Release

In conjunction with the SEC's May 17, 2006 press release, the PCAOB also issued a press release announcing a four-point plan to improve auditors' implementation of internal control reporting and assessment. The PCAOB's goal is to continue to protect investors through the requirement of internal control reporting while implementing guidance, revisions to Auditing Standard No. 2 and auditor inspections to ensure that assessments are done in an efficient and cost-effective manner. In continuation of its efforts to assist with the implementation of Auditing Standard No. 2, the PCAOB will undertake four initiatives:

- *Amend Auditing Standard No. 2*. The PCAOB will consider amendments that will reinforce its expectation that an integrated audit be conducted in the most efficient manner while achieving the objectives of the standard by incorporating key concepts contained in its May 2005 guidance (with a view to minimizing any disruptions to on-going audits based on such guidance). The potential amendments include:
    - clarifying the definitions of "significant deficiency" and "material weakness";
    - reconsidering the "strong indicators of a material weakness" to allow for more judgment in determining whether a deficiency exists;
    - guiding auditors to increase their use of work of others where appropriate;
    - clarifying materiality and scoping decisions;
    - emphasizing the integration of audit of internal control with the audit of the financial statements; and
    - allowing for and promoting auditors' use of experience gained in previous years' audits to focus and make most efficient the work in subsequent years.
- *Reinforce Auditor Efficiency through Inspections*. On May 1, 2006, the PCAOB issued a statement that its 2006 inspections of registered public accounting firms will focus on the firms' efficiency in conducting internal control audits.[20] The May 17, 2006 press release references this earlier statement, and noted that the PCAOB welcomes the SEC's announced intention to inspect its implementation of the 2006 inspections.

---

[20] The press release may be viewed at http://www.pcaobus.org/News_and_Events/News/2006/05-01a.aspx

- *Provide Guidance and Education for Auditors of Small Companies*. The PCAOB plans to develop or facilitate development of implementation guidance for auditors of smaller public companies as well as identify and provide training opportunities for those auditors specific to internal control over financial reporting.

- *Continue PCAOB Forums on Auditing in the Small Business Environment*. The PCAOB will hold a total of eight forums in 2006 for the auditors, directors and financial officers of smaller public companies, which will provide both general education about PCAOB issues as well as monitor in real-time the reactions of these individuals to various internal-control related implementation changes.

6. Concept Release Concerning Management's Reports on Internal Control over Financial Reporting

On July 11, 2006, the SEC published a Concept Release soliciting public comments on the topic of providing the management of public companies additional guidance on how best to comply with Section 404.[21] The Concept Release presents 35 direct questions to elicit specific comment on areas of concern for the SEC. The SEC's goal is to issue the additional guidance in the form of a rule.

The structure of the Concept Release is based on feedback the SEC received since the original implementation of Section 404. Based on comments made at the 2005 and 2006 Roundtables as well as responses to the guidance issued on May 16, 2005, the SEC undertook to use the Concept Release to "understand better the extent of public interest in the development of additional guidance for management."[22] Thus, the Concept Release solicits comment on (1) Risk and Control Identification, (2) Management's Evaluation, and (3) Documentation to Support the Assessment.

- *Risk and Control Identification*. To have effective internal control over financial reporting, a company must both identify risks to reliable financial reporting and design appropriate internal controls addressing those risks. However, feedback to the SEC revealed that many companies were inefficient and ineffective at these tasks, wastefully identifying, documenting, and testing excessive numbers of controls. In response, the SEC plans to issue guidance on two fronts: how management should set overall objectives for internal control over financial reporting and identify

---

[21] Comments may be submitted at http://www.sec.gov/spotlight/soxcomp.htm, through a link under the "Rulemaking" heading. The official comment period closes September 18, 2006.

[22] Concept Release Concerning Management's Reports on Internal Control over Financial Reporting, Rel. No. 34-54122, http://www.sec.gov/rules/concept/2006/34-54122.pdf (July 11, 2006).

the related risks, and, how management can identify significant controls associated with the recognized risks.

- *Management's Evaluation*. The SEC advocates management take a top-down risk-based approach to deciding what to consider in the assessment process. Feedback indicated that accelerated filers had higher-than-anticipated Section 404 compliance costs because they were doing too much work testing and documenting low-risk areas. In response, the SEC intends to provide guidance on several issues related to improving risk assessment and use of controls, including: evaluation objectives, evidence gathering methodologies, scope and timing of evaluation procedures, and assessment of the severity of identified control deficiencies.

- *Documentation to Support the Assessment*. Companies must maintain adequate evidential matter to allow meaningful evaluation of the effectiveness of internal controls over financial reporting, and to support management conclusions about the controls' effectiveness. In response to complaints that companies incurred significant documentation costs in the first year of compliance with Section 404, the SEC plans to provide guidance on appropriate levels of documentation retention.

H. Proposed Amendments to NYSE Corporate Governance Listing Standards

On November 23, 2005, the New York Stock Exchange (the "**NYSE**") filed proposed amendments to its corporate governance listing standards with the SEC for approval.[23] Among other things, the proposals would impact the NYSE's director independence requirements and related proxy disclosures and would mandate notification to the NYSE of any non-compliance with its corporate governance listing standards. Although the NYSE's filing states that its board of directors approved the proposed amendments in April 2005, the SEC must publish them for comment and approve them before they take effect.

The most significant amendments proposed by the NYSE involve its director independence standards. According to the NYSE's filing, the independence disclosures that many companies provided in their 2005 proxy statements either were "not sufficient to allow investors to adequately assess the quality of the board's independence determination" or stated that particular directors had relationships with companies without explaining the basis for the board's determination that these relationships did not preclude independence. In addition, according to the NYSE, many companies were "confused" by the concept of categorical independence standards and often were using the NYSE's bright-line independence tests as the sole criteria in assessing director independence. To date, the prevailing practice has been to adopt categorical independence standards because the listing standards permit companies to disclose these standards in their proxy statements and make a general

---

[23] The NYSE filing, which includes a mark-up showing the proposed changes to the text of the Listed Company Manual, may be viewed at http://www.nyse.com/pdfs/NYSE-2005-81.pdf.

disclosure that their independent directors meet the standards "without detailing particular aspects of [any] immaterial relationships between the individual directors and the company."

To clarify the types of disclosure that companies must provide, the NYSE has proposed two alternative disclosure approaches. Under one approach, a company's board could determine that certain types of relationships are categorically immaterial, and the company could disclose these types of relationships in its proxy statement. For companies that select this alternative, no additional disclosure would be required about individual directors' relationships that fall within the categories of immaterial relationships established by the board. Importantly, boards would not be permitted to treat as categorically immaterial any relationship that is required to be disclosed as a related party transaction under Item 404 of Regulation S-K. Accordingly, for each independent director, the independence disclosures in a company's proxy statement would have to include a discussion of any Item 404 related party transactions that the board determined were not material in concluding that the director is independent. In some cases, however, the disclosure thresholds in Item 404 are lower than those in the NYSE's bright-line independence tests. For example, Item 404 would require disclosure of a transaction between a listed company and an entity where a director is an executive officer if the transaction represented more than 5% the entity's annual revenues, even if the amount of the transaction were less than $1 million, while under the NYSE's business relationship test, the transaction would not preclude the director from being independent unless it exceeded a minimum of $1 million.

Under the other approach proposed by the NYSE, a company could disclose in its proxy statement that an independent director has no relationships with the company (other than as a director and/or shareholder) or has only immaterial relationships. If an immaterial relationship exists, the company would have to provide a "specific description" of the relationship and disclose the basis for the board's determination that the relationship is immaterial and therefore does not preclude a determination of independence.

The proposed amendments also would expressly prohibit companies from summarizing or incorporating disclosures about director independence by reference from another document or a company's website. In view of the proposals, companies should revisit their independence standards and consider the independence disclosures to be included in their upcoming proxy statements.

The remaining amendments proposed by the NYSE would address, among other things:

- *Notification of non-compliance with corporate governance requirements*. CEOs would be required to notify the NYSE in writing promptly after an executive officer becomes aware of any non-compliance with the NYSE's corporate governance listing standards. Currently, notification is required only with respect to a material non-compliance, which also triggers an obligation to file a Form 8-K.

- *Disclosure of code-of-conduct waivers*. Companies would be required to disclose waivers of their codes of conduct that are granted to directors and executive officers within four business days. This is a change from guidance contained in the NYSE's Frequently Asked Questions, in which the NYSE stated that two to three business days would constitute "prompt" notification to shareholders of a waiver, and is being proposed for consistency with the Form 8-K disclosure requirements. The proposed amendments also would specify that companies must disclose waivers by press release, on their websites, or on a Form 8-K.

- *Audit committee review of MD&A.* Current NYSE listing standards require that audit committees "meet" to review and discuss the disclosures in the "Management's Discussion and Analysis of Financial Condition and Results of Operations" section of the company's annual and quarterly reports. The proposed amendments would clarify that telephonic meetings satisfy the meeting requirement if permitted by state corporate law, but that polling audit committee members in lieu of a meeting is not permitted.

- *Executive sessions*. Current NYSE listing standards require that non-management directors hold regular executive sessions and recommend (but do not require) that the independent directors meet by themselves in executive session at least once per year. In recognition of the fact that some boards have chosen to limit all executive sessions to independent directors, the proposed amendments would clarify that regular executive sessions of the independent (rather than non-management) directors satisfy the NYSE requirement. Similarly, companies could satisfy the requirement to establish procedures for "interested parties" to communicate with the presiding director or the non-management directors as a group through procedures that provide for communication with the independent directors only.

- *Corporate governance disclosures and webposting of corporate governance documents*. Currently, various provisions of the NYSE's corporate governance listing standards require that companies make specific disclosures about their corporate governance practices in their proxy statements (or annual reports, for companies that do not file proxy statements), and that companies post their corporate governance documents (including their corporate governance guidelines, codes of conduct, and key committee charters) on their websites. The proposed amendments would prohibit companies from incorporating other required proxy disclosures by reference from another document or a company's website. In addition, the proposals would: (a) eliminate the requirement that companies disclose in their proxy statements that their corporate governance documents are available on their websites; (b) expressly require that companies have and maintain a website; and (c) consolidate the requirements relating to proxy statement and website disclosure in a separate section of the corporate governance listing standards.

- *CEO and SEC Certifications*. Companies would no longer be required to disclose in their annual reports to shareholders (or annual reports on Form 10-K) that they have filed the most recent annual CEO certification mandated by the NYSE (as to compliance with the corporate governance listing standards) and the Section 302 certification required in their most recent annual report. According to the NYSE, this provision caused "significant confusion" because it related to certifications made during a prior year and is no longer necessary in view of SEC disclosure requirements, including the requirement to disclose on a Form 8-K any material non-compliance with NYSE listing standards.

- *Phase-in requirements for companies listing in connection with IPOs*. Companies listing on the NYSE in connection with an IPO would have until the earlier of the date the IPO closes or five business days from the date that trading begins on the NYSE to have one independent director on each of the audit, compensation, and nominating/governance committees. Current listing standards require each of these committees to have one independent committee member as of the date of listing, but according to the NYSE, market practice has been not to appoint independent directors prior to the closing of an IPO due to prospectus liability concerns. Current listing standards also provide a transition period that gives companies listing in connection with an IPO 90 days to have a majority of independent members on their key committees and one year to have fully independent committees. The proposed amendments would extend this transition period to the requirement that companies have a three-person audit committee, giving companies listing in connection with an IPO up to one year after listing to appoint three members to the audit committee. This would avoid the need for companies to appoint directors who are not independent to their audit committees in order to satisfy the three-person minimum.

- *Controlled companies*. The proposed amendments would clarify that a "controlled company" is one in which 50% or more of the voting power for the election of directors is held by an individual, a group, or another company. The proposals also would establish deadlines by which companies that cease to be controlled companies must comply with the requirements for a majority independent board and fully independent compensation and nominating/governance committees. A company would be required to have a majority of independent directors on its board within one year from the date it ceased to be a controlled company. It would be required to have one independent director on each of its compensation and nominating/governance committees on that date, a majority of independent directors within 90 days, and fully independent committees within one year.

- *Foreign private issuers*. Foreign private issuers would be required to disclose on their websites significant differences between their corporate governance practices and NYSE-required practices rather than having the option to provide this disclosure in their annual reports or on their websites.

I. Electronic Notifications of Effectiveness Orders

On April 25, 2006, the SEC announced an effort to provide broader and more timely public notice of important SEC actions and on May 22, 2006, the staffs of the Divisions of Corporation Finance and Investment Management began using the EDGAR system to issue notifications of effectiveness for Securities Act registration statements and post-effective amendments (other than those that become effective automatically by law).[24] These notifications are posted to the EDGAR system the morning after a filing is determined to be effective.

It is important to note that while the Divisions no longer prepare and mail paper effectiveness orders associated with these filings, registrants continue to be notified promptly by telephone that their registration statements or post-effective amendments are effective.

Additionally, as of May 22, 2006, the SEC's website also distributes EDGAR form type effectiveness notices called "EFFECT", posting a list of filings declared effective on the previous business day. For the first time, an interested person can search for a company's filings and be able to see when the staff declared a particular Securities Act registration statement effective.

Orders relating to applications for registration as a transfer agent or as a municipal securities dealer, prepared by the SEC's Office of Filings and Information Services, are also supplemented by electronic notifications distributed through EDGAR on the morning after those applications are granted. The SEC stated that it believes "that this is a significant step in providing an on-line picture of a company's filing history for both registrants and the public." The SEC continued that "the implementation of this new system will afford members of the public and participants in securities offerings prompt, reliable public confirmation that registration statements are effective."

J. Institutional Shareholder Services Updates for 2006 Proxy Season and Related Developments

In November 2005, Institutional Shareholder Services ("**ISS**"), a leading proxy advisory firm, released its U.S. and international corporate governance policy updates for the 2006 proxy season.[25] Among other of the policy positions released in November 2005:

- ISS now considers recommending a vote "Against" a shareholder proposal seeking implementation of a majority voting standard in the election of directors if a company has adopted a corporate governance principle that addresses certain key points and the company satisfies other criteria.

- ISS factors in long-term stock price performance when determining voting recommendations on director nominees in uncontested elections.

---

[24] SEC to Replace Many Paper Effectiveness Orders With Electronic Notifications of Effectiveness, Release No. 2006-61 (April 25, 2006), *available at* http://www.sec.gov/news/press/2006/2006-61.htm.

[25] The text of the U.S. policy updates may be viewed at http://www.issproxy.com/pdf/2006USPolicyUpdate111705.pdf and the text of the international policy updates may be viewed at http://www.issproxy.com/pdf/2006InternationalPolicyUpdate.pdf. ISS has also issued guidance on the 2006 policy updates in the form of questions and answers. *See* "Majority Elections: Questions and Answers on ISS 2006 Voting Policy," *available at* http://www.issproxy.com/pdf/FAQMVPolicy2006.pdf.

- ISS considers recommending "Withhold" votes from director nominees who serve on audit committees where the company has serious internal controls issues and from nominees who serve on compensation committees where the company has poor compensation practices. ISS also encourages compensation committees to include "tally sheet" or other total compensation disclosures with respect to CEO compensation.

1. Shareholder Proposals on Majority Voting Standards

For 2006, ISS generally supports "reasonably crafted" shareholder proposals (regardless of whether binding or non-binding) asking a company to implement a majority voting standard in uncontested director elections. However, ISS considers recommending votes "Against" this type of shareholder proposal if the company has adopted formal corporate governance principles that "present a meaningful alternative to the majority voting standard and provide an adequate response to both new nominees as well as incumbent nominees who fail to receive a majority of votes cast." At a minimum, such principles should:

- apply to each nominee in an uncontested election who fails to receive affirmative votes of a majority of the votes cast in the election (i.e., not a majority of outstanding shares standard);
- contain guidelines that are disclosed annually in the company's proxy statement;
- provide a clear and reasonable timetable for all decision-making regarding the status of a nominee who does not receive a majority vote;
- state that the process for determining the nominee's status will be managed by independent directors, excluding the nominee in question;
- detail the range of remedies that can be considered concerning the nominee (i.e., accept a resignation from the nominee, cure issues underlying the voting results, etc.);
- commit to prompt disclosure of the nominee's status via an SEC filing; and
- describe the timeline for disclosing the directors' decision regarding a nominee's status and explaining how the decision was reached.

The ISS 2006 policy updates states that "[i]n addition, the company should articulate to shareholders why this alternative [implementing a corporate governance policy on majority voting as opposed to changing the voting standard] is the best structure at this time for demonstrating accountability to shareholders." Finally, in considering its voting recommendation, ISS also evaluates the company's accountability to shareholders, including whether it has a classified board or a history of not responding to shareholder proposals that received a majority vote.

2. Voting Recommendations on Director Nominees

a. Performance Test for Directors

ISS determines on a case-by-case basis whether to recommend "Withhold" votes from directors at a company where weighted one-, three- and five-year total shareholder return is at the low range within the company's industry peer group. In evaluating the voting recommendation for nominees at such companies, ISS will take into account:

- any performance improvement in the current year;
- changes in management or board composition;
- recent transactions at the company;
- the company's overall governance practices; and
- the company's financial health.

b. Overboarded Directors

ISS continues to recommend "Withhold" votes from a director who serves both as a CEO of a publicly-traded company and on more than three public company boards (including his or her own company's board), but will only make that recommendation with respect to the CEO's service on other company's boards. ISS also continues to recommend "Withhold" votes from any director nominee who is not an active CEO and serves on more than six public company boards.

c. Director Independence Definition

ISS categorizes directors as "inside directors," "affiliated outside directors" or "independent outside directors" and applies these categories for various purposes in its voting recommendations. For example, ISS recommends "Withhold" votes from director nominees it classifies as "affiliated outside directors" if such directors serve on a company's audit, compensation or nominating committee. ISS updated its definition of an "affiliated outside director" to include:

- an interim CEO who served longer than 18 months (if such service lasted between 12 and 18 months, ISS will assess the interim CEO's employment agreement);
- one of the company's founders; and
- a nominee with "[a]ny material financial tie or other related party transactional relationship to the company."

d. Director Term Limits

When making voting recommendations on director nominees, ISS now includes "cautionary language" in its voting recommendation report if the average tenure for the entire board exceeds 15 years.

e. Failure to Respond to Shareholder Proposals that Receive Majority Support

ISS recommends "Withhold" votes from incumbent director nominees at companies who have ignored a shareholder proposal that either (i) was approved by a majority of the votes cast for two consecutive years, or (ii) was approved by a majority of the shares outstanding at the last shareholders' meeting. Some companies have attempted to avoid the ISS recommendation by proposing action to implement the shareholder proposal but not recommending that shareholders vote for the action. ISS clarified that this approach will not avoid a "Withhold" recommendation.

3. Audit Committee Members

In considering whether to recommend "Withhold" votes from directors who serve on a company's audit committee, ISS assesses on a case-by-case basis whether the company is one where:

- a material weakness in internal controls over financial reporting rises to a level of a "serious concern;"
- there are "chronic" internal control issues; and
- there is an "absence" of established effective control mechanisms.

4. Compensation Committee Members

a. "Poor" Compensation Practices

ISS recommends "Withhold" votes from directors who serve on a company's compensation committee (and, if applicable, may recommend votes "Against" an equity compensation plan proposal), if the company has poor compensation practices. ISS notes that poor disclosure of compensation practices compounds the problem of excessive pay. ISS's non-exclusive list of "poor" pay practices includes:

- egregious employment/severance agreements;
- excessive perks that dominate compensation;
- huge bonus payouts not sufficiently linked to performance;
- performance metrics that are changed during the performance period;
- egregious Supplemental Executive Retirement Plan ("**SERP**") payouts;
- a new CEO with an overly generous new hire package; and
- internal pay disparity.

b. Tally Sheets for CEOs

While not adopting a formal "Withhold" vote policy, ISS is "strongly encouraging" companies to disclose "tally sheet" or other total compensation information on the CEO's pay. The disclosure should itemize base salary, stock options, restricted stock, performance shares, deferred compensation, SERPs, perquisites, tax gross-ups, various forms of severance and any post-retirement pay package. ISS's 2006 policy updates include an example of the items that might be covered by a "tally sheet." Although this sample tally sheet reflects the difficulty in developing a uniform "total compensation" calculation by encompassing both grant and payout valuations, the ISS representatives stated that they are sensitive to concerns about double-counting. For those companies that do not meet a minimum standard of tally sheet disclosure, ISS will note the deficiency and provide cautionary language in its voting recommendation report.

5. Company Compensation Proposals

a. New Voting Criteria

In considering whether to recommend votes "For" an equity compensation plan, ISS no longer evaluates voting power dilution under the plan and instead measures plan cost only through the ISS Shareholder Value Transfer ("**SVT**") calculation. ISS views the ability to provide dividend equivalent rights under a plan as increasing SVT. ISS has also made it easier for a company with a high burn rate to nevertheless obtain a "For" recommendation on an equity plan proposal by committing to lower the burn rate in the future. In addition, ISS does not apply its burn rate standard to certain types of plan amendments.

b. Treatment of Transferable Stock Options (TSOs)

ISS expects that companies may increasingly implement, on either a one-time or an on-going basis, a program that permits options to be transferred for value to a third party (along the lines of the option transfer program that Microsoft announced in late 2003). ISS recommends "Withhold" votes from compensation committee members if they fail to seek shareholder approval of a one-time TSO program. On the other hand, ISS will recommend votes "For" a one-time TSO program if it meets certain standards (including that executives and directors not be able to participate), and it does not recommend votes against a stock plan or plan amendment solely on account of a TSO feature.

6. Other Types of Company Proposals

ISS's 2006 policy updates include new and/or revised voting policies on company proposals to ratify poison pills, to increase the authorized number of shares of common stock and to engage in a transaction that will allow the company to cease to be an SEC reporting company ("going dark" transactions).

7. Voting Policies on Shareholder Proposals

ISS also has new and/or revised voting policies on a variety of shareholder proposals, including cumulative voting proposals, proposals seeking to restrict or eliminate poison pills, and proposals on a number of corporate responsibility issues. The latter include statements on when ISS will recommend a vote against proposals on disclosure of political contributions and proposals addressing policies on nuclear safety, toxic chemicals, drug reimportation, animal testing and drug pricing.

8. ISS Corporate Governance Quotient

The ISS Corporate Governance Quotient ("**CGQ**") is a benchmarking tool that rates the corporate governance structures and policies of nearly 7,500 companies worldwide. Covered companies receive two scores in percentiles relative to the scores of other covered companies in their index and industry groups, respectively. A covered company's CGQ scores are posted on Yahoo! Finance and are featured on the front of each company's ISS proxy analysis issued in advance of the company's shareholders' meeting.

ISS revised the CGQ in June 2005 and, as a result, many company CGQ scores decreased. For example, companies no longer receive CGQ points for having a lead independent director, but a company will receive additional CGQ points if it commits to conduct individual director performance reviews annually and includes only financial experts on its audit committee. Moreover, CGQ scores fluctuate as companies in an index or peer group revise their corporate governance practices. Companies should check their CGQ scores, to consider what, if any, changes in their corporate governance practices are appropriate and to reflect those changes in their proxy or governance policies.

9. Suggested Practices

The ISS 2006 policy updates reflect significant feedback from ISS's clients, from the corporate community and from others. They reflect increased focus from institutional shareholders on board governance and director independence issues and on executive compensation practices. At the same time, ISS has stated that an increasing number of its institutional shareholder client base - particularly the largest institutional shareholders - have implemented or are working with ISS to implement customized voting guidelines that reflect particular concerns of the client's proxy voting committee. In addition, it is important to note that ISS's voting policies are extensive and continue to cover many issues in addition to those addressed in the 2006 policy updates.

The 2006 policy updates and the voting policies of other proxy advisory firms and of institutional shareholders can significantly impact the vote that companies receive on matters presented to their shareholders. In addressing the 2006 updates, companies should consider the following steps:

- Consider the discussions and policy issues that are raised by director majority vote proposals and the new ISS voting policy. Evaluate what approach, if any, may be appropriate for the company to adopt. See that the board has a clearly articulated basis for any policy that it adopts.

- Consider the nature and relevance of any material financial ties or other related party transactional relationships between the company and its director nominees, and whether those relationships will affect the vote on a director who serves on the company's audit, compensation or nominating committee.

- Use directors' and officer's questionnaires to address all issues of interest to proxy advisory firms. For example, determine if any director will be considered "overboarded" by ISS and, if relevant, discuss the situation with the director (and the nominating committee) before finalizing proxy materials.

- The compensation committee should carefully review and make sure that the proxy discloses all elements of compensation. If applicable, the committee should explicitly describe the manner in which compensation payouts have been tied to company performance, including how that performance was measured. Clarity and precision in the compensation committee report is increasingly important.

- Companies should highlight in their proxy statements or governance policies steps that have been taken or are being implemented to respond to poor corporate performance or the perception of poor governance or compensation practices.

- Reevaluate how ISS will view the company's equity compensation plans in light of the new SVT and burn rate calculations. Also, reconsider whether ISS will recommend "Withhold" votes from compensation committee members because of the "pay for performance" criteria that ISS adopted in 2005 or the "poor" compensation practices standard included in the 2006 policy updates.

III. The Sarbanes-Oxley Act of 2002 and Rules Thereunder

On July 30, 2002, President George W. Bush signed into law the Sarbanes-Oxley Act.[26] This sweeping legislation addressed a number of issues of critical importance to public companies. Among its many provisions are those that established new certification and disclosure requirements applicable to companies and their CEOs and CFOs, including: the restriction of certain executive officer and director transactions; the acceleration of Section 16 reporting; the imposition of new obligations on corporate audit committees; the establishment of a new regulatory body to oversee public company auditors and to redefine the relationship between auditors and their clients; the imposition of new rules of professional responsibility on attorneys and securities analysts; and the enhancement of a variety of enforcement measures and criminal penalties for securities-related offenses. In addition, the Sarbanes-Oxley Act requires the SEC to study and issue reports on a variety of topics.

Many provisions of the Sarbanes-Oxley Act are applicable to any issuer that is subject to reporting requirements under Section 13(a) or 15(d) of the Exchange Act. As a result, many of the provisions are applicable to foreign companies that are subject to the Exchange Act. Some provisions are also applicable to companies that have registered debt under the Securities Act or that

---

[26] The Sarbanes-Oxley Act of 2002, 15 U.S.C.A. § 7201 (2002), *available at* http://www.financialservices.house.gov/media/pdf/H3763CR_HSE.PDF.

have voluntarily or contractually undertaken to file Exchange Act reports, even though their equity securities may not be publicly traded.

The Sarbanes-Oxley Act covers a wide variety of issues. In many cases, the Sarbanes-Oxley Act instructs the SEC (alone or in conjunction with other regulatory organizations) to adopt implementing or clarifying regulations. In addition, in the Sarbanes-Oxley Act, Congress provided the SEC general authority to adopt "such rules and regulations, as may be necessary or appropriate in the public interest or for the protection of investors, and in furtherance of," the Sarbanes-Oxley Act. In the last year, the SEC has adopted a number of final rules to implement sections of the Sarbanes-Oxley Act.

A. Code of Ethics for Senior Financial Officers

In a January 23, 2003 release, the SEC adopted rules implementing Section 406 of the Sarbanes-Oxley Act, which requires disclosure about a company's code of ethics.[27] The rules, which go beyond the requirements of Section 406, require an issuer to disclose in its annual report whether or not it has a code of ethics applicable to its chief executive officer and senior financial officers. An issuer that has adopted a code of ethics must disclose this fact in its annual report on Form 10-K. Issuers that have not adopted a code of ethics must disclose their reasons for failing to do so. Additionally, an issuer must make the code available to the public by attaching a copy of that code as an exhibit to its annual report on Form 10-K, posting it on the company's website or providing copies of the code upon written request.

The rules define a "code of ethics" to be a codification of standards reasonably designed to: (i) deter wrongdoing and promote honest and ethical conduct; (ii) provide full, fair, accurate, timely and understandable disclosure in public reports; (iii) comply with applicable laws; (iv) ensure the prompt internal reporting of code violations; and (v) provide accountability for adherence to the code.

The rules require the prompt disclosure of any change in or waiver of an issuer's code of ethics that applies to the issuer's principal executive officer or senior financial officer. This disclosure may be made by a Form 8-K filing or by publishing a statement on the issuer's website. Issuers who elect to disclose this information on their websites, however, must give advance notice of that election in their annual reports on Form 10-K. They also must disclose the specific website address where the code of ethics information may be found.

Finally, foreign issuers are required under the rules to disclose annually, on Form 20F, whether or not they have adopted a code of ethics. Because foreign issuers are not required to file current reports (similar to Form 8-K) under U.S. law, they should disclose modifications to, and waivers of, their codes in their periodic reports or on their websites.

The final rules became effective March 1, 2003.

---

[27] Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Release Nos. 33-8177, 34-47235 (Jan. 23, 2003), *available at* http://www.sec.gov/rules/final/33-8177.htm.

B. Audit Committee Financial Experts

The SEC also issued rules implementing Section 407 of the Sarbanes-Oxley Act, which requires annual disclosure regarding "audit committee financial experts."[28] Under the rules, an issuer must disclose whether or not at least one member of its audit committee is an audit committee financial expert. If an issuer's audit committee does not have such an expert, the issuer must explain their reasons for not having one. The rules permit, but do not require, the issuer to disclose the number and names of the "audit committee financial experts" serving on its audit committee. Finally, the issuer must disclose whether the audit committee financial expert or experts serving on its audit committee are "independent" of management.

The rules define the term "audit committee financial expert" as a person with all of the following attributes:

- an understanding of GAAP and financial statements;
- the ability to assess the general application of GAAP in connection with the accounting for estimates, accruals and reserves;
- experience preparing, auditing, analyzing or evaluating financial statements that are of the same level of complexity as those that can be expected to be in the registrant's financial statements or experience supervising people engaged in such activities;
- an understanding of internal controls and procedures for financial reporting; and
- an understanding of audit committee functions.

Under the rules, a company's audit committee financial expert must acquire such qualifications through one or more of the following means:

- education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor, or experience in one or more positions that involve the performance of similar functions;
- experience "actively supervising" a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions;
- experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of the financial statements; or
- other relevant experience.

If a person qualifies as an audit committee financial expert by virtue of "other relevant experience," the rules require the company to briefly list that person's relevant experience.

---

[28] *Id.*

The rules implementing Section 407 also apply to foreign issuers. A foreign issuer's audit committee financial expert must have an understanding of the generally accepted accounting principles used by the foreign issuer in preparing its primary financial statements filed with the SEC. It is not mandatory that a foreign issuer's audit committee financial expert possess expertise relating to U.S. GAAP principles, but the release indicates that an ability to reconcile the foreign issuer's accounting principles to U.S. GAAP principles may be helpful.

The final rules contain a safe harbor providing that an audit committee financial expert will not be deemed an "expert" for any other purpose, including for purposes of Section 11 of the Securities Act. Additionally, the rules provide that the designation of a person as an audit committee financial expert does not impose any duties, obligations or liability on the person that are greater than those imposed on such person as a member of the audit committee in the absence of such designation, nor does it affect the duties, obligations or liability of any other member of the audit committee or board of directors.

The final rules became effective March 1, 2003. Since the rules took effect, practices with respect to disclosure about audit committee financial experts have varied among companies. Nearly all companies have named at least one audit committee financial expert. Some companies have elected to disclose that they have two or more audit committee financial experts, while other companies have chosen to disclose the name of only one audit committee financial expert even though other committee members qualify as such.

C. Conditions for the Use of Non-GAAP Financial Information and Filing of Earnings Releases

In a release dated January 22, 2003, the Commission adopted rules pursuant to Section 401(b) of the Sarbanes-Oxley Act providing that non-GAAP financial information included in any periodic or other report filed with the Commission, or in any public disclosure or press or other release, be presented in a manner that: (i) does not contain an untrue statement of material fact or omit to state a material fact necessary to make the pro forma financial information, in light of the circumstances under which it is presented, not misleading and (ii) reconciles such pro forma information with the financial condition and results of operations of the issuer under GAAP. In order to implement the Section 401(b) directive, the Commission adopted Regulation G and amended Item 10 of Regulations S-K and S-B (the "**Item 10 Amendments**").[29] Additionally, the Commission amended Form 8-K to require public companies to file certain press releases.

1. Regulation G

Regulation G requires any public company that publicly discloses material information that includes a non-GAAP financial measure to accompany the non-GAAP information with the most direct comparative GAAP financial measure and provide a quantified reconciliation of the non-GAAP financial measure with the most direct comparative GAAP financial measure.

---

[29] Conditions for Use of Non-GAAP Financial Measures, Release Nos. 33-8176, 34-47226 (Jan. 22, 2003), *available at* http://www.sec.gov/rules/final/33-8176.htm.

A non-GAAP financial measure is defined as a numeric measure of an issuer's financial performance that either: (i) excludes amounts or is subject to adjustments that have the effect of excluding amounts, that are included in the comparative measure calculated and presented in accordance with GAAP in the statement of income, balance sheet or statement of cash flows of the issuer or (ii) includes amounts or is subject to adjustments that have the effect of including amounts that are excluded from the comparative measure calculated and presented in accordance with GAAP. A non-GAAP financial measure does not include:

- operating and other statistical measures such as unit sales and number of employees;
- ratios or statistical measures that are calculated using exclusively one or both of: (i) financial measures calculated in accordance with GAAP and (ii) operating measures or other measures that are not non-GAAP financial measures; or
- financial measures required to be disclosed by GAAP, SEC rules or governmental or self-regulatory rules that are applicable to a registrant.

Examples of non-GAAP financial measures include earnings before interest and taxes ("**EBIT**"), earnings before interest, taxes, depreciation and amortization ("**EBITDA**") and operating income that excludes expense or revenue items identified as non-recurring. Examples of ratios and measures that are GAAP financial measures include sales per square foot (if the sales figure is computed in accordance with GAAP), same store sales (if the sales figure is computed in accordance with GAAP), estimated revenues or expenses of a new product line (if the estimates are made in the same manner as would be computed under GAAP) and measures of profits and losses for segments required to be disclosed in accordance with GAAP.

If the non-GAAP financial measure is released orally, telephonically, by webcast, by broadcast or by similar means, the company may provide the accompanying information required by Regulation G by posting the information on the company's website and disclosing the location and availability of the required accompanying information during its presentation.

Regulation G and Regulation FD operate in tandem. Thus, for example, if a company official communicates material, non-public information regarding a non-GAAP financial measure to an analyst or a shareholder, it must satisfy the Regulation FD public disclosure requirements and the Regulation G requirements regarding quantitative reconciliation.

With regard to the reconciliation of forward-looking non-GAAP financial measures, Regulation G requires a schedule or other presentation detailing the differences between the forward-looking non-GAAP financial measure and the appropriate forward-looking GAAP financial measure. If the GAAP financial measure is not accessible on a forward-looking basis, the registrant must disclose that fact and provide reconciling information that is available without an unreasonable effort. The company must also identify information that is unavailable and disclose its probable significance.

Regulation G also prohibits public companies from making public disclosure of a non-GAAP financial measure which, when taken together with the information accompanying it, contains an untrue statement of material fact, or omits to state a material fact necessary in order to make the presentation of the non-GAAP financial measure, in light of the circumstances presented, not misleading.

Regulation G applies to all public companies, including foreign private issuers. An exception exists, however, for certain disclosures or releases of non-GAAP financial measures made by foreign private issuers when the following three conditions are met: (i) the securities of the foreign private issuer are listed or quoted on a securities exchange or inter-dealer quotation system outside the United States; (ii) the non-GAAP financial measure and comparative financial measure are not presented in accordance with U.S. GAAP; and (iii) the disclosure is made outside the United States or is included in a written communication released only outside the United States or the communication is released in the United States, but occurs contemporaneously with or after the release of information outside the United States and is not otherwise targeted at persons located in the United States. As applied to foreign private issuers, GAAP refers to the accounting principles of the country under which the issuer's principal financial statements are prepared.

Regulation G does not apply to disclosure of non-GAAP financial information relating to a proposed business combination, if the disclosure is contained in a communication that is subject to the communications rules applicable to business combination transactions.

2. Item 10 Amendments

As noted above, the Commission also amended Item 10 of Regulations S-K and S-B to codify the Commission's policy on the use of non-GAAP financial information in SEC filings by requiring any non-GAAP presentations to be accompanied by a quantified reconciliation to GAAP as well as a discussion of why investors may find such non-GAAP financial measures useful. As adopted, Item 10 permits the use of non-GAAP per-share measures and EBITDA measures.

For purposes of these amendments, the definition of non-GAAP financial measures is the same as it is for Regulation G. These amendments require companies using non-GAAP financial measures in filings with the SEC to provide:

- a presentation, with equal or greater prominence, of the most directly comparable GAAP financial measure;
- the same quantified reconciliation to GAAP as required by Regulation G;
- a statement disclosing the reasons why the company's management believes that presentation of the non-GAAP financial measure provides useful information to investors regarding the registrant's financial condition and results of operations; and
- to the extent material, a statement disclosing the additional purposes, if any, for which the registrant's management uses the non-GAAP financial measures that are not otherwise disclosed.

With respect to forward-looking information, the rules include the same unreasonable efforts exception from quantitative reconciliation as that contained in Regulation G. In addition, Item 10 of Regulations S-K and S-B prohibit the following:

- excluding charges or liabilities that required, or will require, cash settlement, or would have required cash settlement absent an ability to settle in another manner, from non-GAAP liquidity measures, other than EBIT or EBITDA;
- adjusting a non-GAAP performance measure to eliminate or smooth items identified as non-recurring, infrequent or unusual, when: (i) the nature of the charge or gain is such that it is reasonably likely to recur within two years or (ii) there was a similar charge or gain within the prior two years;
- presenting non-GAAP financial measures on the face of the registrant's financial statements prepared in accordance with GAAP or in the accompanying notes;
- presenting non-GAAP financial measures on the face of any pro forma financial information required to be disclosed by Article 11 of Regulation S-X; and
- using titles or descriptions of non-GAAP financial measures that are the same as, or confusingly similar to, titles or descriptions used for GAAP financial measures.

Unlike the proposed rules, the final rules do not prohibit the use of non-GAAP per share financial measures.

The Item 10 prohibitions do not apply to SEC filings submitted by a non- U.S. issuer if:

- the non-GAAP financial measure relates to the GAAP used in the issuer's primary financial statements included in its filing with the SEC;
- the non-GAAP financial measure included in the SEC filing is required or expressly permitted by the standard setter that is responsible for establishing the GAAP used in such financial statements; and
- the non-GAAP financial measure is included in the annual report prepared by the issuer for use in the jurisdiction in which it is domiciled, incorporated or organized for distribution to its security holders.

3. Item 2.02 of Form 8-K

Finally, the Commission added Item 12 to Form 8-K, now Item 2.02 of Form 8-K, requiring public companies to "furnish" any earnings release or earnings announcement for any completed fiscal period on Form 8-K.[30] Item 2.02 relates to any public announcement or release that discloses

---

[30] As originally proposed, this Item of Form 8-K would have required registrants to "file" the quarterly information on a Form 8-K. As adopted, however, Item 2.02 requires that the registrant only "furnish" this information on a Form 8-K. The difference between "furnishing" and "filing" is that information "furnished" to the Commission is: (i) not subject to Section 18 of the Exchange Act unless the registrant specifically states that the information is to be considered

material, non-public information regarding a registrant's results of operations or financial condition for a completed annual or quarterly fiscal period (generally, an earnings release) that is made after March 28, 2003. The rule does not, however, require companies to issue earnings releases or other press releases.

The filing requirement is triggered when material, non-public information is released regarding results of operations or financial operations for a completed fiscal quarter or year, but is not triggered by earnings updates during a fiscal period unless such earnings updates include material non-public earnings information for a *completed* fiscal period. However, any public disclosure of financial information for a completed fiscal period that is made orally, telephonically, by webcast, broadcast or other similar means in a presentation that is complementary to, and occurs within 48 hours after, a related written release or announcement that triggers the requirements of Item 2.02 would not be required to be furnished if:

- the related, written release or announcement has been furnished to the SEC on Form 8-K pursuant to Item 2.02 prior to the presentation;
- the presentation is broadly accessible to the public by dial-in conference call, webcast or similar technology;
- the financial and statistical information contained in the presentation is provided on the company's web site, together with any information that would be required under Regulation G; and
- the presentation was announced by a widely disseminated press release that included instructions as to when and how to access the presentation and the location on the company's web site where the information would be available.

Pursuant to Item 2.02, within four days of the public announcement or release, registrants will be required to furnish to the SEC a Form 8-K identifying the public announcement or release and including the announcement or release as an exhibit.

Item 2.02 requires that any earnings release furnished to the SEC must present the most directly comparable GAAP financial measure with equal or greater prominence as the non-GAAP financial measure presented and must provide a reconciliation to the most directly comparable GAAP financial measure.

If any non-GAAP financial measure is used in a public announcement or release, then the requirements of Regulation G are triggered and, in addition, Item 2.02 of Form 8-K requires that the most directly comparable GAAP financial measure be presented with equal or greater prominence and that an explanation be included in the Form 8-K report (or in the release or announcement) as to why management believes the non-GAAP financial measure is useful to investors.

"filed"; (ii) not incorporated by reference into a registration statement, proxy statement or other report unless the registrant specifically incorporates that information into those documents by reference; and (iii) not subject to the requirements of amended Item 10 of Regulation S-K or Item 10 of Regulation S-B. Final Rule: Conditions for Use of Non-GAAP Financial Measures, Release No. 33-8176, (Jan. 22, 2003), *available at* http://www.sec.gov/rules/final/33- 8176.htm.

An earnings release that triggers the requirements of Item 2.02 is also subject to Regulation FD. Regulation FD permits a registrant to satisfy its disclosure obligations under that rule by furnishing the relevant information to the SEC pursuant to Item 7.01 of Form 8-K, as long as the registrant furnishes the information within the time frame required by Regulation FD. A registrant may simultaneously satisfy the requirements of the new earnings release rule and those of Regulation FD by furnishing a release to the SEC pursuant to Item 2.02 and Item 7.01 of the same Form 8-K, as long as it furnishes the release within the time frames required by both rules.

4. Points to Remember

Companies should consider the following when they review their use of non-GAAP financial information:

- Non-GAAP financial measures may not appear on the face of financial statements or pro formas, or in the related notes. If a company wants to use these measures in a Form 10-K, Form 10-Q or registration statement, it should include them in the MD&A discussion.
- In SEC filings, non-GAAP financial measures may not be given more prominence than GAAP measures.
- Companies should expect the SEC staff to carefully scrutinize non-GAAP financial measures that exclude non-recurring charges and to challenge the categorization of a charge as non-recurring.
- If management plans to disclose a non-GAAP financial measure in a conference call or meeting with investors and analysts, it should post the reconciliation required by the new rules on its website before the call, and inform participants that the reconciliation is available on the website.
- The staff has indicated informally that the ratio of earnings to fixed charges is not a non-GAAP financial measure within the meaning of the new rules, since disclosure of this measure is required by SEC rules.
- The staff has also indicated that disclosure of revenues generated by a particular product line will not be treated as a non-GAAP financial measure, as long as the total revenues presented for each product line equal the revenue amount presented in the company’s financial statements.
- If a company discloses non-GAAP financial information and complies with Regulation FD by “furnishing” the information to the SEC pursuant to Item 7.01 of Form 8-K, it need not comply with Item 10 requirements. The staff has clarified that the requirements apply only to material that is “filed” with the SEC, and not to material “furnished” to the SEC.

With respect to the earnings release requirement, companies should keep in mind the following points:

- Repetition of earnings release information in quarterly and annual reports to shareholders does not trigger a new filing requirement.
- Corrections that are material will trigger a new filing requirement.

- Companies that schedule earnings release conference calls can satisfy their obligations under both Item 2.02 and Regulation FD by: (i) furnishing the earnings release to the SEC on Form 8-K at the same time that the release is publicly disseminated; (ii) posting the release on the website; (iii) ensuring that the public has access to the call; and (iv) making a public announcement regarding the call. To avoid having to file a transcript of the earnings call (where material nonpublic information is provided during the call), the call should be held within 48 hours of the time the release is first disseminated and furnished on Form 8-K.
- Companies should be aware that the foregoing requirement regarding website posting is broader than the obligation under Regulation FD. Regulation FD does not necessarily require that earnings information disclosed in a conference call be posted on the company's website, whereas the new rules do require that the information be posted.
- Companies should remember that if they include a non-GAAP financial measure in an earnings release that is required to be furnished under Item 2.02 of Form 8-K, Item 2.02 requires most of the disclosures contained in Item 10(e), including a reconciliation to GAAP, presentation of the most directly comparable GAAP measure at least as prominently as the non-GAAP financial measure, management's belief as to why the non-GAAP measure is useful to investors and, if material and not otherwise disclosed, identification of any other purposes for which management uses the non-GAAP financial measure. The prohibitions set forth in Item 10(e)(1)(ii), however, do not apply.
- Earnings information furnished on Form 8-K will not be automatically incorporated by reference in registration statements. Companies that wish to incorporate the earnings release information by reference into a registration statement that is already on file may state in their 8-K that they want the earnings release to be incorporated by reference.

In general, companies should be aware of the potential breadth of the new 8-K requirement. Read literally, the rule applies whenever management discloses material, nonpublic information regarding its results of operation or financial condition for a completed annual period or quarter. Thus, for example, if the CEO provides information regarding revenue attributable to a particular product line or information regarding a particular type of expense for a completed quarter during a conference call with analysts, this information arguably must be furnished to the SEC pursuant to Item 2.02 of Form 8-K.

D. Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements, Contractual Obligations and Contingent Liabilities and Commitments

In a January 27, 2003 release, the SEC adopted amendments implementing Section 401(a) of the Sarbanes-Oxley Act.[31] Section 401(a) added Section 13(j) to the Exchange Act, which required the Commission to adopt final rules mandating each annual and quarterly financial report required to be filed with the Commission to disclose "all material off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of the issuer with unconsolidated entities or other persons that may have a material current or future effect on financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenues or expenses."

The SEC's rules implemented this requirement by adding Item 303(a)(4) to Regulation S-K, requiring a registrant to provide an explanation of its off-balance sheet arrangements in a separately captioned subsection of the "Management's Discussion and Analysis" (MD&A) section in its disclosure documents, including Forms 10-K and 10-Q. The rules also require registrants (other than small business issuers) to provide an overview of certain known contractual obligations in a tabular format. Obligations that must be presented in tabular form include long-term debt, capital lease obligations, operating leases, purchase obligations and other long-term liabilities reflected on the issuer's balance sheet under GAAP. The table must disclose the aggregate amounts of such obligations existing as of the latest fiscal year end balance sheet date coming due within less than one year, within one to three years, within three to five years and after five years. The first three categories of contractual obligations are defined by reference to U.S. GAAP accounting pronouncements. The SEC has stated that a registrant that prepares its financial statements in accordance with non-U.S. GAAP, however, should include in the table contractual obligations that are consistent with the classifications used in the GAAP under which its primary financial statements are prepared.

The rules include a "definition of 'off-balance sheet arrangements' that primarily targets the means through which companies typically structure off-balance sheet transactions or otherwise incur risks of loss that are not fully transparent to investors."[32] The definition of "off-balance sheet arrangements" employs concepts in accounting literature in order to define the categories of arrangements with precision. The definition includes the following categories of contractual arrangements:

- certain guarantee contracts;
- retained or contingent interests in assets transferred to an unconsolidated entity;
- derivative instruments that are classified as equity; and

---

[31] Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements, Contractual Obligations and Contingent Liabilities and Commitments, Release Nos. 33-8182, 34-47264 (Jan. 27, 2003), *available at* http://www.sec.gov/rules/final/33-8182.htm.

[32] *Id.*

- material variable interests in unconsolidated entities that conduct certain activities.

The rules require disclosure of off-balance sheet arrangements that either have, or are reasonably likely to have, a current or future effect that is material to investors. Disclosure is to be made regarding the registrant's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources. That disclosure threshold is "consistent with the existing disclosure threshold under which information that could have a material effect on financial condition, changes in financial condition or results of operations must be included in MD&A."[33]

Disclosure of off-balance sheet arrangements must include material facts and circumstances that provide investors with a "clear understanding" of the company's off-balance sheet arrangements and their material effects. The disclosure must cover the most recent fiscal year, and should discuss changes from the previous year if such a discussion is necessary to an understanding of the disclosure. The following specific disclosures must be made:

- the reasons for using off-balance sheet arrangements;
- the financial importance of off-balance sheet arrangements;
- the magnitude of off-balance sheet arrangements and circumstances that could trigger obligations; and
- the risks of termination of benefits from the arrangements.

The final rules also include a "principles-based requirement" that registrants must provide "such other information that the registrant believes is necessary" for an understanding of its off-balance sheet arrangements and the material effects of these arrangements on its "financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources."

The term "off-balance sheet arrangements" is defined by reference to U.S. GAAP, and the requirement to make the disclosures applies regardless of the GAAP under which an issuer's primary financial statements are presented. The SEC has stated in its release announcing the disclosure requirements that it is not, however, imposing U.S. GAAP on non-U.S. issuers and that a non-U.S. issuer's MD&A disclosure should continue to focus on its primary financial statements, despite the fact that its disclosures regarding its off-balance sheet arrangements are defined by reference to U.S. GAAP. The SEC has also confirmed that the requirements regarding the disclosure of off-balance sheet arrangements do not apply to Form 6-K reports submitted to the SEC by non-U.S. issuers. Consequently, a non-U.S. issuer is not required to update its disclosures regarding off-balance sheet arrangements more frequently than annually unless it files a registration statement with the SEC that includes interim period financial statements.

Off-balance sheet arrangements should be aggregated into groups or categories that provide information in an efficient manner, avoiding unnecessary repetition and the disclosure of immaterial

---

[33] *Id.*

information. Common or similar effects that result from groups of off-balance sheet arrangements must be analyzed in the aggregate if such aggregation increases understanding. The final rules do not require disclosure of preliminary negotiations of off-balance sheet arrangements. Disclosure is required only if a binding definitive agreement is executed or, if there is no such agreement, when settlement of the transaction occurs.

The MD&A discussion of off-balance sheet arrangements need not repeat information provided in the footnotes to the financial statements. Instead, the registrant may make cross-references to specific information in the relevant footnotes. The registrant should integrate the substance of the footnotes into the MD&A discussion so that readers understand the significance of the information that is not included in the body of the discussion.

Registrants are required to comply with the disclosure requirements for off-balance sheet arrangements in Commission filings that are required to include financial statements for the fiscal years ending on or after June 15, 2003. Registrants are also required to comply with the tabular reporting format for selected obligations on Commission filings that are required to include financial statements for the fiscal years ending on or after December 15, 2003.

On June 15, 2005, the SEC released a staff report regarding off-balance sheet arrangements, special purpose entities and related issues as mandated by Section 401(c) of the Sarbanes-Oxley Act.[34] Section 401(c) requires the SEC to study issuer filings and issue a report concerning the use of off-balance sheet arrangements and to assess the transparency and adequacy of current issuer financial statements in reporting off-balance sheet arrangements. The staff report sets several goals for increasing the quality and transparency of financial reporting, including:

- discouraging transaction structures that are motivated by non-economic concerns such as accounting and reporting;
- expanding the use of objective-oriented standards rather than rule-based standards;
- improving the consistency and relevance of disclosures, including supplemental disclosure beyond the basic financial statements; and
- improving issuers' focus on communication with investors, not on technical rule compliance.

The staff report also provides recommendations for changes in accounting and reporting standards, such as:

- additional accounting guidance concerning consolidation of financial statements of other entities;

[34] The text of the staff report can be found on the SEC's website at: http://www.sec.gov/news/studies/soxoffbalancerpt.pdf.

- reconsideration of accounting standards for defined-benefit retirement arrangements;

- reconsideration of accounting standards for leases;

- continued exploration of fair value reporting of all financial instruments; and

- development of a clearer and more concise disclosure framework for the notes to the financial statements.

E. Insider Trades During Pension Fund Blackout Periods

Section 306(a) of the Sarbanes-Oxley Act prohibits directors or executive officers of an issuer from, either directly or indirectly, purchasing, selling or otherwise acquiring or transferring any equity security of the issuer (other than an exempted security) during any pension fund blackout period with respect to such equity security if the director or officer acquired the equity security in connection with his or her service or employment as a director or executive officer.

In a January 22, 2003 release, the Commission adopted rules to clarify the application of Section 306(a).[35] Known as Regulation Blackout Trading Restriction ("**Regulation BTR**"), the rules incorporate many of the concepts used in Section 16 of the Exchange Act. Section 306(a) and Regulation BTR took effect on January 26, 2003.

Section 306(a) applies to directors and executive officers of reporting companies (including foreign private issuers, banks and savings associations and small business issuers). The term "director" has the same definition under the Exchange Act rules and the term "executive officer" means "officer" as defined in Section 16(a) of the Exchange Act (as opposed to the definition of "officer" in Rule 3b-2 under the Exchange Act).

Section 306(a) of the Sarbanes-Oxley Act applies to equity securities, but under Regulation BTR, this term also includes derivative securities (as defined in the rules under Section 16 of the Exchange Act relating to equity securities). Regulation BTR also applies to indirect and direct acquisitions and dispositions of equity securities where a director or executive officer has a pecuniary interest in the transaction. The term "pecuniary interest" also has the same meaning it has under the Section 16 rules, thereby including certain acquisitions and dispositions made by family members, partnerships, corporations, limited liability companies and trusts.

Regulation BTR exempts the following transactions:

- acquisitions of equity securities under dividend or interest reinvestment plans;
- purchases or sales of equity securities that satisfy the affirmative defense conditions of Exchange Act Rule 10b5-1(c) (that is, Rule 10b5-1 trading plans);
- purchases or sales of equity securities pursuant to certain employee benefit plans, other than "discretionary transactions" (as defined under the Section 16 rules);

[35] Insider Trades During Pension Fund Blackout Periods, Release No. 34-47225 (Jan. 22, 2003), *available at* http://www.sec.gov/rules/final/34-47225.htm.

- compensatory grants and awards of equity securities pursuant to programs under which grants and awards occur automatically;
- exercises, conversions or terminations of certain derivative securities which, by their terms, occur only on a fixed date or are exercised, converted or terminated by a counter-party who is not subject to the influence of the director or executive officer;
- acquisitions or dispositions of equity securities involving a bona fide gift or a transfer by will or the laws of descent and distribution;
- acquisitions or dispositions of equity securities pursuant to a domestic relations order;
- sales or other dispositions of equity securities compelled by the laws or other requirements of an applicable jurisdiction;
- acquisitions or dispositions of equity securities in connection with a merger, acquisition, divestiture or similar transaction occurring by operation of law; and
- increases or decreases in equity securities holdings resulting from a stock split, stock dividend or pro rata rights distribution.

Regulation BTR also specifies the timing and content of an issuer's notice obligations to directors, executive officers and the Commission.

The Section 306(a) statutory prohibition is triggered only if the blackout period lasts more than three consecutive business days and temporarily suspends the ability of at least 50% of the participants or beneficiaries under all individual account plans maintained by the issuer to purchase or sell an interest in issuer equity securities held in an account plan.

Different standards apply to foreign private issuers. Regulation BTR provides that, in the case of a foreign private issuer, the Section 306(a) trading prohibition is only triggered if the 50% test is satisfied and the number of U.S. plan participants subject to the temporary trading suspension is either: (i) greater than 15% of the issuer's worldwide workforce; or (ii) greater than 50,000 in number.

Section 306(a) also provides remedies for violation of the prohibition. An issuer or a security holder of that issuer (on behalf of the issuer) may bring an action to disgorge profits realized by a director or executive officer who trades during a blackout period. Additionally, a violation of the trading prohibition would subject the director or executive officer to possible enforcement action by the Commission.

Pursuant to new Item 5.04 of Form 8-K, effective March 31, 2003, a registrant is required to file notice of pension fund blackout periods with the SEC on the same day as such notice (as required under Section 306(a)) is transmitted to the registrant's directors and executive officers.

The Department of Labor also issued rules regarding pension fund blackout periods on January 24, 2003. New Section 101(i) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), as enacted by the Sarbanes-Oxley Act, requires that written notice be provided to participants and beneficiaries of individual account plans of any blackout period during which their right to make investments, obtain loans or obtain distributions may be suspended. The new rules give guidance to plan administrators and participants regarding the requirements for furnishing these notices. They also establish procedures for the assessment of civil penalties by the Department of Labor for failure to comply with the notice requirements.

F. Standards of Professional Responsibility for Attorneys "Appearing and Practicing" before the SEC

In a January 29, 2003 release, the SEC issued rules implementing Section 307 of the Sarbanes-Oxley Act. The rules took effect on August 5, 2003.[36] Section 307 directs the SEC to set forth standards of professional conduct for attorneys "appearing and practicing" before the Commission in the representation of issuers.

1. Overview

The final rules adopted by the SEC:

- require attorneys to report evidence of misconduct up-the-ladder to an issuer's chief legal officer (or chief legal officer and chief executive officer) and board of directors;
- permit issuers to create a Qualified Legal Compliance Committee ("**QLCC**") as an alternative procedure for reporting evidence of misconduct;
- set forth circumstances under which an attorney may disclose confidential information to the SEC without the consent of the issuer-client; and
- create a safe harbor from private liability for violations of the rules.

The rules supplement standards of professional conduct maintained by states and other jurisdictions and are not meant to limit states from imposing additional obligations not inconsistent with the rules. Where state standards conflict with the rules, however, the rules will govern. Preemption of state standards is most likely to arise with respect to disclosure of confidential client information, as discussed below.

2. Attorneys Appearing and Practicing Before the SEC

The final rules require attorneys "appearing and practicing" before the SEC in the representation of issuers to report evidence of a material violation of law or breach of fiduciary duty by the issuer or its agent up-the-ladder to the chief legal counsel ("**CLO**") or to both the CLO and the chief executive officer ("**CEO**"). If the CLO or CEO fails to provide an "appropriate response" to the evidence, the attorney must report the evidence to the audit committee, another independent committee or the full board of directors.

---

[36] Implementation of Standards of Professional Conduct for Attorneys, Release Nos. 33-8185, 34-47276 (Jan. 29, 2003), *available at* http://www.sec.gov/rules/final/33-8185.htm.

The term "appearing and practicing" is defined to include:

- transacting any business with the SEC, including communications in any form;
- representing an issuer in SEC administrative proceedings or in connection with any SEC investigation, inquiry, information request or subpoena;
- providing advice with respect to the federal securities laws or SEC rules thereunder regarding any document that the attorney has notice will be filed with or submitted to the SEC; and
- advising an issuer as to whether information or a statement, opinion or other writing is required to be filed with or submitted to the SEC.

The rules do not apply to an attorney who engages in the above activities other than in the context of providing legal services to an issuer with whom the attorney has an attorney-client relationship. Thus, attorneys at public broker-dealers and other issuers who are licensed to practice law and who may transact business with the SEC, but who are not in the legal department and do not provide legal services within the context of an attorney-client relationship, are not covered by the rules. The adopting release emphasizes, however, that attorneys need not serve in an issuer's legal department to be covered if they are providing legal services within the context of an attorney-client relationship.

The rules also do not apply to non-appearing foreign attorneys. The term "non-appearing foreign attorney" is defined as an attorney who: (i) is admitted to practice law in a jurisdiction outside the United States; (ii) does not hold himself or herself out as practicing, and does not give legal advice regarding, U.S. federal or state law; and (iii) conducts activities that would constitute appearing and practicing before the SEC only incidentally to a foreign law practice or in consultation with U.S. counsel. A foreign attorney must satisfy all three parts of the definition to be excluded from the rules. The rules also contain a provision stating that an attorney practicing outside the United States will not be required to comply with the rules to the extent that compliance is prohibited by applicable foreign law.

Under the rules, an attorney who is retained or directed by an issuer to investigate evidence of a material violation will be deemed to be "appearing and practicing" before the SEC. At the same time, the rules relieve attorneys retained or directed to investigate or litigate reports of violations from reporting up-the-ladder under certain circumstances. Specifically, an attorney retained or directed by the CLO to investigate evidence of a material violation is not obligated to report that evidence up-the-ladder if: (i) the attorney reports the results of the investigation to the CLO; and (ii) except where the attorney and the CLO each reasonably believes that no material violation exists, the CLO reports the results to the board, an independent board committee or the QLCC. Similarly, an attorney retained or directed by the CLO to assert a colorable defense on behalf of the issuer or the issuer's agent in any investigation or judicial or administrative proceeding relating to evidence of a material violation has no obligation to report that evidence up-the-ladder if the CLO reports the progress and outcome of the proceeding to the board, an independent board committee or the QLCC. An attorney retained or directed by a QLCC to investigate evidence of a material violation or to assert a colorable defense on behalf of the issuer or the issuer's agent in any investigation or judicial or administrative proceeding relating to evidence of a material violation has no obligation to report that evidence up-the-ladder.

3. Material Violations

The rules set forth an objective standard for determining which types of evidence will trigger an attorney's reporting obligations. These obligations will be triggered only if the attorney has "credible evidence" based upon which it would be unreasonable for a prudent and competent attorney not to conclude that it is "reasonably likely" that a material violation has occurred, is ongoing or is about to occur. The adopting release indicates that to be "reasonably likely," a material violation must be more than a mere possibility but need not be "more likely than not."

The term "material violation" is defined to include a material violation of U.S. federal or state securities law, a material breach of fiduciary duty arising under U.S. federal or state law, or a similar material violation of any U.S. federal or state law. The term "breach of fiduciary duty" refers to any breach of fiduciary or similar duty to the issuer recognized under an applicable U.S. federal or state statute or at common law, including misfeasance, nonfeasance, abdication of duty, abuse of trust and approval of unlawful transactions.

4. Obligations of Chief Legal Officer

Upon receiving evidence of a material violation, the CLO must cause an appropriate inquiry into the evidence to determine whether the alleged violation has occurred, is ongoing or is about to occur. If the CLO determines that no material violation exists, he or she must notify the reporting attorney and advise him or her of the basis for such determination. Unless the CLO reasonably believes that no material violation exists, however, he or she must take "all reasonable steps" to cause the issuer to adopt an appropriate response, and must advise the reporting attorney of the response.

In lieu of causing such an inquiry, the CLO may refer a report of evidence to the QLCC (discussed below), but only if the issuer has established the QLCC prior to the report.

5. Appropriate Response

As noted above, an attorney who does not receive an "appropriate response" from the CEO or CLO after reporting evidence of misconduct is required to report the evidence to the issuer's audit committee, another board committee consisting solely of directors who are not employed by the issuer (if the board has no audit committee) or the full board of directors (if the board has no committee consisting solely of directors who are not employed by the issuer). The rules provide that an "appropriate response" is one that leads the reporting attorney to reasonably believe:

- that no material violation has occurred, is ongoing or is about to occur;
- that the issuer has adopted appropriate remedial measures to stop ongoing violations, prevent future violations and remedy or otherwise address past violations; or
- that the issuer (with the consent of the board, an independent board committee or the QLCC) has retained or directed an attorney to review the reported evidence and has either (i) substantially implemented any remedial recommendations made by such attorney or (ii) been advised that such attorney may assert a colorable defense on behalf of the issuer or its agent in any investigation or proceeding relating to the reported evidence.

The adopting release states that the factors a reporting attorney might consider in determining whether he or she could "reasonably believe" that an issuer's response was appropriate include the amount and weight of evidence of a material violation, the severity of the apparent material violation, and the scope of the investigation into the report.

6. Qualified Legal Compliance Committee

The rules authorize an issuer to create a QLCC as an alternative procedure for reporting evidence of material violations. This alternative procedure permits, but does not require, an attorney to report evidence of a material violation directly to a QLCC, if the issuer has previously formed such a committee. Under the rules, an attorney who reports evidence to a QLCC is deemed to have satisfied his or her reporting obligations and is not required to assess the issuer's response to the evidence.

Under the rules, a QLCC may be a separate committee of the issuer's board of directors, or it may be an audit or other standing committee of the board. In any event, the QLCC must consist of at least one member of the issuer's audit committee and two or more additional directors who are not employed by the issuer and who are not, in the case of a registered investment company, "interested persons." The SEC has indicated that it does not intend for service on a QLCC to result in increased liability for any member of the board under state law.[37]

The QLCC must adopt written procedures for the confidential receipt, retention and consideration of any report of evidence of a material violation. In addition, the QLCC must have the authority and responsibility to:

- inform the issuer's CLO and CEO of any report of evidence of a material violation;
- determine whether an investigation is necessary and, if so, to: (i) notify the audit committee or the full board; (ii) initiate an investigation; and (iii) retain such additional expert personnel as the QLCC deems necessary;
- at the conclusion of any such investigation: (i) recommend (by majority vote) that the issuer implement an appropriate response; and (ii) inform the CLO, CEO and board of the results of the investigation and the appropriate remedial measures to be adopted; and
- acting by majority vote, take "all other appropriate action."

Under the rules, although the QLCC must have the authority and responsibility to recommend that an issuer implement an appropriate response, the QLCC is not required to direct the board or the issuer to take action. The QLCC must have the authority, however, to notify the SEC if the issuer fails to implement an appropriate response that the QLCC has recommended.

---

[37] *Id.*

7. Documentation Requirements

Proposed documentation requirements, which would have imposed mandatory record-keeping obligations upon issuers and attorneys, were eliminated from the final rules. The SEC believes, however, that voluntary documentation of attorney reports and issuer responses may be appropriate in many cases.

8. Issuer as Client

The rules provide that an attorney appearing and practicing before the SEC in the representation of an issuer owes his or her professional and ethical duties to the issuer as an organization, not to the issuer's individual officers, directors or employees. The reference in the proposed rules to an attorney having a duty to act in the "best interests" of the issuer and its shareholders was not included in the final rules.

9. Disclosure of Confidential Information

An attorney who has reported evidence of a material violation may use that report (and any response to the report) in connection with any investigation, proceeding or litigation in which the attorney's compliance with the rules is at issue. In addition, the rules provide that an attorney may, without the issuer's consent, reveal to the SEC confidential information related to the representation to the extent that the attorney reasonably believes necessary to:

- prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interests or property of the issuer or investors;
- prevent the issuer, in an SEC investigation or administrative proceeding, from committing perjury or another illegal act that is likely to perpetrate a fraud on the SEC; or
- rectify the consequences of a material violation by the issuer that caused, or may cause, substantial injury to the financial interests or property of the issuer or investors, in furtherance of which the attorney's services were used.

As noted above, the rules are not intended to restrict states from imposing more stringent obligations not inconsistent with the rules. To the extent that state standards conflict with the rules, however, the rules will govern. This is particularly significant in jurisdictions that bar the disclosure of information permitted to be disclosed under the SEC rules.

10. Responsibilities of Supervisory and Subordinate Attorneys

Under the rules, a "supervisory attorney" (including a CLO) must make reasonable efforts to ensure that any subordinate attorney whose actions are supervised or directed by the supervisory attorney conforms to the rules. To the extent that a subordinate attorney appears and practices before the SEC in the representation of an issuer, that attorney's supervisory attorneys also appear and practice before the SEC. Furthermore, a supervisory attorney is responsible for complying with the rules' reporting requirements when a subordinate attorney has reported evidence of a material violation to the supervisory attorney.

A "subordinate attorney" is deemed to have complied with the reporting requirements if the subordinate attorney reports to his or her supervisory attorney evidence of a material violation of which the subordinate attorney has become aware. The rules provide, however, that an attorney who appears and practices before the SEC under the direct supervision of the CLO is not considered a subordinate attorney and therefore, must comply with the reporting requirements in full.

11. Remedies and Safe Harbor

The rules provide that an attorney who violates the rules will be subject to all civil penalties and remedies available to the SEC under the federal securities laws.

The rules include a safe harbor to protect attorneys, law firms and issuers from private liability for violations of the rules. The rules are not intended to, nor do they, create a private right of action based upon compliance or non-compliance with rule provisions.

12. Additional Proposed Rules Regarding Attorney Conduct and "Noisy Withdrawal"

On January 29, 2003, the SEC revised and extended the comment period for its proposed rules relating to "noisy withdrawal" by attorneys.[38] As initially proposed, the noisy withdrawal rules would require attorneys to withdraw and report to the SEC if the issuer's board failed to respond appropriately to evidence of a material violation. In response to comments, the SEC extended the comment period and proposed an alternative approach under which the issuer (not the attorney) would be required to disclose a notification by one of its attorneys of his or her withdrawal or failure to receive an appropriate response. To date, the SEC has not acted on either proposal.

13. Enforcement Actions

a. Gatekeeper

On September 23, 2004, the SEC instituted, and simultaneously settled, cease-and-desist proceedings against an attorney whose "failure to fulfill his gatekeeper role" as general counsel of an issuer was a cause of the issuer reporting materially false financial results.[39] Specifically, the attorney failed to provide important information to the issuer's audit committee, board of directors and auditors regarding a significant accounting transaction that enabled the issuer to report a profit rather than a loss. According to the SEC, the attorney's inaction allowed the issuer's chief financial officer and controller to hide an ongoing fraud. Moreover, while in possession of written legal advice stating that the law prohibited the transaction at issue, the attorney was involved in the review process for the issuer's quarterly report filed with the SEC describing the transaction and the resulting impact on the issuer's income.

---

[38] Implementation of Standards of Professional Conduct for Attorneys, Release Nos. 33-8186, 34-47276 (Jan. 29, 2003), *available at* http://www.sec.gov/rules/final/33-8186.htm.

[39] In the Matter of John E. Isselmann, Jr., Release No. 34-50428 (Sept. 23, 2004), *available at* http://www.sec.gov/litigation/admin/34-50428.htm.

Although the cease-and-desist proceedings related to events that occurred prior to the effective date of the SEC's up-the-ladder reporting rules, they clearly demonstrate the SEC's willingness to pursue attorneys who fail to fulfill their "gatekeeper" role under the federal securities laws.

b. Negligence

The SEC has generally been exceedingly cautious about bringing actions challenging legal advice and has repeatedly affirmed that it will not proceed against attorneys for mere professional negligence. However, the SEC's recent decision in In re Ira Weiss may signal the SEC's new willingness to sue securities lawyers whose mere professional negligence results in violations of the federal securities laws.[40]

Ira Weiss, an experienced bond attorney, was sued by the SEC for legal work performed in connection with a tax-exempt municipal bond offering by a Pennsylvania school district. Weiss issued an unqualified legal opinion that the bonds had been validly issued and the interest payable on the bonds would be exempt from the federal income tax. The IRS later determined that the interest was, in fact, taxable. The SEC found that the attorney violated Sections 17(a)(2) and 17(a)(3) of the Securities Act, which do not require proof of intentional or reckless conduct. Under these sections, mere negligence suffices to establish a violation. The SEC noted that Weiss's conduct was "at least negligent" and that Weiss's conduct had "departed from the standard of reasonable prudence." Given the SEC's continued focus on "gatekeepers," virtually every enforcement investigation today examines the conduct of the attorneys. The decision may signal a belief that it is appropriate to investigate and charge attorneys whose professional negligence results in violations of the securities laws.

14. Google, Inc.

On January 13, 2005, the SEC charged Google, Inc. for failing to meet the requirements of various registration exemptions for stock options issued before its initial public offering in the fall of 2004 and charged its general counsel for causing the violation. The charge against Google, Inc. and its general counsel may indicate a change in the SEC's willingness to charge lawyers personally for advising a legal strategy that is later determined to violate securities law.

The SEC appears to be expressing a view that no violations of law are minor and that the costs of violating the law cannot be measured by civil litigation costs. Attorneys disregarding legal requirements, even seemingly minor matters, will not be overlooked by the SEC, even if no economic harm results. The Google case shows that the quality of legal services and the diligence review undertaken will be factors in an enforcement review if the SEC believes the advice given was incorrect. Attorneys should document their efforts and analysis when determining what advice to give to their clients in order to support their conclusions. Lawyers failing to disclose the risks of legal strategies to their clients, particularly risky strategies, may be deemed by the SEC to have made the decisions themselves.

---

[40] In the Matter of Ira Weiss, Administrative Proceeding File No. 3-11462, (December 2, 2005), *available at* http://www.sec.gov/litigation/admin/33-8459.htm.

G. Auditor Workpaper Retention

On January 24, 2003, the Commission issued a release adopting rules to implement Section 802 of the Sarbanes-Oxley Act.[41] Section 802 of the Sarbanes-Oxley Act requires that the SEC promulgate "rules and regulations, as are reasonably necessary, relating to the retention of relevant records such as workpapers, documents that form the bases of an audit or review, memoranda, correspondence, communication, other documents, and records (including electronic records) which are created, sent or received in connection with an audit or review and contain conclusions, opinions, analyses, or financial data relating to such an audit of an issuer of securities . . . ."

These rules require auditors to retain specific information for seven years after completing an audit or review of a registrant's financial statements.

The rules define the documents to be retained to include not only workpapers that support the auditor's conclusions, but also documents that may cast doubts on the auditor's conclusions. As a result, an auditor would be required to retain any documentation that influences the auditor's opinion about accounting and auditing issues.

The rules became effective March 3, 2003. Compliance is required for all audits and reviews completed on or after October 31, 2003.

H. Auditor Independence

In a release dated January 28, 2003, the SEC adopted rules to implement the provisions in Sections 201-206 of the Sarbanes-Oxley Act strengthening auditor independence and requiring revised disclosures to investors about the services provided to issuers by the independent auditor.[42]

The rules list nine non-audit services that, if provided to an audit client, would impair an accounting firm's independence. These nine services are defined as follows:

- bookkeeping or other services related to the accounting records or financial statements of the audit client;
- financial information systems design and implementation;
- appraisal or valuation services, fairness opinions or contribution-in-kind reports;
- actuarial services;
- internal audit outsourcing services;
- management functions or human resources;
- broker or dealer, investment adviser or investment banking services;

[41] Retention of Records Relevant to Audits and Reviews, Release Nos. 33-8180, 34-47241 (Jan. 24, 2003), *available at* http://www.sec.gov/rules/final/33-8180.htm.

[42] Strengthening the Commission's Requirements Regarding Auditor Independence, Release Nos. 33-8183, 34-47265 (Jan. 28, 2003), *available at* http://www.sec.gov/rules/final/33-8183.htm.

- legal services; and
- expert services unrelated to the audit.

Sections 201 and 202 of the Sarbanes-Oxley Act provide that an issuer's audit committee must pre-approve allowable services to be provided by the auditor of the issuer's financial statements. The new rules implement these sections by requiring that the audit committee pre-approve all services. In doing so, the audit committee may establish policies and procedures for pre-approval provided they are consistent with the Sarbanes-Oxley Act, detailed as to the particular service and designed to safeguard the continued independence of the accountant.[43]

The rules also include a *de minimis* exception for the inadvertent failure to pre-approve non-audit services, which will likely prove applicable in only a limited number of circumstances, because this exception requires that non-audit services: (i) do not aggregate to more than five percent of total revenues paid by the audit client to its accountant in the fiscal year when services are provided; (ii) were not recognized as non-audit services at the time of the engagement; and (iii) are promptly brought to the attention of the audit committee and approved prior to the completion of the audit by the audit committee or one or more designated representatives.

The final rules require disclosure in periodic reports of audit fees and fees for non-audit services approved by the audit committee. In their annual reports, issuers must provide fees paid to the independent accountant for: (i) audit services; (ii) audit-related services; (iii) tax services; and (iv) other services. Additionally, the disclosures must include a description of the audit committee's policies and procedures for pre-approval of services by the independent accountant, if such a policy has been adopted, as well as the percent of fees paid subject to the *de minimis* exception.

Section 201 of the Sarbanes-Oxley Act provides that "a registered public accounting firm may engage in any non-audit service, including tax services," that is not expressly prohibited, after audit committee pre-approval. Accordingly, accountants will be able to continue to provide tax compliance, tax planning and tax advice to audit clients, subject to audit committee pre-approval requirements. There are, however, circumstances in which providing certain tax services to an audit client would impair the independence of an accountant. For example, the release authorizing the auditor independence rule states that an auditor would impair its independence by representing an audit client in tax court. Moreover, the PCAOB also recently adopted final rules that proscribe the scope of tax services that can be provided. See Sections II.H. 1-6 below.

For purposes of the requirements for partner rotation and partner compensation, the rules contain a definition for the term "audit partner." An "audit partner" is defined as a partner who is a

---

[43] On August 7, 2003, the office of the Chief Accountant of the SEC issued an FAQ regarding the auditor independence rules. The FAQ is available at http://www.sec.gov/info/accountants/ocafaqaudind080703.htm. The FAQ states, among other things, that, although the level of detail that is appropriate in a pre-approval policy depends on a company's facts and circumstances, the establishment of monetary limits alone is not sufficient because these limits do not, without more, provide sufficient detail or adequately inform the audit committee.

member of the audit engagement team who has responsibility for decision-making on significant auditing, accounting and reporting matters that affect the financial statements, or who maintains regular contact with management and the audit committee. "Audit partner" includes: (i) the lead and concurring partners as well as partners who serve the client at the issuer level, other than a partner who consults with others on the audit engagement team regarding technical or industry-specific issues; and (ii) the lead partner on subsidiaries of the issuer whose assets or revenues constitute 20% or more of the consolidated assets or revenues of the issuer.

Section 203 of the Sarbanes-Oxley Act specifies that the lead and concurring partner must be subject to rotation requirements after five years. The new rules mandate that the lead and concurring partner rotate after five years and be subject to a five-year "time out" period after rotation. Additionally, certain other significant audit partners will be subject to a seven-year rotation requirement with a two-year time out period.

The new rules also provide that an accountant is not independent if, at any point during the audit and professional engagement period, any audit partner earns or receives compensation based on that partner procuring engagements with the audit client to provide any services other than audit, review or attest services.

Section 206 of the Sarbanes-Oxley Act establishes a one-year cooling-off period before a member of the audit engagement team may accept employment in designated financial or executive positions with an issuer client. The rules, therefore, provide that an accounting firm is not independent if a member of management involved in overseeing financial reporting matters was the lead partner, the concurring partner or any other member of the audit engagement team who provided more than ten hours of audit, review or attest services for the issuer within the one year period preceding the commencement of the audit of the current year's financial statements (which, in practical terms, can mean cooling-off periods that extend for up to 23 months, depending on the circumstances).

Section 204 of the Sarbanes-Oxley Act requires timely reporting of specific information by accountants to audit committees. Pursuant to this section, the new rules require the accounting firm to report to the audit committee, prior to the filing of its audit report with the Commission: (i) all critical accounting policies and practices used by the issuer; (ii) all material alternative accounting treatments of financial information within GAAP that have been discussed with management, including the ramifications of the use of such alternative treatments and disclosures, and the treatment preferred by the accounting firm; and (iii) other material written communications between the accounting firm and management.

In recognition of the fact that some of these provisions may impose an undue burden on certain smaller accounting firms, the new rules provide that firms with fewer than five audit clients and fewer than ten partners may be exempt from the partner rotation and compensation provisions, provided each of these engagements is subject to a special review by the PCAOB at least every three years.

The SEC has also recognized that foreign accounting firms or foreign private issuers may face additional hurdles in implementing these rules. Rules relating to partner rotation and the scope of personnel subject to the "cooling off" period apply to foreign accounting firms. Additional time, however, is afforded to foreign accounting firms with respect to compliance with rotation requirements. The rules also provide guidance on the provision of non-audit services by foreign accounting firms, including the treatment of legal services and tax advice.

On July 26, 2005, the PCAOB adopted several new auditor independence and ethics rules that focus on an auditor's provision of tax services to audit clients.[44] As discussed in more detail below, the PCAOB's rules include several important matters for issuers to consider. For example, the PCAOB's rules include specific guidance regarding the manner in which audit committees are to pre-approve permissible tax services to be performed by the outside auditor. In addition, the PCAOB's rules provide that an auditor will not be deemed independent if the auditor (1) plans, markets or opines in favor of certain types of tax transactions for the audit client, or (2) provides any tax services to an audit client for a contingent fee. The rules also restrict an outside auditor from providing tax services to persons at an audit client who perform a "financial reporting oversight role" (other than directors).

On April 19, 2006, the SEC approved the PCAOB's auditor independence and ethics rules.[45]

1. Additional Procedures Relating to Audit Committee Pre-Approval of Tax Services (PCAOB Rule 3524)

The PCAOB's rules expand the responsibilities that an auditor has under existing SEC rules to seek pre-approval of tax services from an audit committee. Specifically, the auditor must (1) provide a written description to the audit committee detailing the nature and scope of the proposed tax service, including the fee structure for the services; (2) discuss any implications that performance of the tax services may have on the auditor's independence; and (3) document all such discussions. Additionally, auditors must disclose to the audit committee any amendments, written or unwritten, to tax service engagements.

In contrast to the PCAOB's initial proposal, the rules do not mandate audit committee review and approval of the engagement letter for each tax service. The PCAOB states in its release that the underlying purpose of the requirement is "to establish a manageable collection of information" from which audit committees can pre-approve tax services. The PCAOB also states that in adopting these procedural requirements it did not intend to dictate whether an audit committee pre-approves tax services on an *ad hoc* basis or on an annual basis through pre-approval policies and procedures. Audit committees will need to examine their pre-approval policies and procedures to determine whether the policies and procedures are structured such that they would satisfy the new requirements for pre-approving tax services.

---

[44] The final rules concerning independence, tax services, and contingent fees adopted by the PCAOB can be found at http://www.pcaobus.org/Rules/Docket_017/2005-07-26_Release_2004-014.pdf.

[45] The SEC release approving the PCAOB's rules can be found at http://www.sec.gov/rules/pcaob/2006/34-53677.pdf. As the release notes, the PCAOB adopted certain technical amendments to certain rules on November 22, 2005 (PCAOB Release No. 2005-020) and on March 28, 2006 (PCAOB Release No. 2006-001).

2. Provision of Tax Services to Persons in Financial Reporting Oversight Roles (PCAOB Rule 3523)

The PCAOB's rules provide that an auditor will not be deemed independent if it provides tax services to any individual who is in a "financial reporting oversight role" (as defined by the SEC) of the audit client, or an immediate family member of such an individual. The PCAOB's rules expressly exclude directors from the category of individuals in financial reporting oversight roles. The rules also exclude individuals who serve in financial reporting oversight roles at an affiliate of the audit client, but only if the affiliate's financial statements are immaterial to those of the audit client, or if the affiliate is audited by a different, unassociated auditor. In addition, the rules include an exception to address situations where individuals become subject to the rule because they are hired or promoted into a financial reporting oversight role at an audit client. It allows the auditor to provide tax services to such individuals where the engagement was in existence prior to the hiring or promotion and the services are completed within 180 days after the individual is hired or promoted.

3. Planning, Marketing or Opining in Favor of Certain Tax Transactions (PCAOB Rule 3522)

The PCAOB's rules provide that an auditor is not independent if it plans, markets, or opines "in favor of" confidential or aggressive tax transactions for the audit client. The PCAOB's rules largely codify the SEC's guidance in its 2003 auditor independence release regarding the care that audit committees should take in approving certain tax services.[46] Specifically, the PCAOB's rules prohibit auditors from planning and marketing tax transactions that were recommended initially by the auditor, its affiliate, or an advisor with whom the auditor has a formal arrangement, if a significant purpose of the transaction is tax avoidance, and if the transaction is more likely than not to be disallowed under applicable tax laws. To establish that a transaction is more likely than not to be allowed under applicable tax laws, auditors must make an objectively reasonable and defensible decision that the proposed tax treatment of the transaction is likely to be permitted if challenged. The PCAOB's rules also prohibit auditors from planning and marketing confidential tax transactions (which are transactions with tax-advisor imposed conditions of confidentiality that the IRS has identified as potentially abusive). The SEC release noted that subsequent listing of a transaction that was allowable at the time the tax services were provided does not result in a *per se* violation of the new auditor independence standards. The SEC encouraged the PCAOB to provide guidance regarding the subsequent determination of independence after a transaction is listed.

4. Contingent Fees (PCAOB Rule 3521)

The PCAOB's rules provide that an auditor is not independent if it enters into a contingent fee arrangement or receives a contingent fee for the provision of tax services, either directly or indirectly, from an audit client. Fees that are fixed by a court or another public authority are

---

[46] *See* Strengthening the Commission's Requirements Regarding Auditor Independence, 68 Fed. Reg. 6006, 6017 (Feb. 5, 2003).

permissible under the PCAOB's rules, but only if they are not dependent on a particular result and will not create a mutual interest between the auditor and the client.[47]

5. Responsibility of Audit Firm Personnel Not to Cause Violations (PCAOB Rule 3502)

The PCAOB's rules place an ethical obligation on individuals that are associated with registered public accounting firms to avoid intentionally or recklessly causing such firms from violating securities laws, rules, regulations, and professional standards. The PCAOB's rules provide that the PCAOB may discipline an associated person of a registered public accounting firm for acts or omissions if the individual "knew, or [was] reckless in not knowing," that such conduct would "directly and substantially contribute to such a violation." The associated person's conduct must constitute or contribute to the violation in a material or significant way, though it need not be the only or final cause of the violation. According to the PCAOB's release accompanying its rules, tangential or remote conduct, even if it contributes to the violation, will not in and of itself subject an associated person to discipline.

6. Transition Periods

To account for existing arrangements, the PCAOB's new rules include several transition periods. Specifically, for audit committee pre-approval of tax services, the PCAOB proposal provides that the new procedural rules will not apply to tax services that the audit committee pre-approves (i) on an ad-hoc basis on or before June 19, 2006 (i.e., within 60 days from the SEC's April 19, 2006 order) or (ii) pursuant to its policies and procedures, on or before April 19, 2007. If an auditor provides tax services to an individual who is in a financial reporting oversight role, or to his or her family member, the auditor may continue providing such services so long as those services are being provided pursuant to an engagement letter in effect as of April 19, 2006 and they are completed on or before October 31, 2006. The PCAOB release also provides that the restrictions on services that involve planning, marketing or opining on certain tax transactions will not apply if those services are completed on or before June 19, 2006. Finally, the contingent fee rule will not apply to a contingent fee that is paid in its entirety, converted to a fixed fee, or otherwise unwound on or before June 19, 2006.

I. Standards related to Listed Company Audit Committees

In an April 9, 2003 release, the SEC adopted Exchange Act Rule 10A-3 implementing Section 10A(m)(1) of the Exchange Act, as added by Section 301 of the Sarbanes-Oxley Act.[48] This

---

[47] This aspect of the PCAOB's new rules codifies an interpretation of the SEC's independence rule issued by the SEC's Office of Chief Accountant in 2004. *See* Letter from Donald T. Nicolaisen, Chief Accountant, SEC, to Bruce P. Webb, Professional Ethics Executive Committee Chair, AICPA (May 21, 2004), *available at* http://www.sec.gov/info/accountants/staffletters/webb052104.htm.

[48] Standards Relating to Listed Company Audit Committees, Release Nos. 33-8220, 34-47654 (Apr. 9, 2003), *available at* http://www.sec.gov/rules/final/33-8220.htm.

rule implements the Sarbanes-Oxley Act's requirement that the SEC direct the national securities exchanges and national securities associations to refuse listing of securities of issuers whose audit committees do not comply with the five requirements specified in the Sarbanes-Oxley Act. These five requirements relate to: (i) the independence of audit committee members; (ii) the audit committee's responsibility to select and oversee the issuer's independent accountant; (iii) procedures for handling complaints regarding accounting or auditing matters; (iv) the authority of the audit committee to engage outside advisors; and (v) funding for the outside auditor and any outside advisors engaged by the audit committee. The rule, as adopted in final form, implements all five of these requirements.

1. Definition of Independence

Under Section 301 of the Sarbanes-Oxley Act, listed companies must have audit committees consisting entirely of independent directors. The Act provides that, to be independent, an audit committee member must not accept any "consulting, advisory or other compensatory fee" from the issuer, other than amounts received as compensation for membership on the board of directors, the audit committee or any other committee. Indirect payments, including payments to a law firm or consulting firm where the director is a partner, would also prevent the individual from being viewed as an independent director. There is no exception in the rules permitting *de minimis* payments to directors.

In addition, a member of the audit committee may not be an "affiliated person" of the listed company or any subsidiary. The final rules define an "affiliated person" as a person who directly or indirectly controls, is controlled by or is under common control with, the company or a subsidiary. The rules include a safe harbor for persons who are not executive officers of the listed company and who own less than 10 percent of the company's securities. According to the SEC staff, those who are ineligible to rely on the safe harbor may still rely on a "facts and circumstances" analysis to determine control.

2. Accommodation for New Issuers

The final rules include an accommodation for new public companies. Such companies must have one independent member on their audit committee at the time of listing, a majority-independent audit committee within 90 days after listing and a fully independent audit committee within one year after listing.

3. Accommodations for Holding Companies

In addition, the rules contain an accommodation for holding companies whose directors also serve as directors of a subsidiary. Under the rules, concurrent service on both companies' boards will not preclude a director from serving on either company's audit committee, provided the director is otherwise independent.

4. Accommodations for Foreign Issuers

Given concerns about conflicting regulations and practices in some foreign jurisdictions, the rules include limited exemptions for foreign issuers. First, the rules exempt from the independence requirements certain non-management employees named to the audit committee pursuant to home country “co-determination” and similar requirements. According to the SEC staff, employees serving on the audit committee under this exemption may not be “executive officers,” defined in part as persons with a “policymaking function.” Similarly, in accordance with home country requirements, a foreign government representative may serve on the audit committee if he or she is not an executive officer of the issuer and does not receive compensation from the issuer (other than director and committee fees).

Second, the rules include a limited exception from the independence requirements for controlling shareholders of foreign issuers. Specifically, one member of a foreign issuer’s audit committee may be a controlling shareholder or shareholder representative, but only if the shareholder or representative does not receive compensation from the issuer, has only observer status on the audit committee and is not an executive officer of the issuer.

Third, the rules are not intended to conflict with any requirement in an issuer’s home jurisdiction that requires shareholders to select, approve or ratify the selection of the independent auditor. In addition, the rules are not meant to conflict with home country requirements relating to shareholder approval of auditor termination and auditor compensation.

Finally, alternative structures, such as boards of auditors and statutory auditors, are permitted to perform auditor oversight functions where such structures are provided for under local law, provided that such auditors are not elected by the issuer’s management.

Foreign issuers that are required to disclose whether they have an audit committee financial expert will also be required to disclose whether that individual is “independent” under the applicable SRO listing standard.

Other special provisions for non-U.S. issuers include the following:

- In recognition of the fact that in some countries employee representatives may be required to serve on a company’s audit committee as a matter of law or pursuant to an employee collective bargaining agreement, the listing standards may permit an employee of a non-U.S. issuer to serve on the audit committee if that employee is not an executive officer of the issuer and if he or she is elected to the audit committee pursuant to the issuer’s governing law or documents, an employee collective bargaining agreement or other home country legal or listing requirements.
- An affiliate of a non-U.S. issuer or a representative of such an affiliate may be permitted to serve as a non-voting observer on the issuer’s audit committee provided that he or she is not the chair of the audit committee.
- In a situation in which a non-U.S. government is an affiliate of a non-U.S. issuer, there may be an exemption for a representative of that government to serve on the issuer’s audit committee.

A non-U.S. issuer that avails itself of any of the special provisions listed above will be required to disclose that fact in its annual report on Form 20-F and to disclose its assessment of whether reliance on any of the special provisions materially adversely affects the ability of its audit committee to act independently.

In adopting these special provisions, the SEC has noted its authority under the Sarbanes-Oxley Act to grant further relief to non-U.S. issuers in response to, and has indicated its intent to remain sensitive to, future conflicts between non-U.S. corporate governance rules and practices and the listing standards required by Section 301.

5. Responsibilities of the Audit Committee

The rules provide that a listed company's audit committee must be directly responsible for the appointment, compensation, retention and oversight of the company's independent auditor, and the independent auditor must report directly to the audit committee. Former SEC Commissioner Harvey Goldschmid has stated that, under the rules, the audit committee is also responsible for firing the independent auditor when appropriate.

Under the rules, the audit committee must establish procedures for: (i) the receipt, retention and treatment of complaints regarding accounting, internal controls and auditing matters, and (ii) the confidential, anonymous submission by employees of the company of concerns regarding accounting and auditing matters. Moreover, the audit committee must have the authority to engage independent counsel and other advisers as it determines necessary to carry out its duties. The listed company must provide appropriate funding, as determined by the audit committee, to compensate the independent auditor and outside advisors.

6. Issues to Consider

Four years after the passage of the Sarbanes-Oxley Act, audit committees continue to face increased responsibilities and a host of legal and regulatory requirements. The audit committee is expected to play an active role in the relationship with a company's external auditors, and in overseeing the integrity of company financial statements and compliance with legal and regulatory requirements. What follows are 10 "key issues" for audit committees to consider in discharging their responsibilities.

a. Consider whether your audit committee's practices have been updated to comply with all recent rules and regulations and whether they comply with current views of best practices

Audit committees should consider the federal and state laws, securities exchange rules and rules of the PCAOB that define or affect their obligations. In particular, audit committees should continue to assess whether their practices and charters continue to comply with listing standards of the New York Stock Exchange and Nasdaq.

b. Consider the amount of time and attention you are able to devote to your audit committee duties

Be prepared to spend a significant amount of time on your duties.

- Consider whether you have time to deliberate carefully on committee actions/decisions. Under the new rules, audit committee duties have been expressly expanded. For example, audit committees must meet separately with management and the company's external auditors and be responsible for the company's whistleblower procedures. Many cases in which directors are found liable involve situations in which the directors failed to spend even a minimal amount of time considering an issue.

- According to a survey by J.D. Power and Associates of 758 audit committee chairs and 900 CFOs, audit committee chairs generally spend between 50 and 150 hours per year on their audit committee duties.

- According to a survey by Deloitte & Touche, the average number of meetings of the audit committee of surveyed companies rose from 4.9 before enactment of Sarbanes-Oxley to 7.9 thereafter. Twenty-one percent of the surveyed companies' audit committees met more than 9 times per year post Sarbanes-Oxley, compared to 2 percent prior to its enactment.

- Given the breadth of the new audit committee responsibilities, audit committees need to carefully consider priorities and establish agendas in order to use their time and resources most effectively.

Consider limiting the number of other boards/audit committees on which you serve.

- Under the New York Stock Exchange listing standards, audit committee members may not serve on the audit committee of more than two other public companies, unless the board has affirmatively determined that such service does not impair the members' ability to serve on the audit committee. Any such determination must be disclosed in the annual proxy statement to shareholders.

- Consider whether, as an officer of another public company or as a "professional" director/audit committee member, you will be capable of spending the requisite amount of time on the duties of each company's audit committee.

c. Make sure you understand the business, financial condition and risk profile of the company

- Familiarize yourself with the company's and its peers' financial and accounting practices so that the audit committee can exercise its oversight obligations effectively.

  - Improper expense and revenue recognition, along with measures to "smooth" earnings, are major sources of restatements and SEC investigations; audit committees should understand well their companies' policies and practices in these areas.

- Continually evaluate whether the disclosure controls and procedures (i.e., procedures designed to ensure that information required to be disclosed is collected and reported within the required time periods) and internal control over financial reporting (i.e., processes designed to provide reasonable assurance regarding the reliability of financial reporting) are operating effectively.

    - While management is responsible for evaluating and reporting on the company's controls and procedures, the audit committee should be aware of any significant issues arising out of such evaluations.

    - The audit committee should evaluate the company's experience with its management report and auditor attestation with respect to internal control over financial reporting pursuant to Section 404 of the Sarbanes-Oxley Act. The audit committee should consider areas in which the internal controls could be improved, including remediation of identified deficiencies, and the effectiveness of the monitoring and reporting process.

    - Audit committees should evaluate their companies' readiness to continue internal control evaluations as an ongoing compliance matter.

d. Consider the relationships and communications among the audit committee, management, internal auditors and external auditors

- Audit committees are directly responsible for the appointment, compensation, retention and oversight of the external auditors, including the external auditors' independence.

    - Audit committees should familiarize themselves with the auditor independence rules and monitor independence issues. For example, large multinational corporations should be alert to relationships between foreign subsidiaries and the local representatives of the company's external auditors, which may be less closely supervised and thereby give rise to independence issues.

    - Audit committees should consider the performance of the external auditors and request changes to the audit team if necessary. In addition, audit committees should consider every several years whether a rotation of audit firms would be appropriate.

- Consider whether you are receiving all information necessary for the audit committee to exercise its oversight obligations effectively.

    - The audit committee should learn promptly about significant events or issues relating to the company, particularly if they relate to financial performance or auditing or accounting matters, whether as a result of the whistleblower hotline or through other channels.

    - Consider whether management is fostering an appropriate "tone at the top" of the company: one that encourages employees to raise concerns as appropriate.

    - Audit committees should ensure that there is an open line of communication between the audit committee and the external auditors, even between audit committee meetings.

- Meet regularly in separate sessions with the company's external auditors, members of management, internal audit team and general counsel.

    - Consider separating the internal audit function from reporting to the chief financial officer of the company. Increasingly, companies have their chief audit executives report directly to the audit committee.

- Make sure the audit committee is "asking the tough questions."

    - It is no longer sufficient for audit committees to listen passively to management/auditor presentations. Audit committee members must actively probe analyses to ensure they will hold up when viewed with 20/20 hindsight.

    - The AICPA Audit Committee Toolkit (available at www.aicpa.org) offers sample questions that an audit committee may want to ask various constituencies, including senior management, the internal audit team, the external auditors and the general counsel.

e. Make sure members of the audit committee receive continuing education as to developments in accounting, finance, laws and regulations and other issues relevant to the audit committee. The New York Stock Exchange requires boards of directors to address this issue in their corporate governance guidelines

- There are a number of resources available for director continuing education.

- Major accounting firms and business schools offer programs designed specifically for audit committee members. The National Association of Corporate Directors gives directors of member companies access to a variety of information relevant to continuing education.

- Major accounting firms offer resources, such as the KPMG Audit Committee Institute, designed specifically for audit committee members.

- Consider asking the company's external auditors to give regular presentations to update the audit committee on accounting developments, particularly those relevant to the company's "critical" accounting policies and estimates.

    - A survey of participants in KPMG's 2004 Audit Committee Institute found that nearly 45% of participants with sales of more than $1 billion were planning to provide a company-specific educational session to audit committee members in the next year.

f. Understand your company's directors' & officers' insurance policies and indemnification provisions

- Recent corporate scandals and resulting litigation have had an adverse impact on the D&O market.

    - In the last few years, the cost of insurance coverage has increased while the scope of coverage has decreased (in recent months, this situation seems to be improving somewhat). In addition, existing policies may be more difficult to collect under as a result of insurance company insolvency and stronger efforts by insurance companies to contest claims based on allegations of fraud.

- In the future, there may be increased pressure for directors to bear some personal liability in connection with breaches of their fiduciary duties. Recently, former non-management directors of Enron and Worldcom agreed to bear substantial personal liability to fund a portion of federal class action litigation settlements.

- Audit committee members should periodically evaluate their company's D&O insurance coverage and indemnification and expense reimbursement policies.

    - New policies may contain exclusions for claims involving "insured vs. insured" claims, improper personal benefit or deliberate fraud by the insured, regulatory proceedings and securities law claims. Some companies are exploring alternative funding mechanisms, such as dedicated indemnification trusts, captive insurance companies, finite risk policies or fronting arrangements.

    - Become familiar with the mechanisms of coverage: the relation of insurance to indemnification, coverage in bankruptcy, limitations on settlement, allocation, defense costs, and severability and possible rescission.

g. Consider developing policies concerning how the audit committee and the company will approach issues when they arise

- Policies should be appropriate to the size and complexity of the company and flexible enough to deal with different situations. Rarely is one set approach appropriate for all scenarios.

    - Consider how complaints and concerns will be processed and investigated, whether by the general counsel, a chief ethics or governance officer, or outside advisors.

    - Consider when the audit committee should be informed or involved.

    - Consider when the external auditors should be informed.

    - A 2004 survey by KPMG revealed that 40% of participating audit committee members either were unsure about or had not addressed the level of detail the audit committee would review in their whistleblowing procedures.

- Make sure the management team feels free to approach the audit committee with potentially significant issues as they arise, even before they are "solved".

h. Consider obtaining independent advice

- Changes to listing standards mandated by the Sarbanes-Oxley Act make it clear that audit committees have the authority to directly engage independent advisors at the company's expense.

- Audit committees should consider establishing relationships with independent law firms, forensic accountants or other advisors, so the audit committee can obtain advice quickly when necessary.

i. Consider record retention issues with respect to audit committee meetings

- Committees must strike a balance between the need to create a record to document the topics discussed and items that require follow up and the risk that notes of committee members or others may be discoverable in litigation.

- Consider implementing a formal records retention policy that is strictly followed by members of the committee.

j. Conduct evaluations of audit committee performance. The New York Stock Exchange requires boards and committees to conduct annual performance evaluations

- Consider whether the membership of the audit committee continues to be appropriate in terms of number of members, experience and term of service on the audit committee.

- Audit committees may want to consider evolving views on independence that may develop outside of SEC regulations and listing standards.

    - Recent Delaware case law suggests that social, educational and community ties may call into question a director's independence. In addition, shareholder activists such as ISS have opposed election of directors based on their own heightened independence standards. Audit committees should consider these issues as well as the standards enumerated by the New York Stock Exchange or Nasdaq listing standards, as applicable, when considering the independence of their members.

- Management and external auditors are required to evaluate audit committee effectiveness as part of their assessment of the company's internal controls. See PCAOB Auditing Standard No. 2 for guidelines external auditors consider in evaluating audit committee effectiveness.

7. Reporting Requirements

The rules also update existing SEC disclosure requirements relating to audit committees. An issuer must disclose: (i) the use of any exemptions in the rule and its assessment of whether, and how, such exemption may materially adversely affect the ability of their audit committee to act independently and satisfy the other requirements of the rule; (ii) the identification of the audit committee in annual reports; and (iii) disclosures concerning the audit committee's independence in proxy statements. With respect to disclosures contained within a proxy statement, the audit committee must provide a report disclosing whether the audit committee has reviewed the company's audited financial statements with management and discussed various matters with the independent auditors. Issuers must also disclose whether the audit committee is governed by a charter, and if so, must appropriately disclose the that charter has been posted on the issuer's website as required by the applicable SEC rules. Last, the issuer must disclose whether members of the audit committee are "independent." This latter disclosure requires non-listed companies to choose a definition of "independent" from among those used in the listing standards of the New York Stock Exchange, the NASDAQ, and the American Stock Exchange. In all other respects, the rule only affects listed companies.

8. Timing

Domestic listed companies were required to comply with the new listing standards by the date of their first annual shareholder meeting after January 15, 2004, but, in any event, no later than October 31, 2004. Foreign issuers and small business issuers were required to comply by July 31, 2005.

J. Management Assessment of Internal Controls

In a June 5, 2003 release, the SEC adopted rules implementing Section 404 of the Sarbanes-Oxley Act, requiring public companies, other than investment companies, to include a report of management on the company's internal control over financial reporting in their annual reports on Form 10-K.[49] The rules also require the independent auditor of each public company to issue an attestation report on management's assessment of the company's internal controls, and this attestation report must be included in public companies' annual reports on Form 10-K.

Importantly, the SEC provided an extended transition period, pursuant to which domestic issuers that are subject to the accelerated reporting requirements were not required to include management's internal control report and the auditor's attestation report until the first annual report on Form 10-K that is filed for fiscal years ending on or after November 15, 2004. On March 2, 2005, the SEC extended the date by which non-accelerated filers and foreign private issuers must comply with the new requirements to begin with their first fiscal years ending on or after July 15, 2006.[50] On September 22, 2005, the SEC again extended the compliance date to the first fiscal year

---

[49] Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reporting, Release No. 33-8238 (June 5, 2003), *available at* http://www.sec.gov/rules/final/33-8238.htm. As part of its guidance with regard to the PCAOB's Auditing Standard No. 2, the SEC has provided additional guidance with regard to internal controls. *See* Section II.F above.

[50] Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports of Non-Accelerated Filers and Foreign Private Issuers, Release Nos. 33-8545; 34-51293 (March 2, 2005), *available at* http://www.sec.gov/rules/final/33-8545.htm.

ending on or after July 15, 2007 for companies that are not accelerated filers.[51] On May 17, 2006, the SEC issued a press release announcing that it will provide another brief extension to non-accelerated filers (though it did not specify an exact date). However, the SEC noted that all filers will nonetheless be required to comply for fiscal years beginning on or after December 16, 2006 (which effectively means that there is no extension for non-accelerated filers with fiscal years that coincide with the calendar year). In August 2006, the SEC extended the compliance date for some foreign private issuers.[52] As discussed below, the SEC is also proposing to further extend compliance dates for smaller public companies.[53]

Under the final rules, each annual report on Form 10-K (and foreign company annual reports on Form 20-F or Form 40-F) must include an internal control report setting forth:

- a statement of management's responsibility for establishing and maintaining internal controls and procedures for financial reporting;
- a statement about the effectiveness of the company's internal controls and procedures, based on management's evaluation of those controls and procedures;
- a statement identifying the framework used by management to evaluate the company's internal controls over financial reporting; and
- a statement that the company's independent auditor has attested to, and reported on, management's evaluation of the internal controls and procedures for financial reporting.

---

51 Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports of Companies that Are Not Accelerated Filers, Release Nos. 33-8618; 34-52492 (Sept. 22, 2005), *available at* http://www.sec.gov/rules/final/33-8618.htm. In the release, the SEC also invited comments regarding the implementation of the rules, including with respect to possible modifications of the testing and auditor attestation requirements for smaller companies under Auditing Standard No. 2 and the SEC's rules promulgated pursuant to Section 404 of the Sarbanes Oxley Act.

52 Adopting Release: Foreign Private Issuer Deadline Extension, Release Nos. 33-8730A; 34-54294A; File No. S7-06-03 (August 9, 2006), *available at* http://www.sec.gov/rules/final/2006/33-8730a.pdf. The SEC extended the compliance date for foreign private issuers that are accelerated filers, but not large accelerated filers, for amendments to Forms 20-F and 40F that require a foreign private issuer to include in its annual reports an attestation report by the issuer's registered public accounting firm on management's assessment on internal control over financial reporting. The foreign private issuer must begin to comply with the requirements in the annual report filed for its first fiscal year ending on or after July 15, 2007.

53 Proposal: Smaller Company Compliance Extension, Release Nos. 33-8731; 34-54295; File No. S7-06-03 (August 9, 2006), *available at* http://www.sec.gov/rules/proposed/2006/33-8731.pdf.

The SEC has stated that management's assessment of the effectiveness of the issuer's internal control over financial reporting must be supported by evidence, including documentation to provide reasonable support for: (i) the evaluation of whether the control is designed to prevent or detect material misstatements or omissions; (ii) the conclusion that the tests were appropriately planned and performed; and (iii) the conclusion that the results of the tests were appropriately considered.

Under the final rules, the SEC defines "internal control over financial reporting" to be:

> A process designed by, or under the supervision of, the registrant's principal executive and principal financial officers, or persons performing similar functions, and effected by the registrant's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:
>
> - pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the registrant;
> - provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the registrant are being made only in accordance with authorizations of management and directors of the registrant; and
> - provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the registrant's assets that could have a material effect on the financial statements.[54]

The definition encompasses the subset of internal controls addressed in the now familiar standards for internal controls over financial reporting set forth in the report of the Committee of Sponsoring Organizations of the Treadway Commission (the "**COSO Report**"). In this regard, the SEC also indicated that the framework set forth in the COSO Report is an acceptable framework upon which management can base its evaluation of internal controls.

The final Section 404 rules also require management to determine on a quarterly basis whether there have been any material changes in the company's internal controls and to report any material changes that have occurred.

On October 6, 2004, the SEC released guidance, in the form of Frequently Asked Questions, regarding management's responsibilities relating to internal control over financial reporting and certification of disclosure in Exchange Act reports.[55] The topics discussed included the following:

---

[54] *Id.*

- For an equity method investment, controls over the recording of transactions into the investee's accounts are not required as part of the registrant's control structure, but the registrant must have controls over the recording of amounts related to such investments that are recorded in the registrant's consolidated financial statements. However, the rules do not preclude a registrant from evaluating the controls over the financial reporting of an equity method investment.

- If it is not possible for the registrant to conduct an assessment of the internal control of an entity in the time between the acquisition date and the date of management's assessment, the registrant may refer to the discussion in the registrant's Form 10-K or 10-KSB regarding the scope of the assessment, including disclosure noting that the acquired business was excluded from the assessment of internal control over financial reporting. The registrant must disclose any material change to its internal control over financial reporting due to the acquisition.

- A report by management or the accountant, timely filed in a 10-K or 10-KSB, concluding that the registrant's internal control over financial reporting is not effective can still be considered timely and current for Rule 144 and Forms S-3 and S-8 eligibility if an unqualified opinion on the financial statements is included in such filing.

- Management may not qualify its conclusion that the registrant's internal control over financial reporting is effective by making such a conclusion subject to certain qualifications or exceptions.

- An identification of a material weakness regarding internal control over financial reporting by management or the accountant, but not the other, does not constitute a disagreement between the registrant and its auditor that is required to be reported pursuant to Item 304 of Regulations S-K or S-B, unless the situation results in a change in the auditor.

- A registrant that is not already subject to accelerated filing should determine whether it is an accelerated filer at the end of its fiscal year, based on the market value of its public float at the end of the most recently completed second fiscal quarter.

- The registrant must provide management's report on internal control over financial reporting, and the related auditor attestation report, when filing a transition report on Form 10-K or 10-KSB.

---

[55] Office of the Chief Accountant, Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Report (October 6, 2004), *available at* http://www.sec.gov/info/accountants/controlfaq1004.htm.

- The registrant is not required to report material changes made to its internal control in the registrant's first management report on internal control over financial reporting if these changes are made to improve the internal control system in advance of the compliance deadline. After the first management report, Item 308 of Regulations S-K or S-B requires the registrant to identify and disclose any material changes in the registrant's internal control over financial reporting in each quarterly and annual report.

- Management must assess control over outsourced operations when management has outsourced certain functions to third party service providers. Management may rely on a SAS 70, Type 2 report even if the auditor for the service provider and the registrant were the same, but management may not engage the registrant's audit firm to prepare a SAS 70, Type 2 report on the service provider.

- The SEC expects management to use the term "material weakness" when providing full disclosure relating to any material weakness, although no specific language is required.

- If a Form 10-K or Form 10-KSB is incorporated into a Securities Act filing, management must obtain consent from the auditor regarding the auditor's report on management's assessment of internal control over financial reporting.

- The Office of the Chief Accountant recommends that issuers include both management's report on internal control over financial reporting and the auditor report on management's assessment of internal control over financial reporting in the annual report and is recommending the Commission make amendments to Rules 14a-3 and 14c-3 as well as Item 13 of Schedule 14A to include such a requirement. Changes to the proxy rules may be forthcoming to address this preferred approach.

Separately, the Public Company Accounting Oversight Board met on November 30, 2004 to adopt a temporary rule that would permit the delayed filing of auditors' internal control reports consistent with the SEC's order. The temporary rule would permit auditors to date their reports on management's assessment of the effectiveness of internal control over financial reporting later than the date of their reports on the financial statements. In addition, the PCAOB's temporary rule would waive the requirement that the auditor's report on the financial statements include a paragraph that refers to a separate report on internal control over financial reporting. The PCAOB's temporary rule is subject to approval by the SEC.

On August 9, the SEC issued proposed and final rules intended to grant smaller public companies and many foreign companies additional relief from compliance with Sarbanes-Oxley's Section 404 internal control reporting requirements. First, the SEC proposed to grant relief to smaller public companies by extending the date by which non-accelerated filers must start providing management assessment of the effectiveness of a company's internal controls over financial reporting. The initial compliance date for such issuers would be moved from fiscal years ending on or after July 15, 2007 to fiscal years ending on or after December 15, 2007. The SEC also proposed to extend the date by which non-accelerated filers must begin to comply with the Section 404(b) requirement to include an auditor's attestation report on internal controls in their annual reports. This deadline would be moved to the first annual report for a fiscal year ending on or after December 15, 2008. This proposal would result in all non-accelerated filers being required to complete only the management's portion of the internal control requirements in their first year of compliance. The proposed extension would give such issuers and their auditors an additional year to consider and adapt to both the changes in Auditing Standard No. 2 that the SEC and the Public Company Accounting Oversight Board intend to make, and to the guidance for management the SEC intends to issue to improve the efficiency of the Section 404(b) auditor attestation report process.[56]

The SEC also adopted a final rule granting relief from Section 404(b) compliance for foreign private issuers that are accelerated filers (but not large accelerated filers) that file their annual reports on Form 20-F or 40-F. Such companies will have their compliance deadline extended for an additional year, so that they will not begin complying with the Section 404(b) requirement to provide an auditor's attestation report on internal control over financial reporting in their annual reports until fiscal years ending on or after July 15, 2007. These issuers will be required to comply only with the Section 404 requirement to include management's report in the Form 20-F or 40-F annual report filed for their first fiscal year ending on or after July 15, 2006. They will not need to comply with the requirement to provide the registered public accounting firm's attestation report until they file a Form 20-F or 40-F annual report for a fiscal year ending on or after July 15, 2007. These initiatives would not change the date by which a foreign private issuer that is a large accelerated filer must comply with the requirements of both Section 404(a) and (b). Such filers are required to include both a report by management and an attestation report by the issuer's registered accounting firm on internal control over financial reporting in their Form 20-F or 40-F filed for a fiscal year ending on or after July 15, 2006.[57]

The SEC also proposed a transition period for new public companies regarding Section 404. This relief would apply to any company that has become public through an IPO or a registered exchange offer, or that otherwise becomes subject to the Exchange Act reporting requirements, and would include a foreign private issuer that is listing on a U.S. exchange for the first time. The SEC proposed to amend its rules so that a company would not be required to provide a management assessment or an auditor attestation report until it has previously filed one annual report with the SEC.[58]

---

[56] SEC Release Nos. 33-8731, 34-454295 (August 9. 2006), *available at* http://www.sec.gov/rules/proposed/2006/33-8731.pdf.

[57] SEC Release Nos. 33-8730A, 34-454294A (August. 9, 2006), *available at* http://www.sec.gov/rules/final/2006/33-8730a.pdf.

[58] SEC Release Nos. 33-8731, 34-454295 (August 9. 2006), *available at* http://www.sec.gov/rules/proposed/2006/33-8731.pdf.

K. Improper Influence on the Conduct of Audits

In a May 20, 2003 release, the SEC issued a final rule implementing Section 303(a) of the Sarbanes-Oxley Act. Section 303 required the SEC to issue rules prohibiting officers and directors of issuers, and others acting under their direction, from improperly influencing the conduct of an audit of the issuer's financial statements.[59] The final rule and the adopting release significantly expand on the text of Section 303. The new rules became effective as of June 27, 2003.

Section 303(a) of the Sarbanes-Oxley Act provides that:

> It shall be unlawful, in contravention of such rules or regulations as the Commission shall prescribe as necessary or appropriate in the public interest and for the protection of investors, for any officer or director of an issuer, or any other person acting under the direction thereof, to take any action to fraudulently influence, coerce, manipulate or mislead any independent public or certified accountant engaged in the performance of an audit of the financial statements for that issuer for the purpose of rendering such financial statements materially misleading.

The final rule issued by the SEC under Section 303(a) supplemented the prior Rule 13b2-2. The final rule moved the text of the prior Rule 13b2-2 to Rule 13b2-2(a) and added two new parts as subsections (b) and (c). Subsection (a) of the rule prohibits officers and directors of issuers from falsifying books and records and from making false or misleading statements or omissions to accountants in connection with an audit or the preparation or filing of a report with the SEC.

Subsection (b) implements the Section 303 prohibition with respect to issuers. The first part substantially mirrors the language of Section 303(a), cited above, with a few notable exceptions. The rule provides that:

> No officer or director of an issuer, or any other person acting under the direction thereof, shall directly or indirectly take any action to coerce, manipulate, mislead or fraudulently influence any independent public or certified public accountant engaged in the performance of an audit or review of the financial statements of that issuer that are required to be filed with the Commission pursuant to this subpart or otherwise if that person knew or should have known that such action, if successful, could result in rendering the issuer's financial statements materially misleading.[60]

The second part of subsection (b) identifies a non-exclusive list of actions that an auditor could be improperly influenced to undertake and that could, if successful, result in rendering the issuer's financial statements materially misleading. For example, the list includes improperly

---

[59] Improper Influence on Conduct of Audits, Release No. 34-47890 (May 20, 2003), *available at* http://www.sec.gov/rules/final/34-47890.htm.

[60] *Id.*

influencing an auditor to issue an unwarranted report on the issuer's financial statements and improperly influencing an auditor not to communicate matters to the issuer's audit committee.

Subsection (c) of Rule 13b2-2, as modified by the final rule applies only to registered investment companies. In addition to implementing the Section 303 prohibition with respect to investment companies, subsection (c) also expressly applies the current Rule 13b2-2 prohibition to investment companies.

The text of the final rule and the adopting release emphasize the SEC's broad view of the scope of Section 303. Most notably:

- The rule does not require specific intent to render the issuer's financial statements materially misleading, nor does it require that an action achieve its desired end or actually result in misleading financial statements. The rule requires only that the person exerting the improper influence "*knew or should have known* that such action, *if successful*, *could* result in rendering the issuer's financial statements materially misleading."
- The SEC interprets the phrase "under the direction of" broadly to include third parties. In addition to employees of the issuer, the SEC could initiate enforcement action under the rule against an issuer's customers, creditors and outside advisers, including accountants, attorneys and financial advisers.
- The rule is not limited to improper influence with respect to the formal audit engagement period of an issuer's current outside auditor. The rule covers any "independent public or certified public accountant" engaged in the "audit or review" of the issuer's financial statements. The SEC interprets the phrase "engaged in the performance of an audit or review" broadly to encompass not only the formal engagement period, but also any time prior to or after such period where the accountant is called upon to make decisions or judgments about the financial statements, such as a decision to issue a consent to the use of prior years' audit reports.

The final rule addresses intent in two places. First, the rule requires that the person exerting improper influence "knew or should have known" that his or her actions, if successful, could result in rendering the financial statements materially misleading. Here, the final rule departs from the text of Section 303 by using "knew or should have known," a negligence standard, in place of the statutory "for the purpose of" language, which would require specific intent. Thus, the SEC will not be required to show that a person's actions were intended to render the issuer's financial statements materially misleading, but only that the person knew, or was negligent in not knowing, that his or her actions could achieve that result. The distinction is illustrated by an example in the adopting release:

> For example, if an officer of an issuer coerces an auditor not to conduct certain audit procedures required by generally accepted auditing standards ("**GAAS**") because the officer wants to conceal his embezzlement of funds from the issuer, then it is possible that his actions might not be found to be for the "purpose of rendering the financial statements misleading." If that officer, however, knew or should have known that not performing the procedures could result in

> the auditor not detecting and seeking correction of material errors in the financial statements, then we believe the officer's conduct should be subject to the rule.[61]

Second, the rule requires that the person "coerce, manipulate, mislead or fraudulently influence" an auditor. Here, the SEC has re-ordered the text of Section 303 to place "fraudulently influence" after "coerce, manipulate, mislead" rather than at the beginning of the list. This change emphasizes the SEC's position that "fraudulently" modifies "influence" and not "coerce, manipulate or mislead." Thus, the SEC has eliminated any additional scienter requirement that may have been required with respect to charges of coercing, manipulating or misleading. Explaining this change, the SEC states that coerce and manipulate "imply pressure, threats, trickery, intimidation or some other form of purposeful action," and therefore, no further modifier is necessary. Further, the adopting release states that causing misleading statements to be made to an auditor is already prohibited by current Rule 13b2-2, and therefore, attaching "fraudulently" to "mislead" would heighten the standard required by existing law, and undercut the rule's objective to enhance investor confidence in the audit process.

The adopting release contains a non-exclusive list of types of conduct that the SEC believes could constitute improper influence if the other requirements of the rule are met (*i.e.*, that the person knew or should have known that the action, if successful, could result in rendering the issuer's financial statements materially misleading), including:

- offering or paying bribes or other financial incentives, including offering future employment or contracts for non-audit services;
- providing an auditor with an inaccurate or misleading legal analysis;
- threatening to cancel or canceling existing non-audit or audit engagements if the auditor objects to the issuer's accounting;
- seeking to have a partner removed from the audit engagement because the partner objects to the issuer's accounting;
- blackmailing; and
- making physical threats.

Additionally, the final rule makes clear that actions do not have to be successful in meeting their objective to be improper under the rule, nor must they actually result in the financial statements being rendered materially misleading. Rather, the rule requires only that the action, if successful, could have led to that result.

The final rule covers actions by officers, directors and "any other person acting under the direction thereof." The rule does not define "direction," but the adopting release makes clear that the SEC interprets the term to encompass a broad range of behavior that could reach persons beyond those under the supervision or control of an officer or director. Such persons "might include not only the issuer's employees, but also. . . customers, vendors or creditors . . . [or] partners or

---

[61] *Id.*

employees of the accounting firm (such as consultants or forensic accounting specialists retained by counsel for the issuer) and attorneys, securities professionals or other advisers." Thus, the SEC may initiate action under the rule against such third parties "who participate in an effort to improperly influence the auditor when those third parties knew or should have known that the effect of their conduct would be to render an issuer's financial statements materially misleading."[62] For example, the SEC could take action against an attorney who, at the request of an officer, prepares a misleading legal analysis that is relied upon by the company's auditor in making a decision relevant to the company's audit.

In response to comment letters expressing concern that including third parties within the ambit of the rule would produce a "chilling effect" on communications between an issuer's auditor and third parties, the SEC comments in the adopting release that it does not intend "to hold any party accountable for honest and reasonable mistakes or to sanction those who actively debate accounting or auditing issues." The adopting release states that third parties should, however, "exercise reasonable attention and care in those communications." Further, the SEC declined to follow the suggestion offered by some commentators, which would have required that a third party act at the specific instruction or direction of an officer or director to come within the scope of the rule.

The final rule is directed at improperly influencing an "independent public or certified public accountant" who is "engaged in the performance of an audit or review of the financial statements of that issuer that are required to be filed with the Commission." Once accounting firms are registered with the PCAOB established by the Sarbanes-Oxley Act, the terms "independent public or certified public accountant" will cover registered public accounting firms and persons associated with such a public accounting firm, as defined in the Sarbanes-Oxley Act.

The SEC interprets the phrase "engaged in the performance of an audit or review" broadly, to apply to all accountants engaged in auditing or reviewing an issuer's financial statements or issuing attestation reports to be filed with the SEC. The SEC's position is that the phrase encompasses the formal audit engagement period and "any other time the auditor is called upon to make decisions or judgments regarding the issuer's financial statements." This includes the negotiation period prior to formal retention of the auditor, such as by making hiring contingent upon limiting the scope of the audit, and later periods, when a former auditor of the company is asked to consent to the use of prior years' audit reports. Further, the rule is not limited to an issuer's annual financial statements, but also includes improperly influencing an auditor during the review of interim financial statements.

The rule identifies a non-exclusive list of actions that could, if successful, result in rendering an issuer's financial statements materially misleading. An officer or director could improperly influence an accountant within the meaning of the rule by coercing, manipulating, misleading or fraudulently influencing an auditor:

- to issue a report on an issuer's financial statements that is not warranted in the circumstances, due to material violations of generally accepted accounting principles, generally accepted auditing standards or other professional or regulatory standards;

---

62 *Id.*

- not to perform an audit, review or other procedures required by generally accepted auditing standards or other professional standards;
- not to withdraw an issued report; or
- not to communicate matters to an issuer's audit committee.

Officers, directors and their advisers should also be aware of the following with respect to the final rule and the adopting release:

- Section 303(b) of the Sarbanes-Oxley Act provides the SEC with sole civil enforcement authority with respect to Section 303 and any rule or regulation issued under the provision, thereby precluding a private right of action.
- There is no exemption or qualification in the final rule limiting its application to foreign private issuers.
- A violation of the rule is an "illegal act" within the meaning of Section 10A(b) of the Exchange Act, and therefore, must be reported by auditors under that section. Attorneys also should be aware that evidence of a violation of the final rule may be reportable under Section 307 of the Sarbanes-Oxley Act if it amounts to "evidence of a material violation," as defined in the SEC's rules under Section 307.
- The SEC states its position that Exchange Act Rule 3b-2, which includes within the definition of "officer" a company's "president, vice president, secretary, treasurer or principal financial officer, comptroller or principal accounting officer, and any person routinely performing corresponding functions," also covers "those who set corporate governance policies and legal policies for an issuer."
- For purposes of Rule 13b2-2, the definition of "issuer" in Section 3 of the Exchange Act is applicable, and not the narrower definition of that term contained in the Sarbanes-Oxley Act. With limited exceptions, the Exchange Act definition covers any person who issues or proposes to issue securities. Thus, the Section 303 prohibition applies to any person who issues or proposes to issue securities whose financial statements are required to be filed with the SEC.

L. Certification of Filings with the SEC and Disclosure Controls and Procedures

1. Section 906 Certification of Periodic Reports

The Sarbanes-Oxley Act contains two divergent certification provisions, each requiring CEOs and CFOs of public companies to certify certain matters in periodic reports filed with the SEC. One of the certification provisions, contained in Section 906 of the Sarbanes-Oxley Act, applies to periodic reports filed by every domestic or foreign issuer on or after July 30, 2002.

a. Filings Subject to the Section 906 Certification Requirement

Section 906 applies to each "periodic report" containing financial statements filed with the SEC on or after July 30, 2002. Thus, the certification requirement applies to each Form 10-K and

Form 10-Q filed by a company subject to Section 13(a) or 15(d) of the Exchange Act, as well as to Forms 20-F filed by foreign issuers. The certification is required to be made by the CEO and the CFO, or the persons holding equivalent positions.

Section 906 does not apply to Forms 8-K or Forms 6-K, since these reports are viewed as current reports and Section 906 applies only to "periodic reports," such as quarterly and annual reports. In its release adopting rules relating to certifications under Section 302 of the Sarbanes-Oxley Act, the SEC confirmed that Forms 8-K and Forms 6-K are not "periodic reports" subject to certification requirements.[63] The SEC has also provided guidance that suggests that Section 906 does not apply to Forms 11-K.[64]

Many companies whose equity securities are closely held file periodic reports, as a result of having issued debt securities in an offering that was registered under the Securities Act. These companies are required, under Exchange Act Section 15(d), to file periodic reports covering the fiscal year in which that registration statement becomes effective. Thereafter, the companies typically continue to file periodic reports with the SEC pursuant to an undertaking in the indenture, even though Section 15(d) states that the duty to file such reports is "automatically suspended" as to any subsequent fiscal year if at the beginning of the fiscal year there are less than 300 holders of the debt securities.[65] Because the Sarbanes-Oxley Act applies only to an issuer whose securities are registered under Section 12 of the Exchange Act or to an issuer that "is required to file reports under Section 15(d)," there is a strong argument that a company that is not required to file under Section 15(d), but which has chosen to do so, is not subject to Section 906, or to other provisions of the Sarbanes-Oxley Act. The same analysis, however, does not apply to other aspects of the Sarbanes-Oxley Act and, in particular, to the Section 302 certification. The 906 certifications apply to "periodic reports," as opposed to Section 302, which applies to "each annual and quarterly report filed or submitted." This "filed or submitted" language under Section 302, coupled with the fact that Section 302 applies to "each company filing periodic reports under Section 13(a) or 15(d)," may provide a hook for the SEC to require "voluntary" 15(d) filers to submit the 302 certifications, even if those voluntary filers do not have to submit 906 certifications, which are applicable to "issuers," a defined term not used in the lead-in to Section 302. Because the Section 302 certifications appear in

---

[63] Certification of Disclosure in Companies' Quarterly and Annual Reports, Release Nos. 33-8124, 34-46427 (Aug. 29, 2002), *available at* http://www.sec.gov/rules/final/33-8124.htm ("SEC Release No. 33-8124").

[64] At the Association of Corporate Counsel annual conference in October 2003, Paula Dubberly, Associate Director of the SEC's Division of Corporation Finance, announced that the SEC, the Department of Justice and members of the President's Corporate Fraud Task Force jointly concluded that Section 906 of the Sarbanes-Oxley Act does not apply to Forms 8-K, 6-K and 11-K.

[65] An informal interpretation by the SEC staff indicates that the provision under Section 15(d) of the Exchange Act, stating that a company is not required to file reports under Section 15(d) during any year (except for the fiscal year in which the registration statement became effective) if the company has fewer than 300 security holders of record at the beginning of such fiscal year, is not conditioned upon the company filing a Form 15 to deregister pursuant to Rule 15d-6.

the filings, one can well imagine the SEC also taking the position that a "voluntary" Form 10-K or 10-Q must fully comply with the content and format requirements applicable to those forms.

b. What the Section 906 Certification Should State

The certification should state that: (i) the periodic report containing the financial statements fully complies with the requirements of Section 13(a) or 15(d) of the Exchange Act; and (ii) the information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer.

The Sarbanes-Oxley Act imposes criminal penalties if the CEO or CFO certifies the statement "knowing" that the periodic report does not comport with the requirements set forth in the statement, and imposes greater penalties if the officer's act is also "willful."

c. The Ramifications of an Executive's Inability to Make the Certification

Because the certification can give rise to criminal liability, where an executive believes that the required statement would not be true, he or she should consult with counsel. The fact that a CEO or CFO believes he or she is unable to make the certification will likely be viewed as material information, resulting in the company's need to consider whether it should publicly disclose in the periodic report that one or both of its executives are unable to provide the certification, together with the reasons for their inability to provide the certification.

It is unclear whether there is any penalty for failing to file the certification. Section 3(b)(1) of the Securities Act provides:

> A violation by any person of this Act . . . shall be treated for all purposes in the same manner as a violation of the [Exchange Act] or the rules and regulations issued thereunder, consistent with the provisions of this Act, and any such person shall be subject to the same penalties, and to the same extent, as for a violation of that Act or such rules or regulations.

Section 906, however, is contained in a part of the Sarbanes-Oxley Act entitled the "White-Collar Crime Penalty Enhancement Act of 2002," so it is unclear whether Section 3(b) applies to this Act-within-an-Act. It is also unclear whether the Sarbanes-Oxley Act provides a civil remedy for failure to file the certification.

d. How the Section 906 Certification Should be Submitted to the SEC

In a June 5, 2003 release, the SEC adopted rules requiring issuers to furnish the 906 certifications as an exhibit to periodic reports.[66] The rules amend Item 601 of Regulations S-B and

---

[66] Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reporting, Release No. 33-8238 (June 5, 2003), *available at* http://www.sec.gov/rules/final/33-8238.htm ("SEC Release No. 33-8238").

S-K to add the 906 certifications as exhibit 32. Corresponding amendments were adopted for companies subject to the Investment Company Act. The rules confirm that a 906 certification may take the form of a single certification signed by the issuer's chief executive officer and chief financial officer. The rules were effective for the Forms 10-Q filed on August 15, 2003.

Because Section 906 requires the certification to "accompany" a filing, as opposed to being included in the filing (the language used for the other certification provision contained in Section 302 of the Sarbanes-Oxley Act), the Sarbanes-Oxley Act does not on its face require the Section 906 certification to be filed with the SEC. In this regard, the rules, as adopted, require issuers to "furnish," rather than "file," the 906 certifications. The "furnished" certifications would not be subject to liability under Section 18 of the Exchange Act and would not be subject to automatic incorporation by reference into an issuer's Securities Act registration statements. The SEC, however, has also amended the Exchange Act rules to mandate that companies submit the 906 certifications, with the result that the failure to do so would constitute a violation of the Exchange Act.

e. Increased Liability as a Result of Section 906

It is unclear whether a Section 906 certification will result in increased liability outside of the context of a criminal action brought by the U.S. Attorneys office under Section 906 for submitting or willfully submitting a certification on a periodic report that the executive knows does not satisfy the standard set forth in the Sarbanes-Oxley Act.

Whether Section 906 certifications lead to increased liability under the foregoing or other theories will, of course, take a number of years to determine and will depend on judicial interpretations. It may be that the certifications will not result in litigation or liability at a company in circumstances where the company would not otherwise have that exposure due to some underlying inaccuracies in a periodic report.

2. Section 302 Certification of Periodic Reports

Section 302 of the Sarbanes-Oxley Act requires a more extensive mechanism for certification of periodic reports by CEOs and CFOs. As directed by Section 302(a) of the Sarbanes-Oxley Act, the SEC adopted rules, which became effective on August 29, 2002, imposing new obligations relating to certification of SEC filings on both principal executive and financial officers and companies.[67] The SEC has since slightly amended the rules regarding Section 302 certifications.

The rules require CEOs and CFOs to certify financial and other information contained in quarterly and annual reports. The rules also require CEOs and CFOs to certify that:

- they are responsible for establishing, maintaining and regularly evaluating the effectiveness of disclosure controls and procedures;
- they have made certain disclosures to the auditors and the audit committee of the board about the internal controls; and

---

[67] SEC Release No. 33-8124.

- they have included information in the quarterly and annual reports about their evaluation and whether there have been significant changes in the internal controls or in other factors that could significantly affect internal controls subsequent to the evaluation.

The SEC also adopted rules that implement certain aspects of the statements required to be made in the CEO and CFO certifications. These include:

- rules requiring companies to maintain disclosure controls and procedures designed to ensure that the information required in reports filed under the Exchange Act is recorded, processed, summarized and reported on a timely basis;
- rules requiring an evaluation of the effectiveness of these controls and procedures on a quarterly basis;
- rules requiring disclosure of the CEO's and CFO's conclusions about the effectiveness of these controls and procedures in the body of the Form 10-K and Form 10-Q; and
- rules requiring companies to disclose significant changes in their internal controls. Note that if a company has revised its recordkeeping practices for option grants (stemming from the substantial coverage of "option backdating"), such change is likely to be a material improvement over the procedures the company had in place, and consequently, the company will need to disclose those changes in its next Form 10-K or 10-Q (regardless of whether the company has previously disclosed problems with its option grants).

These rules codify the significantly increased focus on CEO and CFO involvement with, and accountability for, their company's public disclosures. Following recent corporate scandals in which senior officers testified that they delegated all responsibility for financial and other disclosures to others in management, Congress and the SEC have made it clear that they view such abdication to be inappropriate. While CEOs and CFOs continue to be able to involve and rely on others involved in the disclosure process, in order to make the mandated certifications, CEOs and CFOs will need to be directly involved each quarter in reviewing SEC filings and in monitoring the processes that generate the information required to be disclosed in those filings.

a. Requirements for Section 302 Certification

Sample certifications for Form 10-K and Form 10-Q are included as part of the SEC's rule release. As discussed below, it is important that the text of the certification not vary in any respect from the format required for the particular filing. Under the certifications, each CEO and CFO is required to certify the following items in each covered filing:

1. He or she has reviewed the report.

2. Based on his or her knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the

circumstances under which such statements were made, not misleading with respect to the period covered by the report.[68]

3. Based on his or her knowledge, the financial statements, and other financial information included in the report, *fairly present* in all material respects the financial condition, results of operations and cash flows of the company as of, and for, the periods presented in the report (emphasis added).[69]

4. He or she and the other certifying officers:

   - have designed such disclosure controls and procedures to ensure that material information is made known to them, particularly during the period in which the periodic report is being prepared;
   - have designed such internal controls over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP;
   - have evaluated the effectiveness of the disclosure controls and procedures as of the end of the period covered by the report; and
   - have disclosed any change in internal control over financial reporting that occurred during the most recent quarter that has

---

[68] Note that this statement reflects the anti-fraud disclosure standard embodied in existing Exchange Act Rule 12b-20.

[69] Note that the term "fairly present" is intended by the SEC as a broader representation than the term "fairly presents in accordance with U.S. GAAP." The representation applies to the financial statements (including footnote disclosure), selected financial data, Management's Discussion and Analysis and other financial information included in a filing. The "fairly presents" standard requires an assessment of overall material accuracy and completeness that includes an assessment of whether the accounting principles selected are appropriate under the circumstances, whether the disclosure is informative and reasonably reflects the underlying transactions and events and whether any additional disclosure is necessary to provide investors with a materially accurate and complete picture of the company's financial condition, results of operation and cash flows. It is important to note that the SEC has repeatedly stated that compliance with U.S. GAAP may not of itself provide sufficient disclosure to avoid misleading investors. *See In re Caterpillar, Inc.*, SEC Release No. 34-30532 (Mar. 31, 1992), and *In re Edison Schools, Inc.*, SEC Release No. 34-45925 (May 14, 2002). Significantly, however, the SEC confirmed that the certification requirements are not intended to change existing disclosure standards.

materially affected, or is reasonably likely to affect, the overall internal reporting.

5. He or she and the other certifying officers have disclosed to the auditors and to the audit committee:

   - all significant deficiencies in the design or operation of internal controls which could adversely affect the company's ability to record, process, summarize and report financial data, and have identified for the auditors any material weaknesses in internal controls; and
   - any fraud, whether or not material, that involves management or other employees who have a significant role in the internal controls.

As discussed below, the SEC amended Forms 10-Q and 10-K to impose affirmative obligations on companies regarding maintenance of "disclosure controls and procedures" and to require the disclosures referenced in point 4 of the certifications regarding the officers' assessments of both disclosure controls and internal financial reporting controls.

b. Who is Subject to the Certification Requirements?

1. Reporting Companies

All companies registered under Section 12 of the Exchange Act or that are required to file reports under Section 15(d) of the Exchange Act are subject to the certification rules. The SEC release adopting the certification rules provides slightly different rules for certifications by registered investment companies and for issuers of asset-backed securities.

2. Foreign Private Issuers

The certification requirements clearly apply to all foreign private issuers that file reports under Section 13(a) or 15(d) of the Exchange Act, <u>except</u> those foreign private issuers that furnish materials to the SEC pursuant to Rule 12g3-2(b).

3. Voluntary Filers

Many companies whose equity securities are closely held file periodic reports, as a result of having issued debt securities in an offering that was registered under the Securities Act. These companies are required under Exchange Act Section 15(d) to file periodic reports covering the fiscal year in which that registration statement becomes effective. Thereafter, many companies continue to file periodic reports with the SEC pursuant to an undertaking in the indenture, even though Section 15(d) states that the duty to file such reports is "automatically suspended" as to any subsequent fiscal year if at the beginning of the fiscal year there are less than 300 holders of the debt securities.

(a) Certification Requirement under Section 906

Section 906 of the Sarbanes-Oxley Act requires an *issuer* to make certain certifications in their periodic reports. Section 2(a)(7) of the Sarbanes-Oxley Act defines "issuer" to mean an issuer whose securities are registered under Section 12 of the Securities Act or that is required to file reports under Section 15(d) of the Exchange Act.[70] Thus, it appears that a company that is not required to file under Section 15(d), but which files reports voluntarily or pursuant to an indenture covenant, is not subject to the certification requirements of Section 906.

(b) Certification Requirement under Section 302

Section 302 of the Sarbanes-Oxley Act, in contrast, requires each company filing periodic reports under Section 13(a) or 15(d) of the Exchange Act to make the required certifications. Congress' decisions to use the more narrowly defined term "issuer" in Section 906 and the broader term "company" in Section 302 arguably reflect an intent to apply the certification requirements of Section 302 more broadly. Thus, under rules of statutory construction, Section 302 may be interpreted to apply to more companies than does Section 906, bringing voluntary filers within its scope.

Rule 13a-14 states that "each report … filed on Form 10-Q, Form 10-QSB, Form 10-K, Form 10-KSB, Form 20-F or Form 40-F" must contain the certification. It has long been the SEC staff's position that voluntary filers cannot choose to comply with only select provisions of the forms. SEC staff interpreting the certification requirements have also been informing callers of the staff's view that Section 302 certifications are required for voluntary filers. Further, bond indentures often require the issuer to file periodic reports "as if" they were subject to Section 13(a) or 15(d). Accordingly, voluntary filers should include the certifications and begin the process of establishing, documenting and evaluating their disclosure controls and procedures in order to meet the Section 302 certification requirements. While it may be possible for a voluntary filer to exit the reporting system by filing a Form 15, companies considering such action should review the language of their indentures to determine whether that action is permissible.

c. What Reports are Subject to the Certification Requirements?

The new certification requirements apply to each annual or quarterly report filed under either Section 13(a) or 15(d) of the Exchange Act (*e.g.*, reports on Forms 10-K, 10-Q, 20-F and 40-F). To the extent that information required in a Form 10-K is provided in another document, such as the proxy statement, the certification covers such information.[71] Current reports, such as reports on

---

[70] *See* Section 2(a)(7) of the Sarbanes-Oxley Act. Notably, the Sarbanes-Oxley Act defines "issuer" more narrowly to include only a subset of those defined as issuers under Section 3(a)(8) of the Exchange Act. Section 3(a)(8) of the Exchange Act defines "issuer" as any person who issues or proposes to issue any security.

[71] The SEC has requested comment on whether certifications should be required with respect to proxy statements and Exchange Act registration statements. Thus, further rulemaking may be forthcoming on the scope of the certification requirements.

Forms 6-K and 8-K, are not subject to the certification requirements applicable to periodic reports.[72] In addition, the SEC specifically excluded reports on Form 11-K from the new certification requirements of Section 302.

d. Questions about the Certification Requirements

1. Format and Location of CEO and CFO Certifications

A separate Rule 13a-14 certification must be provided for each CEO and CFO. The SEC amended Forms 10-K and Forms 10-Q, and the other forms which require certifications, to provide for the certifications to appear immediately following the signature section.

The SEC has adopted amendments to the certifications required by Section 302 to facilitate investors' ability to locate the certifications within the company reports.[73] The new rules require a company filing periodic reports under Section 13(a) or 15(d) of the Exchange Act to file 302 certifications as an exhibit to the periodic reports. The rules amended Item 601 of Regulations S-B and S-K to add the 302 certifications to the list of required exhibits as new Item 31.

2. Changes to the Certificates

The SEC has said that the required certification must be in the exact form set forth in the amended forms and may not be altered in any way, "even if the change would appear to be inconsequential in nature." It is important to note that the language of the certification differs depending on what report is being filed. For example, the language required for an annual filing on Form 10-K differs from the language required for a quarterly filing on Form 10-Q. Therefore, companies should carefully check that their officers are submitting the correct form of certification with a particular filing.

3. Signatures and Powers of Attorney

A CEO or CFO is not permitted to have the certification signed on his or her behalf pursuant to a power of attorney or other form of confirming authority. Clients are advised to coordinate the certification process in advance of filing deadlines to avoid logistical difficulties in collecting signatures. Companies are required to retain the original certifications, which their CEO and CFO signed at the time they authorized their signatures to be typed onto the certification being filed via EDGAR, but companies are not required to file original signed copies of the certifications with the SEC. The certification requirement does not alter the current signature requirements for quarterly and annual reports, and the signatures appearing on the certifications are subject to the same rules and procedures for EDGAR filings.

---

[72] The SEC adopting release makes clear that a report on Form 8-K and a foreign company report on Form 6-K is a current report, as opposed to periodic report, for purposes of the new certification requirements of Section 302, as well as for the purpose of Section 906. *See* Section III.B. of SEC Release No. 33-8124.

[73] SEC Release No. 33-8238.

e. Disclosure Controls and Procedures vs. Internal Control Over Financial Reporting

The language of the certifications distinguishes between two types of controls: "internal control over financial reporting" and "disclosure controls and procedures."

Pursuant to Section 404 of the Sarbanes-Oxley Act, the SEC adopted rules, in addition to those required under the Section 302 certifications, requiring annual assessments of internal controls and certain disclosures related thereto.[74] While Section 404 of the Sarbanes-Oxley Act requires implementation of only an annual review of internal controls, the rules, as adopted, require quarterly certification, but only of the fact that no major changes have taken place that have materially and adversely affected, or will likely materially and adversely affect, an issuer's internal control over financial reporting. Issues relating to internal control over financial reporting are discussed in greater detail above.

The SEC specifically intended the new concept of disclosure controls and procedures "to cover a broader range of information than is covered by an issuer's internal controls related to financial reporting."[75] The new term adds an important element that extends beyond financial controls to require a greater involvement of the company's business and legal officers. While the certifications require the CEO and CFO to state their responsibility for establishing and maintaining disclosure controls, as a practical matter, we expect that these officers will work closely with other senior company officials, including the general counsel, to confirm that controls and procedures are in place to make certain that *all* information required to be disclosed, not just financial information, is properly disclosed. These disclosure controls and procedures must be put in place as a method to assure that such information is collected, communicated to senior management, evaluated and disclosed in a timely manner.

f. What are Disclosure Controls and Procedures?

The SEC adopted new Rule 13a-14(c) to define "disclosure controls and procedures" as controls and other procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer in the reports filed under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.[76] Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in its Exchange Act reports is accumulated and communicated to the issuer's management, including its principal executive and financial officers, as appropriate to allow timely decisions regarding required disclosure.

---

[74] SEC Release No. 33-8238.

[75] *See* SEC Release No. 33-8124, at Section III. B.

[76] In adopting this definition, the SEC imposed a stricter standard on companies than is provided for with respect to CEOs and CFOs under the Sarbanes-Oxley Act, as the language of the CEO and CFO certifications on disclosure controls includes a materiality standard established by Congress.

Importantly, although the certification requirements currently apply only to periodic reports such as Forms 10-K and Forms 10-Q, disclosure controls and procedures are required to address all required SEC disclosures, including proxy statements and Forms 8-K.

In adopting the new rules, the SEC did not prescribe any particular controls or procedure to be used by companies. Instead, the SEC indicated it expects each company to develop a process that is consistent with its business and internal management and supervisory practices.

g. New Disclosure Items for Forms 10-Q and Forms 10-K: Controls and Procedures

The SEC also adopted a variety of rules and disclosure requirements that impose duties on companies in support of the CEO and CFO certification process. New Rule 13a-15(a) requires that companies maintain disclosure controls and procedures, and Rule 13a-15(b) addresses the evaluation of these controls and procedures.[77] Specifically, Rule 13a-15(b) requires a company's management, including the CEO and CFO, to supervise and participate in the evaluation of the effectiveness, design and operation of the company's disclosure controls and procedures. This evaluation must take place within 90 days prior to filing of a report requiring the new certifications. Thus, the CEO and CFO will need to conduct a quarterly assessment of the company's disclosure controls and procedures.

Form 10-Q and Form 10-K have been amended to include new Items 4 and 14, respectively. These items, named "Controls and Procedures," refer to new Item 307 of Regulation S-K. Item 307(a) requires disclosure of the conclusions reached by the CEO and CFO, following their Rule 13a-15(b) evaluation of the effectiveness of the company's disclosure controls and procedures. An issue arises as to the appropriate language for the disclosure required under Item 307(a), given that the CEO and CFO certification itself contains a materiality qualification with respect to the design of disclosure procedures and controls, whereas Rule 13a-15(a) imposes on companies a responsibility to maintain disclosure controls without regard to the materiality of the information being reported. While the issue is not clear, we believe that the Item 307(a) disclosure may contain a materiality reference, in order to conform the disclosure to the language contained in the CEO's and CFO's certification.

New Item 307(b) requires disclosure of any significant changes in a company's internal controls, or in other factors that could significantly affect these controls, subsequent to the date the internal controls were last evaluated by the CEO and CFO.

M. Section 16 Amendments

The Sarbanes-Oxley Act amended and restated Section 16(a) of the Exchange Act to require executive officers, directors and greater than 10% stockholders ("**insiders**") to file Section 16 transaction reports "before the end of the second business day following the day on which the subject transaction has been executed." The Sarbanes-Oxley Act authorized the SEC to exempt

---

[77] Corresponding provisions were adopted under new Rule 15d-15 for companies filing under Section 15(d).

transactions from the two business day reporting requirement if it determines that reporting within that time is not "feasible." In addition, the SEC's general exemptive and rulemaking authority under Section 16(a) was not affected by the Sarbanes-Oxley Act.

The amendment to Section 16(a) became effective on August 29, 2002. On August 27, 2002, the SEC adopted final rules to address the amendments to Section 16(a).[78] Under these rules, the new reporting requirements apply to transactions occurring on or after August 29, 2002.

1. Section 16(a) Reporting Changes

Under the SEC's final rules, the Section 16 reporting rules have been amended as follows:

a. Form 4 Reporting of Transactions between the Company and the Insider

Transactions between an insider and the company (or an employee benefit plan) that are exempt from Section 16(b) liability, but that were previously required to be reported on Form 5, are now reportable on Form 4. As a result, the following transactions are subject to two-business-day reporting:

- Grants, awards and other acquisitions from the issuer that satisfy the requirements of Rule 16b-3(d). This category includes stock option grants, restricted stock grants and acquisitions of stock units under non-tax qualified deferred compensation plans.
- Dispositions to the issuer that satisfy the requirements of Rule 16b-3(e). This category includes shares delivered to the company to pay tax withholding amounts or an option exercise price, options surrendered to the company in an option repricing and sales of shares to a company.
- Discretionary transactions that satisfy the requirements of Rule 16b-3(f). A "discretionary transaction" is a participant-directed movement of a portion of his or her account balance into or out of a company stock fund under a deferred compensation plan. The term does not include transactions made in connection with the plan participant's death, disability, retirement or termination of employment, or that are required to be provided under IRS regulations. Discretionary transactions may occur in a tax-qualified plan, such as a 401(k) plan, or in a non-tax qualified plan, such as a SERP or a directors' fee deferral arrangement. As discussed below, the SEC provided a limited extension of time for Form 4 reporting of discretionary transactions.

---

[78] Ownership Reports and Trading by Officers, Directors and Principal Security Holders, Release No. 34-46421 (Aug. 27, 2002), *available at* http://www.sec.gov/rules/final/34-46421.htm.

b. Accelerated Reporting of Transactions on Form 4

All Forms 4 are due on the second business day after an applicable transaction is executed, subject to two narrow exceptions. As a result, in addition to the transactions described above, stock option exercises and open market purchases and sales are subject to two business-day reporting.

The SEC has provided a limited extension of time for Form 4 reporting for "discretionary transactions" and for transactions pursuant to Rule 10b5-1(c) trading plans, provided that, in both cases, the insider does not select the date the transaction is to occur. Under the limited extension, the two-business-day deadline is counted from a "deemed" transaction date, which is the earlier of the date the insider receives notice that the transaction was executed and the third business day after the date the transaction is executed. Consequently, the latest a Form 4 can be timely filed for these transactions is on the fifth business day after the transaction. Insiders should note, however, that the extended time period for these transactions is not available if the insider has selected the date for transaction execution. For example, if an insider establishes a Rule 10b5-1(c) trading plan that provides for a sale on the first business day of each month, the insider has selected the date of the transaction and the limited extension is not available. If an employee benefit plan operates such that a discretionary transaction occurs on a date determined by the day the insider provides instructions authorizing the transaction, as opposed to being executed on a date selected in the discretion of the plan administrator, the insider arguably has selected the date for execution of the transaction, and consequently, the limited filing extension would not be available. In these circumstances, the insider will need to receive information from the plan administrator to complete and file a Form 4, reporting the transaction within the normal two-business-day deadline.

c. Other Reporting Exemptions Will Continue

All pre-existing exemptions from Section 16 transaction reporting continue to be available. Consequently, as before, insiders are not required to report the following transactions:

- acquisitions under tax-conditioned plans that satisfy the requirements of Rule 16b-3(c), including: (i) purchases that occur pursuant to stock allocations under ERISA profit-sharing plans and employee stock ownership plans ("**ESOPs**"); (ii) purchases that occur pursuant to payroll deductions under 401(k) plans; (iii) excess benefit plans that provide only for benefits or contributions in excess of certain limits imposed on tax-qualified plans; and (iv) employee stock purchase plans that satisfy Section 423 of the Internal Revenue Code and similar plans that are not tax qualified but satisfy certain coverage and participation requirements;
- forfeiture or expiration of stock options or restricted stock;
- acquisitions pursuant to dividend reinvestment plans, other than purchases that result from a discretionary contribution to such plans;
- stock splits, stock dividends and distributions of stock purchase rights;
- transfers pursuant to divorce decrees and domestic relations orders;

- changes in the form of ownership that do not affect the insider's pecuniary interest in the shares, such as changes from indirect to direct ownership;
- transactions following termination of insider status, if the insider has not effected a matchable transaction during the previous six months while still an insider; or
- transactions effected in a fiduciary capacity as a guardian, executor or receiver during the twelve months following the insider's appointment to such position.

d. Form 5 Reporting of Other Transactions

A few categories of transactions remain eligible for reporting annually on Form 5. Consequently, as before, insiders can use Form 5 to report the following transactions:

- acquisitions or dispositions of shares through gifts or inheritance; and
- "small" acquisitions, meaning purchases aggregating less than $10,000, provided that the transactions are not transactions with the company or an employee benefit plan described in Rule 16b-3(d) or (f), which, as addressed above, are now subject to two-business-day reporting. (A common example of small transactions that remain eligible for Form 5 reporting are acquisitions under dividend reinvestment arrangements sponsored by brokerage firms when a company itself does not offer a reinvestment plan. Note, however, that if the $10,000 threshold is exceeded, a Form 4 to report the transactions must be filed within the new two-business-day deadline.)

In addition, Form 5 continues to be available for year-end disclosure of late transaction reports.

e. Form 3 and Form 5 Reporting

The Sarbanes-Oxley Act did not change the filing deadlines for Form 3. For persons who become insiders after a company's initial public offering, a Form 3 is due within 10 days (not business days) after the person becomes a Section 16 insider. When companies initially go public, Forms 3 are due on the effective date of a company's registration under Section 12. The Sarbanes-Oxley Act also does not address the timing of Form 5 filings, and the SEC has retained the deadline it originally developed for that form (i.e., 45 days after the end of the company's fiscal year).

f. Reporting Holdings

Form 4 continues to require "end of period" holdings to be reported, but the SEC has clarified that each Form 4 must report the person's holdings after giving effect to the transaction reported on the form. As in the past, a Form 4 is not required to reflect the effect of a transaction that is not reported on the Form 4 and that has not previously been reported on an insider's holdings, such as the effect of a gift or a discretionary transaction that has not yet been reported, and need only reflect the effect of non-reportable transactions, such as purchases under 401(k) payroll contributions and dividend reinvestment plans, as of the most recently available statement.

g. Form 8-K Reporting

In the release adopting the new rules, the SEC indicated that it will not pursue its proposal to require that companies disclose insiders' stock transactions on a Form 8-K.

2. Section 16 Reporting Changes

Neither the Sarbanes-Oxley Act nor the SEC rules changed any of the pre-existing exemptions from liability under Section 16(b). Thus, any transaction that is exempt from reporting and any transaction that is exempt under a 16(b) rule, such as Rule 16b-3, is not subject to potential matching for purposes of determining short-swing liability.

On August 3, 2005, the Commission adopted amendments intended to clarify the scope of the Section 16(b) rules regarding certain transactions exempt from the private right of action to recover short-swing profits.[79] Because of the recent opinion of the U.S. Court of Appeals for the Third Circuit (the "**Third Circuit**") in *Levy v. Sterling Holding Company, LLC*,[80] doubt was cast as to the nature and extent of transactions exempt from Section 16(b) short-swing profit recovery under Rules 16b-3 and 16b-7.

a. Rule 16b-3

Rule 16b-3 exempts from Section 16(b) liability certain transactions relating to grants, awards or other acquisitions between issuers and their officers and directors. Because grants and awards are compensation based, the Third Circuit held that the "other acquisitions" must have compensation-related aspects in order to be exempted by Rule 16b-3.

In order to clarify its position regarding Rule 16b-3, the Commission passed amendments to Rules 16b-3(d) and 3(e). As adopted, Rule 16b-3(d) exempts any transaction, other than a discretionary transaction,[81] involving an acquisition by an officer or director[82] from the issuer

---

[79] Ownership Reports and Trading by Officers, Directors and Principal Security Holders, Release Nos. 33-8600; 34-52202; IC-27025, (Aug. 3, 2005), *available at* http://www.sec.gov/rules/final/33-8600.htm.

[80] 314 F.3d 106 (3d. Cir. 2002), *cert. denied*, *Sterling Holding Co. v. Levy*, 124 S. Ct. 389 (U.S., Oct. 14, 2003).

[81] A discretionary transaction is an employee benefit plan transaction that is at the volition of a plan participant and results in either an intra-plan transfer involving an issuer equity securities fund, or a cash distribution funded by a volitional disposition of an issuer equity security.

[82] Ten percent owners may be able to exempt their transactions with the issue if they are established as directors by deputization. See *Roth v. Perseus, L.L.C.*, 05 Civ. 10466 (S.D.N.Y.

(including, without limitation, a grant or award), whether or not intended for a compensatory purpose or other purpose, as long as one of the following conditions is satisfied:

- approval of the transaction by the issuer's board of directors or a board committee comprised solely of two or more non-employee directors;
- approval or ratification of the transaction, in compliance with Exchange Act Section 14, by the issuer's shareholders; or
- the officer or director is to hold the acquired securities for a period of six months after acquiring the securities.

Rule 16b-3(e), as adopted, exempts any transaction, excluding discretionary transactions, involving the disposition of issuer equity securities by an officer or director, whether or not intended for a compensatory or other purpose, so long as the terms of such disposition are approved in advance.

In August 2006, the SEC announced an amendment to Rule 16b-3 adding a new "note" that assures directors will not lose the exemption if they are believed to be a non-employee director at the time of the committee approval and they are later determined to have a relationship with the issuer disclosable under Item 404.[83]

b. Rule 16b-7

Rule 16b-7 exempts from Section 16(b) liability certain transactions that do not involve a significant change in the issuer's business or assets. The ruling in *Levy v. Sterling* construed Rule 16b-7 as not exempting an acquisition pursuant to a reclassification that:

- resulted in the insiders owning equity securities (common stock) with different risk characteristics from the securities (preferred stock) extinguished in the transaction, where the preferred stock previously had not been convertible into common stock; and
- involved an increase in the percentage of the insiders' common stock ownership based on the fact that the insiders owned some common stock before the reclassification extinguished their preferred stock in exchange for common stock.

July 28, 2006). However, the Ninth Circuit requires that the issuer's board of directors know that the counterparty is a director by deputization at the time it approves the transaction for which the exemption is claimed. *Dreiling v. American Express Co.*, No. 04-35715 (9th Cir. August 14, 2006). Otherwise, a board is unable to perform its gatekeeping function under Rule 16b-3 by specifically approving the transaction.

[83] Conforming Version, Final Rule, Release Nos. 33-8732A; 34-54302A; IC-27444A; File No. S7-03-06 (August 29, 2006), *available at* http://www.sec.gov/rules/final/2006/33-8732a.pdf.

The Commission determined that the ruling placed conditions on reclassifications under Rule 16b-7 that were not found in the language of the rule. In order to clarify its position, the Commission amended the rule to place "mergers, reclassifications[84] or consolidations" in place of "mergers or consolidations." The Commission also clarified the conditions required to be met in order for the exemption to apply. In order for the acquisition of a security pursuant to a merger, reclassification or consolidation to be exempt from Section 16(b) liability, the security relinquished in exchange for the acquired security must be of a company that, before the transactions, owned:

- 85% or more of the equity securities of all other companies party to the merger or consolidation; or

- 85% or more of the combined assets of all of the companies undergoing merger or consolidation.

The corresponding disposition of a security of an issuer that before such a transaction satisfied either 85% test is exempt under Rule 16b-7(a)(2).

3. Mandated Electronic Filing and Website Posting for Section 16 Reports

In a May 7, 2003 release, the SEC adopted rules requiring electronic filing and website posting of forms filed under Section 16(a) of the Exchange Act, reporting corporate insiders' ownership and transactions in company securities.[85] These rules implement Section 403 of the Sarbanes-Oxley Act and complement the accelerated two-day reporting requirement adopted by the Commission in August 2002. Mandatory electronic filing and website posting requirements became effective on June 30, 2003, a month earlier than required under the Sarbanes-Oxley Act.

Directors, executive officers and 10% owners of a class of securities are required to file Forms 3, 4 and 5 ("**Section 16 Reports**") pursuant to Section 16(a) of the Exchange Act and the rules thereunder. Forms 4 are generally required to be filed within two business days after a reportable transaction. The new rules (i) require insiders to file all Section 16 Reports electronically and (ii) require issuers to post Section 16 Reports on their websites by the end of the business day

---

[84] The Commission noted that the rule does not define reclassifications, but that such transactions generally include transactions in which the terms of the entire class or series are changed, or securities of the entire class or series are replaced with securities of a different class or series of the company's securities and the holders of such securities are entitle to receive the same consideration.

[85] Mandated Electronic Filing and Website Posting for Forms 3, 4 and 5, Release No. 33-8230 (May 7, 2003), *available at* http://www.sec.gov/rules/final/33-8230.htm. In order to satisfy the website posting requirement, the SEC has revised its EDGAR company search web page to allow issuers to link only to the Section 16 forms. The SEC has also issued an FAQ on electronic filing, *available at* http://www.sec.gov/divisions/corpfin/sec16faq.htm. Finally, the SEC has provided additional tips for using the new system, *available at* http://www.Section16.net.

following the filing date. A company can satisfy the website posting requirement by linking to filings on the SEC's EDGAR database or to other third-party databases if certain conditions are satisfied.

Since June 30, 2003 and pursuant to the new rules:

- The deadline for electronic filing of Section 16 Reports has been extended from 5:30 p.m. Eastern Standard Time on the date on which a Section 16 Report is due to 10:00 p.m. Eastern Standard Time. Thus, if a Form 4 is filed electronically before 10:00 p.m. EST on its due date, it will be treated as timely filed. (This extended filing deadline will not be available for other SEC filings, such as Forms 8-K, Forms 10-K and Forms 10-Q, or for registration statements. Although those reports can currently be submitted electronically between 5:30 and 10:00 p.m. EST, they are not deemed to be filed until the next business day.)
- For a period of one year, companies are not required to report an insider's late Section 16 Report filings in their Forms 10-K or proxy statements, if the Section 16 Report is filed only one day late.
- Insiders or issuers who encounter technical difficulties in filing Section 16 Reports are not able to file a Form TH, which provides an automatic deadline extension, for late Section 16 Reports. Instead, they need to request that the Commission adjust the filing date under Rule 13 of Regulation S-T, if they can demonstrate that they meet the requirements for an adjusted filing date to the Commission staff.

The Commission has developed special features for the EDGAR filing system that will facilitate electronic filing of Section 16 Reports. Under the new EDGAR filing system for Section 16 Reports, insiders can type Section 16 transaction data into an on-line template, add any applicable attachments and file the Report. The system is currently operational to make actual electronic filings of Section 16 Reports. Since the June 30, 2003 effective date, insiders have been required to file Section 16 Reports through the new EDGAR filing system. In addition, a number of vendors have developed filing programs that will interface with the new EDGAR filing system for Section 16 Reports.

On August 3, 2005, the Commission amended Item 405 of Regulations S-K and S-B to harmonize the item with the two business day Form 4 due date and mandated electronic filing and Web site posting of Section 16 reports.[86] Previously, Item 405 stated that a form received by the registrant within three calendar days of the required filing date may be presumed to have been filed with the Commission by the required date. When the Sarbanes-Oxley Act was enacted, it amended Section 16(a) to require two business day reporting of changes in beneficial ownership and required that the reports be filed electronically. The adoption of the Sarbanes-Oxley Act made the three

[86] Ownership Reports and Trading by Officers, Directors and Principal Security Holders, Release Nos. 33-8600; 34-52202; IC-27025, (Aug. 3, 2005), *available at* http://www.sec.gov/rules/final/33-8600.htm.

calendar day requirement no longer appropriate or necessary and the Commission therefore amended Item 405 to remove the three calendar day requirement.

N. Consensus Outline on Interpretive Issues under Section 402 of the Sarbanes-Oxley Act

Section 402 of the Sarbanes-Oxley Act generally prohibits public companies from extending credit in the form of a personal loan to any executive officer or director. Section 402, however, contains substantial ambiguities, is the subject of limited legislative history and has not been the subject of any official guidance.[87] In particular, the Sarbanes-Oxley Act does not mandate that the SEC adopt rules implementing or clarifying Section 402, and it appears that the SEC will not provide guidance on many of the issues arising under Section 402 in the near future.[88]

On October 15, 2002, 25 leading law firms, including Gibson, Dunn & Crutcher LLP, released a consensus outline which sets forth the law firms' views regarding a number of activities that, in the absence of contrary official guidance, should be considered "permissible" under Section 402.[89]

The outline lists some of the factors that were considered in support of each conclusion, although each firm that joined in issuing the outline does not necessarily concur in all aspects of these analyses or give all aspects of the analyses equal weight. In addition, the outline reflects that some factual situations are less certain than others. Because the outline is intended to set forth guiding principles and not to provide legal advice on any particular fact pattern, companies should continue to consult counsel as to the applicable analyses, risks and alternatives available for particular situations. It also is important to note that the consensus outline does not mean that any of the situations addressed is free from risk under 402, as the SEC could always provide guidance that takes a contrary position, either through rulemaking, no-action interpretation or enforcement actions.

Finally, it should be noted that a number of the situations addressed in the consensus outline continue to involve sensitive policy issues. One such area is the issue of "cashless" option exercises. When evaluated in light of the actual mechanics involved and the abuses that lead to Section 402, we believe that many cashless exercise arrangements should not be viewed as involving a prohibited extension of credit by either the company or the brokerage firm. Additionally, these programs

---

[87] The SEC has brought its first enforcement case regarding improper loans to executive officers, but the case provides no guidance regarding ambiguities in the prohibitions. The SEC's order in *In the Matter of Peter Goodfellow and Stamatis Molaris* is available at http://www.sec.gov/litigation/admin/34-52865.pdf.

[88] At the American Bar Association Spring Meeting in Los Angeles, California on April 4 and 5, 2003, Alan Beller, Director of the Division of Corporate Finance of the SEC, stated that the staff is not inclined to issue guidance on Section 402.

[89] Consensus Outline, *Sarbanes-Oxley Act: Interpretive Issues under Section 402—Prohibition of Insider Loans* (Oct. 15, 2002), *available at* http://www.gibsondunn.com/practices/publications/detail/id/766/?pubItemId=6371.

should not be seen as inconsistent with the spirit of the Sarbanes-Oxley Act, since they were often implemented, and at times even mandated, by companies for their executives and non-executives alike, not to provide credit, but rather to simplify or outsource option plan administration.[90] Nevertheless, while we hope that the consensus outline will be a helpful reference for analysis of the issues that arise under Section 402, we also understand that some companies may wish to continue to evaluate whether alternative approaches are available for various arrangements to avoid Section 402 issues.

The outline advises the use of customary principles of statutory construction to interpret Section 402. Furthermore, the outline focuses on the definition of a personal loan, which must take the form of a loan, rather than a mere extension of credit. The loan must be personal, as well. For example, a loan whose primary purpose is to advance the business of the issuer would probably not be considered a personal loan.

Specific situations discussed in the outline, and generally thought to be permissible include:

- Advances of cash, in accordance with company policy, to cover reimbursable travel expenses because the advance serves a primary business purpose.

- Personal use of a company credit card, with a requirement for reimbursement because the use of the company card serves a primary business purpose.

- Personal use of a company car, with a requirement for reimbursement because the use of the car serves a primary business purpose.

- The advancement of relocation payments because the payment serves a primary business purpose.

- Payment of stay and retention bonuses subject to repayment because the payment serves a primary business purpose.

- Indemnification advances, where repayment is required under certain circumstances, because the advances do not take the form of a loan, nor are the payments necessarily "personal."

- Deferred compensation because the payments are, if anything, an extension of credit from the officer to the issuer.

---

[90] *But see* IRS Memorandum, March 14, 2003. The IRS has taken the administrative position that companies may pay the required withholding tax within one day of the settlement of the sale, as long as the settlement takes place within three days of the exercise of the options. Since the general SEC guidelines require broker-dealer trades to settle within three days, and since most trades settle within the three day window, this position substantially moots interpretive questions about whether a loan to an executive arises from an employer advancing the withholding taxes in a cashless option exercise.

- Leveraged co-investment in a limited partnership or other entity that will own actual investment assets. Depending on the terms of the loan, and whether the loan is to the individual or the entity, this situation may pose greater risk for a Section 402 violation.

- Tax indemnity payments to overseas-based executive officers because the payments are not in the nature of a loan.

The following situations discussed in the outline involve "arranging" issues. According to the Sarbanes-Oxley Act, an issuer may not arrange a personal loan for an executive. The outline recognizes that issuers will almost certainly assist in facilitating certain loans, but contemplates that "arranging" a loan is a more substantial level of participation in the loan. Similarly, the outline recognizes that there are situations in which the issuer will have arranged some aspect of the loan, but should not be considered to have "arranged" the loan itself. An example of this would be loans from a 401(k) plan, where the issuer has arranged the benefit program, but is not involved in the loan from the program. These arranging situations include:

- Loans from a parent company, who is not an issuer, to an officer of an issuer subsidiary. The permissibility of the loan turns on whether the subsidiary has arranged the loan.

- Loans from a 401(k) plan—the loan is from the plan and not the issuer, and while the issuer has arranged the plan, it should not be considered to have arranged the loan.

- Loans from annuities or other broad-based employee benefit programs—the loan is from the program, and not the issuer.

- Cashless option exercises involve both personal loan issues and arranging issues. Any benefits or extensions of credit granted to the officer are not generally in the form of a loan. Additionally, the transaction is usually available to all employees of the option plan.

Certain situations are permissible due to exceptions or grandfather provisions:

- Securities related loans, other than margin loans subject to the specific exemption—Section 402 allows certain margin loans pursuant to Section 7 of the Exchange Act.

- Drawdowns on committed lines and maintaining demand loans after July 30, 2002—grandfather clauses allow drawdowns on credit lines committed before July 30, 2002 and maintenance of demand loans extended before July 30, 2002.

- Forgiveness of grandfathered loans—forgiveness of a loan constitutes the discharge of a loan and, as such, would not be a "material modification" prevented by the statute.

- Modification favorable to the issuer—because of the purpose of the statute, a modification, such as an increase in interest rate, should not be considered a material modification.

O. Additional Provisions

As discussed above, many of the provisions in the Sarbanes-Oxley Act have already been addressed by the SEC staff by way of final or proposed rules, many of which have been previously discussed in this outline. Nevertheless, each of the Sarbanes-Oxley Act provisions requires close scrutiny by public companies, and some require more immediate attention than others. The following is a summary of additional Sarbanes-Oxley provisions that companies should be aware of.

1. Corporate Responsibility

The Sarbanes-Oxley Act also contains the following provisions regarding corporate responsibility and corporate governance:

a. Disgorgement of Certain Executive Compensation upon Financial Statement Restatements: Section 304

- This provision requires that CEOs and CFOs disgorge bonuses, other incentive- or equity-based compensation and profits on sales of issuer securities where an accounting restatement is required due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws as a result of misconduct. Disgorgement is required for such compensation received or profits realized during the 12-month period following the first public issuance or filing with the SEC (whichever occurs first) of a document embodying the noncompliant report. The SEC may exempt any person from the application of this provision as it deems necessary and appropriate.[91]
- This provision became effective immediately upon enactment. Note that there is no deadline by which the SEC must adopt exemptions.

b. Officer and Director Bars: Sections 305 and 1105

- Section 305 changes the standard governing judicial imposition of officer and director bars in SEC actions under Section 21(d)(2) of the Exchange Act and Section 20(e) of the Securities Act from "substantial unfitness" to "unfitness."
- Section 1105 amends Section 21C of the Exchange Act and Section 8A of the Securities Act to add new provisions giving the

[91] In a recent decision, a U.S. District Court held that there is no private right of action under Section 304 of the Sarbanes Oxley Act. *Neer v. Pelino*, 389 F.Supp.2d 648 (E.D. Pa. 2005).

SEC authority to bar in an administrative cease and desist proceeding an individual who has violated Section 10(b) of the Exchange Act or Section 17(a)(1) of the Securities Act (anti-fraud provisions), or rules or regulations thereunder, from acting as an officer or director of a public company in an administrative cease and desist proceeding, if the person's conduct demonstrates unfitness to serve as an officer or director of a public company.

- The reduced standard for director and officer bars has greatly increased the frequency with which the SEC is seeking and obtaining those bars. The SEC sought a D&O bar over 150 times in the first three quarters of 2004. A SEC staff member has indicated, however, that the increased use of the D&O bar has prompted a harder look at the imposition of temporary versus permanent bars; the more the bars are used, the more likely it seems there will be gradations in the duration of the bar.[92]
- Both sections became effective immediately upon enactment.

c. Statute of Limitations for Securities Fraud: Section 804

- This provision amends 28 U.S.C. § 1658 to extend the statute of limitations for private rights of action involving claims of fraud, deceit, manipulation or contrivance in the contravention of a regulatory requirement concerning the securities laws to the earlier of: (i) two years after discovery of the facts constituting the violation; or (ii) five years after such violation.
- This provision applies to proceedings commenced on or after the date of enactment.

d. Whistleblower Protection: Section 806

- This provision amends federal criminal law to prohibit public companies and their employees, contractors, subcontractors or other agents from discriminating in the terms and conditions of employment with respect to employees who: (i) provide information or make a complaint regarding conduct of the employee "reasonably believes" constitutes a securities violation or securities fraud; or (ii) file or participate in proceedings related to fraud against shareholders.
- An employee may seek relief under this provision by filing a claim with the Occupational Safety and Health Administration ("**OSHA**") (within the Department of Labor) within 90 days after the date of the violation. If a decision is not rendered by the

---

92 Remarks of Joan McKowan, Chief Counsel of SEC Division of Enforcement, at ABA Annual Meeting in Atlanta, Georgia, August 2004.

Secretary of Labor within 180 days, an employee may bring an action for de novo review in the federal district court of jurisdiction. Before conducting an investigation, the Department must be satisfied that the complaint makes a prima facie showing that the protected conduct was a contributing factor in an adverse employment action taken by the employer.

- Following an investigation, the Department will issue its findings and a preliminary order, directing immediate reinstatement, if: (i) there is "reasonable cause" to believe that the employee's protected conduct was a contributing factor to the adverse personnel action alleged in the complaint; and (ii) the employer has not demonstrated by clear and convincing evidence that it would have taken the same unfavorable action in the absence of that behavior. Alternatively, if these elements are not satisfied, the Department will issue a preliminary order dismissing the complaint.

- Potential relief includes reinstatement, back pay with interest and compensation for special damages, such as attorneys' fees and other litigation costs. Employers, and in some cases individuals, found to have retaliated against a whistleblower may be subject to administrative and civil sanctions. The Act thus confronts corporate officers and managers with the prospect of being sued in their individual capacity for personnel decisions they have made.

- The Act protects a whistleblower even if his or her report of wrongdoing is incorrect, provided that the whistleblower reasonably believed that what he or she reported constituted a violation. This means that a company may still *lose* a Sarbanes-Oxley whistleblower case, despite being able to prove that a complainant's understanding of an SEC rule was mistaken, and thus, the complaint of an alleged securities violation was unwarranted.

- It is expected that plaintiffs may seek to use the whistleblower provisions of Sarbanes-Oxley as the predicate for state law claims for wrongful termination in violation of public policy. If viable, such claims will result in exposure to the full range of tort damages, including punitive damages in states where such damages are available. One potential issue is whether or not a federal court action, limited to the remedies set forth in the statute, is the exclusive remedy for retaliation against whistleblowers that would not be actionable absent the Sarbanes-Oxley Act. In some states, including California, it has been held that retaliation claims are actionable in public policy wrongful termination actions, even where the statute sets forth a procedure for agency investigation and action.

- This provision became effective immediately upon enactment.

- In its first decision on the merits in a Sarbanes-Oxley "whistleblower" case, the Department of Labor's Administrative Review Board (the "**ARB**") reversed a decision by an administrative law judge and held that the complainant had not engaged in "protected activity" under the Act.[93] The ARB is the appellate body at the Labor Department that reviews Sarbanes-Oxley whistleblower retaliation decisions by the Department's administrative law judges. Its decisions are reviewed deferentially by the federal courts of appeals. The complainant in the case, Margot Getman, worked as a stock analyst for respondent Southwest Securities. In her suit, she claimed that she had recommended an "accumulate" rating for a certain stock; her manager, she contended, pressed for a more favorable, "strong buy" rating, and when she objected, she claimed, the firm began harassing her and then terminated her employment. In reviewing the trial judge's decision for Getman, the ARB ruled that the claimant's "unspecified 'refusal' [to upgrade the stock rating] was not sufficient to 'provide information'" of a potential securities violation within the meaning of the Sarbanes-Oxley Act. The ARB elaborated: "In the context of a review committee meeting between an analyst and her supervisor, where disagreement over a rating may be a normal part of the process, the analyst must communicate a concern that the employer's conduct constitutes a violation in order to have whistleblower protection. While there may be times where only refusal is sufficient to provide information, reviewing Getman's evidence in the light most favorable to her, it was not in this case." The ARB also drew a distinction between statutes that provide protection for "notifying the employer of a violation" - as the Sarbanes-Oxley Act does - and those that also provide protection for "refusing to commit" a violation. The ARB will play a decisive role in defining the protections of the Sarbanes-Oxley Act's "whistleblower" provision. This ruling is an early indication that ARB will pay close attention to the text of the statute in applying the Sarbanes-Oxley Act's protections. Also notable is ARB's statement that when discussion and "disagreement" over a certain type of matter are "a normal part of the process" for the employer and employee given the employee's duties, protected activity will require that the employee actually "communicate a concern that the employer's conduct constitutes a violation," rather than, for example, merely recommending one course of action rather than another. This aspect of the ruling should deter employees in analyst positions and other, similar jobs from claiming *ex post facto* that statements

93 *Getman v. Southwest Securities, Inc.*, ARB No. 04-059 (July 29, 2005).

made in the ordinary course were, in fact, protected Sarbanes-Oxley "whistleblowing."

- The Supreme Court's subsequent decision regarding the First Amendment rights of government employee "whistleblowers" may also have important implications for whistleblower litigation.[94] The Supreme Court ruled 5-4 that statements made by public employees in the course of performing their official job duties are not protected by the First Amendment and may be the basis for discipline by the employer. The Supreme Court held that public employees speaking pursuant to their official duties do not speak as citizens for First Amendment purposes, and therefore the Constitution does not insulate them from employer discipline for such speech. The Court explained that, without a significant degree of control over its employees' words and actions, a government employer cannot efficiently provide public services. The Court expressed concern that a contrary rule would result in extensive and intrusive "judicial oversight of communications between and among government employees and their superiors in the course of official business." Under the federal Whistleblower Protection Act and other federal statutes protecting employee reporting, the courts have provided that employees do not engage in protected activity when they merely fulfill the fiduciary duties required by their job, and do not take additional steps to voice their concerns. Although legislation has been introduced in Congress to expand the protections afforded private employees under such decisions, enactment of a legislative response appears unlikely in the near future. Accordingly, the Supreme Court's decision in Ceballos is significant additional precedent for a narrower view of the protections provided under Sarbanes-Oxley and other whistleblower statutes applicable to private employers.

- U.S. companies operating in France and Germany should note that courts in those countries have invalidated certain "whistleblower" policies and mechanisms instituted by U.S. companies to comply with the Sarbanes Oxley Act. U.S. employers operating in France and Germany should review local labor laws to ensure that they are in compliance.

e. Retaliation Against Informants: Section 1107

- This provision amends 18 U.S.C. § 1513 (retaliation against a witness, victim or informant) to provide for fines and imprisonment of up to 10 years for anyone who "knowingly, with the intent to retaliate," takes any action harmful to any person,

---

[94] *Garcetti v. Ceballos* 2006, U.S. Lexis 4341 (May 30, 2006).

including interference with the lawful employment or livelihood of any person, for providing to a law enforcement officer any truthful information relating to the commission or possible commission of any federal offense.

- This provision became effective immediately upon enactment.

2. Disclosure Requirements

While most of the disclosure provisions of the Sarbanes-Oxley Act have been addressed by the SEC, it is important to note that Section 408 of the Sarbanes-Oxley Act requires the SEC to review the disclosures of public companies on a regular and systematic basis. At the very least, the disclosures of public companies must be reviewed once every three years. The provision became effective immediately upon enactment of the Sarbanes-Oxley Act.

3. Auditor and Accounting Provisions Related to Review of SEC Filings

The Sarbanes-Oxley Act also contains the following auditor and accounting related provisions:

a. PCAOB: Title I

- This provision establishes a new regulatory body, the PCAOB, to oversee the audit of public companies and companies offering securities to the public, and related matters, subject to oversight by the SEC.[95]

b. Auditor Qualifications: Registration, Oversight and Independence: § 102; Title II

- This provision requires firms that audit the financial statements of an issuer that has filed a registration statement under the Securities Act or that is registered under Section 12 or 15 of the Exchange Act to be registered with, and subject to oversight by, the PCAOB.
- The Sarbanes-Oxley Act further regulates and redefines the relationship between a registered public accounting firm and its audit clients:[96]
    - **Non-Audit Services, Section 201:** This provision amends Section 10A of the Exchange Act to prohibit registered public accounting firms from providing eight categories of non-audit services to their audit clients, including financial

---

[95] *See* Section II.F above.

[96] *See* discussion in Section III.H above. The SEC has adopted rules implementing Sections 201-206 of the Sarbanes-Oxley Act.

information systems design and implementation, valuation services and internal audit outsourcing services. The PCAOB may, subject to SEC review, exempt any person, issuer, accounting firm or transaction from this provision on a case-by-case basis.

- The PCAOB has proposed the following rules regarding an auditor firm's independence from an audit client:

  Rule 3502, stating that a person associated with a registered public accounting firm shall not cause that firm to violate the Act, the Rules of the Board, the securities laws relating to the preparation and issuance of audit reports or professional standards;

  Rule 3520, stating that a registered audit firm must be independent of its audit client throughout the audit and professional engagement period;

  Rule 3521, which would treat registered public accounting firms as not independent if they enter into contingent fee arrangements with their client;

  Rule 3522, prohibiting registered public auditors from providing tax planning relating to or opinions on certain tax transactions that pose special concerns to an auditors independence;[97]

  Rule 3523, removing the independence of a public registered accounting firm if the firm provides any tax service to an officer in a financial reporting role at the audit client during the audit or professional engagement; and

  Rule 3524, requiring that all non-audit services be pre-approved by the audit committee.

- **Audit Committee Pre-Approval of Auditor Services, Section 202:** This provision amends Section 10A of the Exchange Act to require audit committee pre-approval of all services provided by an issuer's outside auditor, subject to a *de minimis* exception. The audit committee may delegate pre-approval authority to one or more members of the audit committee, and pre-approvals for audit-related services may be made in connection with approval of the audit engagement. A description of an issuer's

[97] The transactions include transactions similar to those listed by the IRS as tax avoidance transactions, transactions with tax-advisor-imposed conditions of confidentiality and transactions based on an aggressive interpretation of applicable tax laws.

pre-approval policy, to the extent adopted, must be disclosed in periodic reports.

- **Audit Partner Rotation, Section 203:** This provision amends Section 10A of the Exchange Act to provide that the lead (or coordinating) audit partner and the reviewing audit partner of the registered public accounting firm cannot perform audit services for the same issuer for more than five consecutive fiscal years.
- **Auditor Communication With Audit Committee, Section 204:** This provision amends Section 10A of the Exchange Act to require that registered public accounting firms timely report to audit committees on critical accounting policies and practices, alternative treatments of financial information that have been discussed with management and other material written communications with management.
- **Restrictions on Employment of Auditor Personnel, Section 206:** This provision amends Section 10A of the Exchange Act to prohibit registered public accounting firms from providing audit services to issuers whose CEO, CFO or chief accounting officer, or any person serving in an equivalent position, was employed by the audit firm and participated in the issuer's audit in any capacity within one year of audit initiation.

IV. Adopted and Proposed Changes to Proxy Rules

In response to recommendations in a July 2003 report of the Division of Corporate Finance entitled "Review of the Proxy Process regarding the Nomination and Election of Directors" (the "**Staff Report**"), the SEC proposed or approved several new rules or amendments to the current rules relating to shareholder access to company proxy statements to nominate directors, expanded disclosure regarding board nominating committees and added new disclosure concerning shareholder communications with directors. In addition, the SEC staff continues to use Staff Legal Bulletins to provide guidance on application of Rule 14a-8.

A. Director Election Rules

The standard used in the election of corporate directors has and continues to generate significant attention by the SEC, institutional investors and companies.

1. Proposed SEC Shareholder Access Rules

In a release dated October 14, 2003, the SEC proposed amendments to its proxy rules that have the potential to dramatically change the way corporate directors are nominated and elected by permitting large shareholders and shareholder groups to place some nominees for director in company proxy materials under certain circumstances.[98] The proposal, known as "shareholder access," would implement controversial recommendations in the Staff Report. The Staff Report recommended, among other things, requiring companies to include shareholder nominees for director in company proxy materials if one of two triggers is present: (i) more than 35 percent of shares voted are "withhold" votes for a director, or (ii) a proposal made by a more than one percent shareholder to activate shareholder access receives a majority vote. Once shareholder access is triggered in one of these ways, any group comprised of the holders of more than five percent of the company's stock would be able to place up to three director nominees (depending on the size of the board) in the company's proxy statement and on the company's proxy card for two years.

Many companies have argued that if the final rules are adopted as proposed, then shareholder access could produce "special interest" directors and could turn director elections into costly proxy contests, resulting in a substantial disruption of corporate affairs and discouraging qualified individuals from serving on corporate boards. Questions have also been raised about the SEC's statutory authority to act in this area and the proposal's compliance with rulemaking requirements.

The SEC held a "Security Holder Director Nominations Roundtable" on March 10, 2004 to discuss whether problems in the proxy process need to be addressed; whether the proposed rules are a reasonable solution to those problems; how the proposed rules would apply to companies and investors; the impact of the proposed rules on retail and other investors; federal and state law issues that may be raised by the proposed rules; and how proxy voting mechanics might impact the proposed rules. The SEC also extended the comment period on the proposed rules to March 31, 2004.

Then SEC Chairman William H. Donaldson said that he would not be put on an "artificial timetable" for adopting these proposed rules. New SEC Chairman Christopher Cox has not commented on whether the SEC will pursue these proposed rules.

2. Majority Voting in Director Elections

In large part as a result of the SEC's failure to adopt the proposed shareholder access rules, some institutional investors and commentators recently have called for a move from plurality to majority voting in director elections. As a result, the American Bar Association, the Delaware bar and a working group of companies and labor unions are studying the feasibility of moving to majority voting in director elections.

On June 22, 2005, the American Bar Association's Committee on Corporate Laws released a "Discussion Paper on Voting by Shareholders for the Election of Directors" (the "**Discussion**

---

[98] Security Holder Director Nominations, Release No. 34-48626 (Oct. 14, 2003), *available at* http://www.sec.gov/rules/proposed/34-48626.htm.

Paper”).[99] The Discussion Paper reviews various issues identified by the Committee concerning shareholder voting in director elections at public companies and possible related changes to the Model Business Corporation Act (the “**Model Act**”). In particular, the Discussion Paper focuses on the possible consequences of moving from plurality voting to majority voting in electing directors as well as various alternatives.

The Committee has created a Task Force that is studying whether to recommend to the full Committee any changes to the Model Act’s provisions on the election of directors. Any proposed amendments to the Model Act that result from the Discussion Paper and recommendations of the Task Force must be considered by the Committee at successive meetings and published for comment in The Business Lawyer.

The Discussion Paper is the most recent development concerning the director election process. In large part due to the SEC’s inaction with respect to its October 2003 proposed director election rules, many institutional investors and commentators are calling for a move to majority voting in director elections. This has led to approximately 82 companies receiving majority voting shareholder proposals for consideration at their 2005 shareholders’ meetings. The average level of shareholder support for these proposals to date is approximately 45%, with nine companies receiving majority votes on these proposals. Moreover, the primary sponsor of these proposals, the United Brotherhood of Carpenters and Joiners of America, and two other unions formed a working group with 13 companies to study issues relating to implementation of a majority voting standard.

In addition, the Council of Institutional Investors (the “**CII**”), an organization of more than 140 public, corporate and union pension funds, recently sent a letter to the heads of approximately 1,500 U.S. companies asking that these companies’ charters and bylaws provide that directors be elected by a majority of the votes cast. If not permitted under state law, CII requested that the boards instead adopt policies asking directors to tender their resignations if the number of votes withheld from the candidate exceeds the votes for the candidate and, in the event they fail to tender such resignation, providing that such directors will not be re-nominated after expiration of their current term. CII’s letter indicated that it is “interested in the board’s response to our request and its process for evaluating our suggestion,” and such responses will be posted on CII’s website.

A change to majority voting in director elections raises a number of issues, including:

- how to handle “holdover directors” (incumbent directors who do not receive a majority vote but who “holdover” because their term does not expire until their successor is elected or the director resigns or is removed by shareholders);

- the possibility of increased board vacancies if a nominee to fill a vacant board seat does not receive a majority vote;

[99] The Committee on Corporate Laws on Voting by Shareholders for the Election of Directors Discussion Paper (June 22, 2005) is *available at* http://www.abanet.org/buslaw/committees/CL270000pub/materials/20050621000000.pdf.

- the possibility of majority voting deterring qualified individuals from standing as director nominees;
- the consequences of the chief executive officer not being elected to the board; and
- the risk that majority voting will further politicize and increase the costs of director elections.

Several companies have publicly responded to the issue of majority voting in director elections. Many have revised their corporate governance guidelines to include majority voting policies based either on votes cast or shares outstanding. These policies state that any director nominee who receives a greater number of votes "withheld" from his or her election than votes "for" such election (or, in the case of a policy based on shares outstanding, for whom greater than 50 percent of the outstanding shares are "withheld" from his or her election) shall tender his or her resignation for consideration by the board's nominating/governance committee. This committee will then recommend to the board the action to be taken with respect to such resignation, which may include acceptance of the resignation or a determination that the director should continue on the board.

B. Enhanced Nominating Committee Disclosures

In a November 24, 2003 release, the SEC approved new rules that amend the proxy rules to expand disclosure related to the operation of board nominating committees.[100] The purpose of the rules regarding enhanced disclosure relating to nominating committee activities was to provide information to enable shareholders to evaluate a company's board of directors and nominating committee. The final rules amended Schedule 14A under the Exchange Act to require discussion of the following items in a company's proxy statement:

- whether the company has a standing nominating committee and, if not, why not and who determines nominees for director;
- whether the nominating committee has a charter and where the charter is available (either on the company's website or in its proxy statement);
- whether members of the nominating committee are independent;
- whether the company considers candidates for director put forward by shareholders and, if so, the material elements of its process for considering such candidates;

[100] Disclosure Regarding Nominating Committee Functions and Communications between Security Holders and Boards of Directors, Release No. 33-8340 (Nov. 24, 2003), *available at* http://www.sec.gov/rules/final/33-8340.htm.

- the procedures for shareholders to submit candidates for director (any changes to such procedures must be disclosed in the company's periodic reports);
- any minimum qualifications that the company seeks for director nominees;
- the company's process for identifying and evaluating candidates to be nominated for director;
- a statement regarding the "category" of person(s) who recommended each new nominee approved by the nominating committee for inclusion on the company's proxy card (categories include shareholders, non-management directors, the CEO, other executive officers, third-party search firms and "other");
- whether the company pays any third party a fee to assist in the process of identifying or evaluating candidates; and
- whether the company has rejected director candidates put forward by a shareholder or group of shareholders who beneficially owned more than five percent of the company's stock for at least one year at the time of the recommendation and, if so, the names of the nominating shareholder(s) and the candidate (provided that both the shareholder and the candidate affirmatively consent to being so named).

C. Disclosure Regarding Shareholder Communications with Directors

In a November 24, 2003 release, the SEC also approved final rules to amend Item 22 of Schedule 14A under the Exchange Act to require disclosure concerning shareholder communications with directors.[101] The final rules also amend Schedule 14A to require disclosure of the following information in a company's proxy statement:

- a statement as to whether the board has a process for shareholders to communicate with the board and, if not, why not; and
- if the board has such a process:
    - a description of the manner in which shareholders may communicate with the board and, if applicable, with individual directors;
    - a description of the company's process (if any) for determining which communications will be relayed to directors; and
    - whether the board has a policy with respect to directors' attendance at the annual meeting of shareholders and information regarding directors' attendance at the previous year's annual meeting.

D. Staff Legal Bulletin No. 14B: Shareholder Proposals

[101] *Id.*

On September 15, 2004, the staff of the SEC's Division of Corporation Finance issued Staff Legal Bulletin No. 14B ("**SLB 14B**"), providing guidance on certain issues that commonly arise in processing shareholder proposals under Rule 14a-8 of the Exchange Act.[102] SLB 14B clarifies and updates some of the guidance contained in Staff Legal Bulletin No. 14, published in July 2001, and provides additional guidance regarding certain substantive and procedural aspects of the shareholder proposal process. Specifically, SLB 14B:

- clarifies the manner in which the staff will apply Rule 14a-8(i)(3) when assessing arguments that proposals or supporting statements are false and misleading in an attempt to limit the use of certain arguments by companies;
- reiterates that companies should be specific in notices of defects to shareholder proponents and provides further guidance on the proof of beneficial ownership companies should request from shareholder proponents to satisfy the Rule 14a-8(b) minimum ownership requirements;
- discusses the potential consequences of a company's failure to submit a no-action request more than 80 days before the filing date of the company's definitive proxy statement, as required by Rule 14a-8(j);
- provides guidance on how the staff analyzes an opinion of counsel when a company asserts that a proposal is excludable based on matters of state, federal or foreign law; and
- addresses the public availability of Rule 14a-8 no-action requests and discusses procedures for the staff's release of response letters.

1. Clarifying the Application of Rule 14a-8(i)(3) as a Basis for Exclusion

SLB 14B clarifies the availability of certain arguments under the false and misleading prong of Rule 14a-8(i)(3). The staff notes that their prior interpretative guidance led some companies to argue that virtually every statement in proposals and supporting statements were false and misleading. In practice, the staff typically has afforded proponents the opportunity to revise their proposals or supporting statements to address these types of arguments. However, in SLB 14B, the staff cites Rule 14a-8(l)(2), which provides that the "company is not responsible for the contents of [the shareholder proponent's] proposal or supporting statement." Accordingly, the staff will not require proponents to revise, or permit companies to exclude, all or portions of a supporting statement or of a proposal under Rule 14a-8(i)(3) based on claims that:

- factual assertions are not supported;
- factual assertions, while not materially false or misleading, may be disputed or countered;

[102] Staff Legal Bulletin No. 14B (CF): Shareholder Proposals (Sept. 15, 2004), *available at* http://www.sec.gov/interps/legal/cfslb14b.htm.

- factual assertions may be interpreted by shareholders in a manner that is unfavorable to a company, its directors or its officers; and/or
- statements representing the opinion of the shareholder proponent or a referenced source are not identified specifically as such.

The staff advises that, instead of addressing these types of issues as a basis for exclusion in no-action requests, companies should address these objections in their statements in opposition contained in their proxy statements.

However, SLB 14B confirms that Rule 14a-8(i)(3) still may be available to exclude or modify a proposal or supporting statement where:

- statements directly or indirectly impugn character, integrity or personal reputation, or directly or indirectly make charges concerning improper, illegal or immoral conduct or association, without factual foundation;
- a company demonstrates objectively that a statement is materially false or misleading;
- the resolution contained in the proposal is so inherently vague or indefinite that neither the shareholders voting on the proposal, nor the company in implementing the proposal (if adopted), would be able to determine with any reasonable certainty exactly what actions or measures the proposal requires; and
- substantial portions of the supporting statement are irrelevant to the subject matter of the proposal, such that there is a strong likelihood that reasonable shareholders would be uncertain as to the matter on which they are being asked to vote.

2. Notices of Defects to Shareholder Proponents under Rule 14a-8(f)

In SLB 14B, the staff reiterates guidance about the proper methods for notifying shareholder proponents about eligibility or procedural defects in the proponents' submissions, such as failure to demonstrate that they have satisfied the stock ownership requirements. More specifically, a company's notice of defects should:

- provide adequate detail about what the shareholder proponent must do to remedy the defect(s) (with appropriate references to Rule 14a-8(b));
- quote from the specific requirements, or include a copy, of Rule 14a-8; and
- notify the proponent that its response must be sent within 14 calendar days of receipt of the notice of defects.

In addition, because companies have the burden of showing that they properly notified the proponents of defects in the proponents' submissions and that the proponents failed to timely respond, the staff recommends that companies send correspondence to proponents by a means that allows them to determine when the proponents received the notices.

3. Application of Rule 14a-8(j)'s 80-Day Requirement

SLB 14 provides guidance on the potential consequences of a company's failure to comply with Rule 14a-8(j), which requires a company to submit any shareholder proposal no-action letter request no later than 80 calendar days before filing definitive proxy materials with the SEC. A company need not wait 80 calendar days to file its definitive proxy materials if the staff finds that the company demonstrated "good cause" for missing the Rule 14a-8(j) deadline. The staff indicates that "good cause" most often exists where the shareholder proponent did not submit the proposal to the company in a timely manner, and, as a result, the company did not receive the proposal until after the 80-day no-action request submission deadline.

If the staff finds that the company has not satisfied its burden of proof in this regard, the staff will generally still consider and issue a response on whether they concur with the company's reasons for excluding the proposal, although the staff reserves the right not to respond. However, if the staff concurs that a proposal may be excluded, but states its views that a company has failed to demonstrate "good cause" for not satisfying the 80 day rule, the staff notes that filing the definitive proxy statement in less than 80 days "may not be in accordance with the procedural requirements" of Rule 14a-8.

4. Opinions of Counsel under Rule 14a-8

The staff states that a company should provide an opinion of counsel when the company's bases for excluding a proposal under Rule 14a-8 are based on matters of state, federal or foreign law. The staff advises that the company and its counsel should consider whether the law underlying the opinion is unsettled or unresolved. Moreover, when possible, the opinion of counsel should contain citations to relevant legislative authority or judicial precedent. The staff further advises companies regarding proposals that would result in the company breaching existing contractual obligations because implementing the proposal would require the company to violate applicable law or would not be within the power or authority of the company to implement. In those situations, companies should provide the staff with a copy of the relevant contract, cite specific provisions of the contract that would be violated and explain how implementation of the contract would cause the company to breach those contractual obligations.

In analyzing the opinion, the staff will take into account the extent to which the opinion of counsel makes assumptions regarding the proposal "not called for by the language of the proposal" and whether counsel is licensed to practice law in the jurisdiction where the law is at issue. Opinions of counsel may take the form of a separate legal opinion, or companies may instead indicate that the arguments advanced regarding the relevant law constitute opinions of counsel.

5. Processing Matters in Connection with Staff Review of No-Action Requests

The staff reiterates that shareholder proposal no-action requests are made publicly available upon receipt (whereas no-action requests under other rules may not be available until the staff issues its response). Some commercial databases make these incoming requests publicly available once the staff has forwarded them to the SEC's Public Reference Room. Thus, a company's arguments for exclusion may become public before the staff responds to the letter and before a company files its definitive proxy materials.

As a courtesy, during the highest volume periods of the 14a-8 season, the staff may fax copies of responses to no-action requests (in addition to placing the responses in regular mail to both the company and the proponent(s)). If the staff has a fax number for the company, but not for the shareholder proponent, the staff will fax the response to the company only if the company agrees to promptly forward the response to the shareholder proponent. To facilitate prompt delivery of staff responses, the staff urges companies to include in any no-action request all relevant correspondence with the shareholder proponent so that the staff has access to proponents' contact information (including, if provided, fax numbers).

6. Recommended Procedural and Practice Points

- In recent years, an increasing number of companies have included language in their proxy statements disclaiming responsibility for the content of shareholder proposals and supporting statements. In light of SLB 14B, companies may wish to include language similar to the following in future proxy statements, where relevant:

  > "The proposal[s] and supporting statement[s] are presented as received from the shareholders in accordance with the rules of the Securities and Exchange Commission, and the Board of Directors and the Company disclaim any responsibility for their content."
  >
  > "All references to 'we' in [proponent's name]'s [proposal/supporting statement] are references to [proponent's name] and not the Company's other shareholders, the Company or the Company's Board of Directors."

- Certain web-based services, like *Securities Lawyer's Deskbook* (published by The University of Cincinnati College of Law), provide access to Rule 14-8 in a format that can be easily printed and enclosed with your notice of defects.[103]

- Companies may wish to review no-action requests recently filed with the SEC to learn the arguments other companies are making about similar or identical shareholder proposals. Although the staff will not yet have commented on the adequacy of these assertions, it is important that no-action requests set forth all feasible arguments since the burden rests with companies to justify exclusion of shareholder proposals.

- If you send the notice of defects to a shareholder proponent by overnight mail, require that the recipient sign for the package. Also, since most overnight delivery services allow you to print delivery information from the Internet, obtain that information for your files once the package is delivered.

---

[103] *See, e.g.*, http://www.law.uc.edu/CCL/34ActRls/rule14a-8.html.

- Companies should brief their investor relations and public relations departments prior to filing no-action requests with the SEC staff in case they receive inquiries from the press or investors about their attempts to exclude the proposals.

- In light of SLB 14B, we recommend that companies include language similar to the following statement in any no-action request to the staff: "The Company hereby agrees to promptly forward to the Proponent any staff response to this no-action request that the staff transmits by facsimile to only the Company.

E. Staff Legal Bulletin No. 14C: Shareholder Proposals

On June 28, 2005, the staff of the SEC's Division of Corporation Finance issued Staff Legal Bulletin No. 14C ("**SLB 14C**") as part of a continuing effort by the Division of Corporation Finance to identify and provide guidance on issues that commonly arise under Rule 14a-8.[104] Specifically, SLB 14C contains information regarding:

- the addresses for submitting no-action requests and shareholder responses to those requests;
- the application of Rule 14a-8(i)(6) to proposals calling for director independence;
- the application of Rule 14a-8(i)(7) to proposals referencing environmental or public health issues;
- the application of Rule 14a-8(l);
- the company facsimile number shareholder proponents should rely on when transmitting proposals and responses to notices of defects;
- the written materials that should accompany a no-action request;
- the withdrawal of a proposal submitted by multiple shareholder proponents; and
- the circumstances under which the SEC will transmit no-action responses by facsimile.

F. Proposed Amendments to Proxy Rules Regarding Internet Availability of Proxy Materials

On December 8, 2005, the SEC proposed amendments to its proxy rules that would permit issuers and non-issuers soliciting proxies from shareholders to deliver proxy materials electronically by posting them to a website.[105] If adopted, these amendments would greatly reduce the costs of printing and mailing proxy materials, and streamline the proxy solicitation process.

---

[104] Staff Legal Bulletin No. 14C (CF): Shareholder Proposals (June 28, 2005), *available at* http://www.sec.gov/interps/legal/cfslb14c.htm.

[105] Internet Availability of Proxy Materials, Release No. 34-52926 (Dec. 8, 2005), *available at* http://www.sec.gov/rules/proposed/34-52926.pdf.

The proposed amendments would provide an alternative model (the so-called "notice and access" model) by which companies conducting proxy solicitations could satisfy the requirement of Rule 14a-3 under the Exchange Act to furnish proxy materials and annual reports by posting these materials on an Internet website and providing shareholders with notice of the Internet availability of the materials. Other soliciting persons also would be permitted to use the proposed "notice and access" model.

An issuer electing to use the proposed "notice and access" model to solicit proxies would post its proxy materials and annual report on a publicly accessible Internet website (other than EDGAR), in a form substantially identical to the paper version of those materials. The issuer would send a "Notice of Electronic Proxy Materials" (the "**Notice**") to shareholders, which could be the size of a postcard, notifying them of the availability of the proxy materials on the Internet. The Notice would be required to be sent at least thirty days prior to the shareholder meeting to which the proxy materials relate, and would be able to contain only the following information:

- a prominent legend in bold type disclosing:
    - the time, date and location of the meeting;
    - the Internet address of the website where the proxy materials are available; and
    - a toll-free telephone number and e-mail address that may be used by shareholders to request paper copies of the proxy materials at no charge (which request must be responded to by the issuer within two business days);
- a clear and impartial description of the matters to be voted on; and
- the issuer's recommendation with respect to each matter to be voted on.

The proposed amendments would allow the proxy card to be accompanied by, and delivered through the same medium (paper or electronic) as, either the Notice or the proxy statement. The proposed amendments would provide that the Notice cannot be accompanied by any other shareholder communications.

Brokers, banks and other intermediaries holding shares on behalf of "street name" beneficial owners would be required to forward Notices on to beneficial owners, as they are today with respect to proxy materials and annual reports. Those beneficial owners could request paper copies of the proxy materials and annual report through either the issuer or the intermediary.

The proposed amendments are not intended to modify any proxy voting mechanics for street name shareholders, including the distinction between non-objecting beneficial owners and objecting beneficial owners (so-called "**NOBOs**" and "**OBOs**"). Further, the SEC has indicated that the proposed amendments would have no impact on any state law obligation regarding soliciting proxies or holding annual meetings, and would not apply to business combination transactions.

If approved, this "notice and access" model would also be available to persons other than issuers who are soliciting proxies, with certain distinctions. First, as provided under the current proxy rules, non-issuers would not be required to solicit all shareholders, but could specifically target certain shareholders, such as only those willing to receive proxy materials electronically. Second, a non-issuer would not have to deliver a notice to shareholders unless the soliciting person wanted to deliver the proxy card to shareholders instead of posting it on an Internet website. Such a notice would have to be provided to shareholders by the later of 30 days before the meeting or 10 days after the issuer files its proxy materials.

V. Corporate Governance

A. Approval of Changes to the Listing Standards of the Major Securities Markets

On November 4, 2003, the SEC approved the final rule proposals for both the NYSE and the Nasdaq with respect to significant changes to their respective corporate governance listing standards.[106] On June 29, 2004, minor amendments to Nasdaq's director independence standards took effect. On November 3, 2004, amendments to the NYSE's corporate governance listing standards, relating to standards for director independence, audit committee responsibilities and several other matters, took effect.[107] On November 23, 2005, the NYSE filed proposed amendments to its corporate governance listing standards with the SEC for approval.[108]

1. The New York Stock Exchange

The approved standards include changes in the following areas:[109]

a. Board Independence

- The board must have a majority of independent directors. Companies have until the earlier of their first annual meeting after January 15, 2004, or October 31, 2004, to comply with the new independence rule[110] and are required to publicly disclose when they have achieved majority independence.

---

[106] NASD and NYSE Rulemaking: Relating to Corporate Governance, Release No. 34-48745 (Nov. 4, 2003), *available at* http://www.sec.gov/rules/sro/34-48745.htm.

[107] *See* Section V.B. below.

[108] *Id.*

[109] The final NYSE listing standards as of November 4, 2003 are available at http://www.nyse.com/pdfs/finalcorpgovrules.pdf. The text of the amended listing standards as of November 3, 2004 is available at the NYSE website at http://www.nyse.com/pdfs/section303A_final_rules.pdf.

[110] Companies listed on the NYSE in conjunction with an initial public offering would have 12 months to comply with the independence requirements. Such companies would have to comply with all other listing requirements at the time of being listed.

- Controlled companies, in which more than 50 percent of the voting power is held by an individual, group or another company, rather than the public, need not meet this board independence requirement.
- For a director to be deemed "independent," the board must affirmatively determine that the director has no material relationship with the listed company other than service as a director.
- Companies must identify in their proxy statements those directors whom the board has determined are independent.
- The basis for board determinations that a relationship is not material must be disclosed in the company's proxy statement or, if the company does not file an annual proxy statement, in the company's annual report on Form 10-K filed with the SEC. The board may adopt and disclose categorical standards to assist it in making independence determinations, and may make a general disclosure if a director meets these standards. Any determination of independence for a director who does not meet the standards must be specifically explained.
- A three-year "cooling off" or "look-back" period applies, during which the following are not considered independent:[111]

  (i) a director who is an employee, or whose immediate family member[112] is an executive officer,[113] of the listed company.

  (ii) a director who receives, or whose immediate family member receives, during any twelve-month period, more than $100,000 in direct compensation from the listed company, other than director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service).

---

111 In order to facilitate a smooth transition to the new independence standards, the NYSE will phase in the "look-back" provisions" by applying only a one-year look-back for the first year after adoption of these standards. The three-year look back for the first year after adoption of these new standards will begin to apply only from and after November 4, 2004.

112 Immediate family members include a person's spouse, parents, children, siblings, mothers and fathers-in-law, sons and daughters-in-law, brothers and sisters-in-law and anyone, other than domestic employees, who lives in the same home.

113 "Executive officer" as used in the corporate governance listing standards has the same meaning as the term "officer" in Exchange Act Rule 16a-1(f).

(iii) (A) a director who is, or whose immediate family member is, a current partner in the listed company's internal or outside auditor; (B) a director who is a current employee of such a firm; (C) a director who has an immediate family member who is a current employee of such a firm and who participates in the firm's audit, assurance or tax compliance (but not tax planning) practice; or (D) a director who has been, or who has an immediate family member who has been, but is no longer, a partner or employee of such a firm and personally worked on the listed company's audit.

(iv) a director who is employed, or whose immediate family member is employed, as an executive officer of another company where any of the listed company's present executive officers concurrently serves on that company's compensation committee.

(v) a director who is an executive officer or an employee, or whose immediate family member is an executive officer, of a company that makes payments to, or receives payments from, the listed company for property or services in an amount which, in any single fiscal year, exceeds the greater of $1 million, or two percent of such other company's consolidated gross revenues.[114]

b. Executive Sessions of the Board/Presiding Director

- Non-management directors must meet at regularly scheduled executive sessions without management. The NYSE also recommends that, if a company's non-management directors include any directors who are not independent, then the independent directors should meet in executive session at least once annually.
- A director must be designated to preside at executive sessions, although there is no requirement to designate a single director who will preside at all sessions. If one director is chosen, the director's name must be disclosed in the proxy statement. Alternatively, a company may disclose the procedure by which a presiding director

[114] Contributions to charitable organizations are not considered "payments" for purposes of this standard, but payments made to charitable organizations as part of a commercial relationship (such as where a listed company serves as a vendor to a charitable organization) are considered "payments" and must be considered in applying the standard. A listed company shall disclose in its annual proxy statement, or if the listed company does not file an annual proxy statement, in the company's annual report on Form 10-K filed with the SEC, any contributions to a charitable organization where a director is an executive officer if, during the last three fiscal years, contributions in any one fiscal year exceeded the $1 million/two percent threshold specified in the NYSE listing standards. In addition, the board should consider contributions to charitable organizations with which directors have relationships when assessing director independence.

is selected. In any case, companies must disclose the means by which stockholders and employees may communicate with the presiding director or the non-management directors as a group.

c. New Requirements for Audit Committee Members and Audit Committees

- Audit committees must have a minimum of three financially literate members.
- Audit committees must be composed entirely of independent directors.
- The audit committee must have a written charter that addresses the committee's purpose, specific responsibilities enumerated by the NYSE and an annual performance evaluation.
- The purpose of the audit committee, at a minimum, must be to prepare the report included in the annual proxy statement and to assist in board oversight of:

  (i) the integrity of the company's financial statements;

  (ii) compliance with legal and regulatory requirements;

  (iii) the outside auditor's qualifications and independence; and

  (iv) performance of the company's internal audit function and of the outside auditor.
- The audit committee must perform additional substantive responsibilities, which must be set forth in its charter. The audit committee must:

  (i) obtain and review, at least annually, a report by the outside auditor describing the auditor's internal quality control procedures and all relationships between the auditor and the company;

  (ii) meet to review and discuss the annual audited financial statements and quarterly financial statements with management and the outside auditor, including reviewing the company's specific disclosures in its MD&A;

  (iii) discuss earnings releases, and financial information and earnings guidance provided to analysts and rating agencies;

  (iv) discuss the company's policies on risk assessment and management;[115]

[115] The rules recognize that it is the job of the company's CEO and senior management to assess and manage the company's exposure to risk. The rules indicate, however, that the audit committee

(v) periodically meet separately with management, internal auditors and the outside auditor;

(vi) have sole authority to retain and terminate the outside auditor, including sole authority to approve all audit engagement fees and terms;

(vii) review with the outside auditor any audit problems or difficulties and management's response;

(viii) set clear hiring policies for employees or former employees of the outside auditors;

(ix) report regularly to the board of directors;

(x) have the authority, without seeking board approval, to obtain advice and assistance from outside legal, accounting or other counsel or consultants; and

(xi) review any difficulties encountered in the course of its audit work and management's response with the outside auditor.

- Each listed company must have an internal audit function.
- In accordance with Section 301 of the Sarbanes-Oxley Act, an audit committee must establish procedures for the receipt, retention and treatment of complaints by the listed company's employees regarding auditing matters, internal controls and accounting.

d. Nominating/Corporate Governance and Compensation Committees

- Companies must have a nominating/governance committee as well as a compensation committee. Controlled companies need not meet this requirement.
- Each committee must be composed entirely of independent directors and must have a written charter.
- Companies may allocate the responsibilities of the nominating and compensation committees to committees of their own denomination, however, regardless of the name, the committees must still be composed entirely of independent directors.
- Company boards may delegate to the compensation committee the authority to approve compensation of executive officers other than the CEO.
- The nominating/corporate governance committee must have a written charter that identifies the committee's purpose and

must discuss guidelines and policies to govern the process by which senior executive officers accomplish these tasks.

responsibilities, which, at minimum, must be to: (i) identify individuals qualified to become board members and select, or recommend that the board select, nominees for election at the annual meeting; (ii) develop and recommend a set of corporate governance principles to the board and (iii) oversee the evaluation of the board and management.

- The charter for the nominating/corporate governance committee also must provide for an annual evaluation of the committee.
- The compensation committee must have a written charter that identifies the committee's purpose and responsibilities, which, at minimum, must be to:
  - review corporate goals and objectives, relative to executive compensation, evaluate CEO performance in light of these corporate objectives, and have the sole authority to set CEO compensation based on achievement of the objectives;
  - make recommendations to the board regarding equity and incentive-based compensation plans that are subject to board approval;
  - make recommendations to the board with respect to non-CEO executive officer compensation; and
  - produce an annual report on executive officer compensation for inclusion in the annual proxy statement.
- The compensation committee charter also must provide for an annual evaluation of the committee.
- Although not mandatory, the NYSE advises that the nominating/corporate governance committee and the compensation committee should have sole authority, without requiring full board action, to retain and terminate outside advisors, such as search firms used to identify director candidates and compensation consultants.

e. CEO Certification

The CEO must certify annually to the NYSE that the company has complied with NYSE listing standards. Any qualifications to the CEO certification must be specified and disclosed in the certification. The CEO must also promptly notify the NYSE after any executive officer becomes aware of any material non-compliance with any listing standards.

f. Corporate Governance Principles

- Companies must adopt a set of corporate governance principles and post these principles on their websites. In addition, the listed company must state in its annual proxy statement[116] that these principles, along with the charters of the company's most important committees, are available on its website, and that the information is available in print to any shareholder who requests it.

- The corporate governance guidelines must address:

  (i) director qualification standards;

  (ii) director responsibilities;

  (iii) director access to management and, when necessary and appropriate, to independent advisors;

  (iv) director compensation, including general principles for determining the form and amount of director compensation and for reviewing those principles;

  (v) director orientation and continuing education;

  (vi) management succession; and

  (vii) an annual performance evaluation of the board to determine how effectively the board and its committees are functioning.

g. Codes of Business Conduct and Ethics

- Companies must adopt and disclose, including by posting on their websites, a code of business conduct and ethics for directors, officers and employees. The code must require that any waivers of compliance with the code for directors or executive officers be made only by the board or a board committee and that such waivers be promptly disclosed to shareholders. The code must also contain compliance standards and procedures that ensure prompt and consistent action against violations of the code.
- A code of business conduct and ethics should address: conflicts of interest; corporate opportunities; confidentiality; fair dealing with the company's customers, suppliers, competitors and employees; protection and proper use of company assets; compliance with laws, rules and regulations, including laws on insider trading; and reporting illegal or unethical behavior.

h. Foreign Issuers

Listed foreign private issuers must comply with the independence requirements applicable to audit committee members under Exchange Act Rule 10A-3. Foreign private issuers generally are not required to comply with other NYSE corporate governance listing standards. Instead, they must

[116] Or, if the company does not file an annual proxy statement, in its annual report on Form 10-K.

disclose, in a brief, general summary, significant ways in which their corporate governance practices differ from those of domestic companies listed on the NYSE.

i. Websites

Companies must post charters for the nominating/governance committee, compensation committee, audit committee and other important committees, along with corporate governance guidelines and codes of conduct, on their websites.

j. NYSE Reprimand Letter

The NYSE may issue a public reprimand letter to any listed company that it determines has violated a NYSE listing standard regardless of type of security listed or country of incorporation. Repeat offenders may be suspended or delisted.

k. Shareholder Approval of Equity Compensation Plans

Shareholders must vote to approve or disapprove <u>all</u> equity compensation plans, except employment inducement option plans, option plans acquired through mergers and certain tax-qualified option plans such as ESOPs and 401(k)s.

2. Nasdaq

Companies were required to implement the new Nasdaq listing standards, with certain exceptions, upon their next annual meeting occurring after January 15, 2004, but no later than October 31, 2004. The Nasdaq rule changes address:

a. Board Independence

- A company's board of directors must be composed of a majority of independent directors.
- The independent directors must meet regularly in "executive sessions."
- The following persons are not considered independent directors:

  (i) a director who is employed by the company or by any parent or subsidiary of the company;

  (ii) a director who accepted or who has a family member who accepted any payments from the company or any parent or subsidiary of the company in excess of $60,000 during any period of 12 consecutive months, other than for compensation for board or board committee service, payments arising solely from investments in the company's securities, compensation paid to a family member who is a non-executive employee of the company or a parent or subsidiary of the company, benefits under a tax-qualified retirement plan, or non-discretionary compensation, or loans permitted under the Sarbanes-Oxley Act, and certain ordinary-course, non-preferential loans and other payments from financial institutions;

(iii) a director who is a family member of an individual who is employed by the company or by a parent or subsidiary of the company as an executive officer;

(iv) a director who is, or has a family member who is, a partner in, or a controlling shareholder or an executive officer of, any organization to which the company made, or from which the company received, payments for property or services that exceed 5% of the recipient's consolidated gross revenues of that year, or $200,000, whichever is more, other than payments arising solely from investments in the company's securities, or payments under non-discretionary charitable contribution matching programs;

(v) a director of the listed company who is, or has a family member who is, employed as an executive officer of another entity where any of the executive officers of the listed company serve on the compensation committee of such other entity; or

(vi) a director who is, or has a family member who is, a current partner of the company's outside auditor, or was a partner or employee of the company's outside auditor who worked on the company's audit.

- Controlled companies are exempt from the requirements for a majority independent board.

b. Strengthen the Role of Independent Directors in Compensation and Nomination Decisions

- Each issuer must certify that it has adopted a formal written charter or board resolution, as applicable, addressing the nominations process and such related matters as may be required under the federal securities laws. Controlled companies are exempt from this requirement.
- Director nominations must be approved by either a majority of the independent directors or an independent nominations committee. Controlled companies are exempt from this requirement.
- A nominations committee that is "independent" for purposes of the requirement relating to independent director approval of director nominations may have a single non-independent director under certain circumstances. If the nominations committee has at least three members, one director who does not meet the Nasdaq definition of "independent director" and who is not a current officer or employee of the company, or a family member of such a person, can serve on the committee for no more than two years, if: (i) the board determines that the individual's membership on the committee is required by the best interests of the company; and (ii)

the company discloses the nature of the relationship (that results in the director not being independent) and reasons for the determination in its proxy statement.

- CEO compensation and other executive officer compensation must be determined, or recommended to the board for determination, by either an independent compensation committee or by a majority of independent directors. The CEO may be present at a meeting where other executive officer compensation is approved, but may not be present during voting or deliberations regarding the CEO's own compensation. Controlled companies are exempt from these requirements.

- A compensation committee that is "independent" for purposes of the requirement relating to independent director approval of executive compensation may have a single non-independent director under certain circumstances. If the compensation committee has at least three members, one director who does not meet the Nasdaq definition of "independent director" and who is not a current officer or employee of the company, or a family member of such a person, can serve on the committee for no more than two years, if: (i) the board determines that the individual's membership on the committee is required by the best interests of the company; and (ii) the company discloses the nature of the relationship (that results in the director not being independent) and reasons for the determination in its proxy statement.

c. Audit Committees

- The audit committee must have a written charter that addresses its purpose and certain authorities and responsibilities mandated under the Sarbanes-Oxley Act. Companies were required to comply with the audit committee charter requirement by the company's first annual meeting after January 15, 2004, but no later than October 31, 2004.

- The audit committee must review and reassess the adequacy of the written charter on an annual basis.

- The audit committee must have at least three members, each of whom must:

  (i) meet the Nasdaq definition of "independent director";

  (ii) meet the criteria for independence set forth in SEC rules under Section 301 of the Sarbanes-Oxley Act;

  (iii) not have participated in the preparation of the financial statements of the company or any current subsidiary of the company at any time during the past three years; and

(iv) be able to read and understand fundamental financial statements at the time of joining the committee.

- A non-independent director may, subject to an "exceptional and limited circumstances" exception, serve on the audit committee for up to two years, although such person must still satisfy the audit committee independence requirements of Exchange Act Rule 10A-3, if: (i) the board determines that the individual's membership on the committee is required by the best interest of the company; and (ii) the company discloses the nature of the relationship (that results in the director not being independent) and the reasons for the determination in its proxy statement. A person serving in reliance on this exemption may not chair the committee.

- The audit committee charter must set forth the committee's purpose of overseeing the company's accounting and financial reporting processes and the audits of the financial statements.

- The audit committee charter must set forth, and the audit committee must perform, the responsibilities required in Exchange Act Rule 10A-3(b)(2-5), which include:

  (i) have the sole authority to hire, fire and determine the compensation of the company's outside auditors;

  (ii) have the authority to engage and determine funding for outside advisors, as set forth in Section 301 of the Sarbanes-Oxley Act; and

  (iv) have the responsibility to establish procedures for complaints relating to auditing and accounting matters, as set forth in Section 301 of the Sarbanes-Oxley Act.

- Audit committees must review and approve all related-party transactions.

- If a listed issuer fails to comply with the audit committee composition requirements, because an audit committee member ceases to be independent for reasons outside the member's reasonable control, the audit committee member can remain on the committee until the earlier of the issuer's next annual shareholders meeting or one year from the occurrence of the event that caused the failure to comply with the requirements; and if an issuer fails to comply with the audit committee composition requirements due to one vacancy on the audit committee, and the aforementioned cure period is not otherwise being relied upon for another audit committee member, the issuer has until the earlier of the next annual shareholders meeting or one year from the occurrence of the event that caused the failure to comply with this requirement.

d. Non-U.S. Companies

- Nasdaq has the ability to provide exemptions to foreign issuers, except to the extent that such exemptions would be contrary to the federal securities laws.
- Non-U.S. companies must disclose any exemptions to the corporate governance requirements at the time of their first U.S. listing and thereafter in their annual reports filed with the SEC.

e. Codes of Conduct

- All companies must have a publicly available code of conduct, which must at least address conflicts of interest and compliance with applicable laws, rules and regulations.
- The code of conduct must also describe an appropriate compliance mechanism and any waivers granted to executive officers and directors must be disclosed. Waivers may only be granted by independent directors and must be promptly disclosed on Form 8-K.
- The code of conduct must contain all of the elements required by Section 406 of the Sarbanes-Oxley Act and the SEC's implementing rules. These rules are described below.

f. Penalties for Corporate Governance Violations

- A company can be delisted for making a material misrepresentation or omission to Nasdaq.
- A company's re-listing application can be denied if Nasdaq finds that the company has violated its corporate governance standards during the period in which the delisting appeal is pending.

g. Equity Based Compensation Plans

- Shareholders must vote to approve all stock option plans and all material modifications of such plans.
- Nasdaq has retained an exception that allows companies to provide inducement grants to new executive officers, but any such grants must be approved by an independent compensation committee or a majority of the independent directors.
- Certain tax-qualified plans, such as ESOPs and plans that merely provide a convenient way to purchase shares on the open market or from the issuer at fair market value, are exempt, as is the assumption of pre-existing grants in connection with a merger or acquisition in certain circumstances.

- The amended rules regarding shareholder approval of equity compensation plans were approved by the SEC on June 30, 2003, and became effective upon SEC approval.[117]

B. Amendments to NYSE Corporate Governance Listing Standards[118]

In November 2004, the Commission approved amendments to the corporate listing standards of the NYSE.[119] The amendments clarified issues that have been the subject of questions and requests for interpretive guidance since the listing standards were approved in November of 2003. In addition, the amendments modified the prior bright-line director independence standard concerning affiliations with a listed company's auditor.

In August 2006, the Commission approved additional changes to the NYSE listing standards, permitting some issuers to post proxy materials and annual reports on a website as opposed to physical delivery, as discussed below.[120]

1. Affiliation with Listed Company Auditor

The amendments change the bright-line independence standard on affiliations with a listed company's auditor to provide that a director is not independent where:

- the director or an immediate family member is a current partner of the listed company's internal or outside auditor;
- the director is a current employee of the internal or outside auditor;
- the director's immediate family member is a current employee of the internal or outside auditor and participates in the auditor's audit, assurance or tax compliance (but not tax planning) practice; or

---

117 Self-Regulatory Organizations; New York Stock Exchange, Inc. and National Association of Securities Dealers, Inc.; Order Approving NYSE and Nasdaq Proposed Rule Changes and Nasdaq Amendment No. 1 and Notice of Filing and Order Granting Accelerated Approval to NYSE Amendments No. 1 and 2 and Nasdaq Amendments No. 2 and 3 Thereto Relating to Equity Compensation Plans, Release No. 34-48108 (June 30, 2003).

118 *See also* Section II, G above.

119 The NYSE listing standards relating to corporate governance are described more fully in Section V.A. of this outline, and the text of the amended listing standards is available on the NYSE website at http://www.nyse.com/pdfs/section303A_final_rules.pdf.

120 Order Approving Proposed Rule Change and Amendment, Release No. 34-54344; File No. SR-NYSE-2005-68 (August 21, 2006), *available at* http://www.sec.gov/rules/sro/nyse/2006/34-54344.pdf.

- the director or an immediate family member was within the last three years (but is no longer) a partner or employee of the internal or outside auditor and personally worked on the listed company's audit within that time.

Under the previous standard, a director was not independent if the director was affiliated with or employed by, or had an immediate family member affiliated with or employed in a professional capacity by, the listed company's present or former internal or outside auditor, until three years after the end of the affiliation or the employment or auditing relationship. The changes to the previous standard were intended to avoid situations where directors are precluded from being independent because of past personal or family member affiliations with an auditing firm in circumstances where the director or family member never worked on the listed company's audit. Although initially the NYSE proposed limiting the family members covered by the independence standard to those covered by Exchange Act Rule 10A-3 (the rule on audit committee independence), which includes a director's spouse, minor child or stepchild, and an adult child or stepchild sharing a home with the director, it withdrew its proposal in response to comments and following discussions with the SEC. The existing definition of "immediate family member" continues to apply, although the NYSE has stated that it intends to continue its dialogue with the SEC on this issue.

2. Direct Payments from Listed Company

The amendments revise the bright-line independence standard on receipt of more than $100,000 "per year" in direct compensation from a listed company to require that companies consider payments made in any 12-month period during the last three years. This change is intended to clarify that the look-back period under this standard is a maximum of 36 months.

3. Payments to Charitable Organizations

The amendments clarify that the bright-line independence standard on listed companies' business relationships (the $1 million/2 percent test) covers payments related to commercial relationships with charitable organizations (such as where a listed company serves as a vendor to a charitable organization). The business relationship test does not cover contributions to charitable organizations, although these contributions are subject to disclosure if they exceed the thresholds specified in the listing standards.

4. Disclosure of Director Independence Determinations

The amendments clarify that companies must identify in their proxy disclosure about director independence those directors whom the board has determined are independent.

5. Audit Committee Responsibilities

The amendments require that the audit committee "meet to review and discuss" the listed company's annual and quarterly financial statements, and that it "review[] the company's specific disclosures" in MD&A.

6. Compensation Committee Responsibilities

The amendments clarify that, for purposes of the requirement that the compensation committee make recommendations to the board about "non-CEO compensation," "non-CEO compensation" refers to executive officer compensation. The amendments also clarify that the board may delegate to the committee the authority to approve compensation of executive officers other than the CEO.

7. Definition of "Executive Officer"

The amendments specify that the term "executive officer" as used in the corporate governance listing standards has the same meaning as the term "officer" in Exchange Act Rule 16a-1(f).

8. Disclosure about Corporate Governance Documents

Previously, companies were required to post their corporate governance guidelines, key committee charters, and codes of conduct on their websites and state in their reports on Form 10-K that these documents are available on the website and in print to any shareholder that requests them. The amendments move the disclosures about the availability of a company's corporate governance documents to the proxy statement for consistency with disclosure requirements elsewhere in the corporate governance listing standards.

9. CEO Certification

Under current listing standards, a listed company's CEO must certify annually to the NYSE that he or she is not aware of any violation by the company of the NYSE's corporate governance listing standards. The amendments clarify that any qualifications to the CEO certification must be specified and disclosed in the certification.

C. Other Corporate Governance Statements

A number of independent organizations have also published suggested guidelines for enhanced corporate governance.

The Business Roundtable published its *Principles of Corporate Governance* in May 2002.[121] *Principles of Corporate Governance* provides a set of guiding principles intended to assist corporate management and boards of directors in their individual efforts to implement corporate governance best practices. Many of the proposals in *Principles of Corporate Governance* were included in the standards adopted by the NYSE and the Nasdaq.

In November 2003, the Business Roundtable also published *Executive Compensation: Principles and Commentary*, which provides more detailed guidance with regard to designing,

---

[121] *Principles of Corporate Governance* is available at http://www.businessroundtable.org/pdf/704.pdf.

implementing and overseeing executive compensation programs.[122] In April 2004, the Business Roundtable published *The Nominating Process and Corporate Governance Committees: Principles and Commentary*, which provides a guide of best practices for companies' director nomination process. The publication also provides guidance with regard to the expanding role of the corporate governance committee in shaping the company's overall governance policies and procedures.[123] In May 2005, the Business Roundtable published *Guidelines for Shareholder-Director Communications*.[124]

In November 2005, the Business Roundtable published updated *Principles of Corporate Governance*, outlining guidelines to assist American public companies in meeting their corporate governance obligations more effectively.[125] The following highlights the most significant changes in the Business Roundtable *Principles*:

- *Corporate governance laws and regulations*: The updated guidelines reflect new legal and regulatory requirements resulting from the Sarbanes-Oxley Act and amended securities market listing standards.

- *Board leadership*: The guidelines also emphasize the critical importance of independent board leadership. In recognition of the fact that there is not one leadership structure that is right for every corporation, the guidelines outline a variety of methods for ensuring independent leadership. A May 2005 survey by the Business Roundtable showed that nearly 82% of member companies' boards are at least 80% independent.

- *Executive sessions*: The updated guidelines recommend including an executive session of independent or non-management directors on the agenda for every regular board meeting, with follow-up with senior management following each such executive session, in order to maximize the effectiveness of executive sessions.

- *Compliance*: The guidelines also include an expanded discussion of compliance that addresses the board's role in compliance oversight and emphasizes the

---

[122] *Executive Compensation: Principles and Commentary* is available at http://www.businessroundtable.org/pdf/ExecutiveCompensationPrinciples.pdf.

[123] *The Nominating Process and Corporate Governance Committees: Principles and Commentary* is available at http://www.businessroundtable.org/pdf/20040421002CorpGovComm.pdf.

[124] *Guidelines for Shareholder-Director Communications* is available at http://www.businessroundtable.org/pdf/20050527001ShareholderCommunicationsGuidelines-FINAL-5.26.05.pdf.

[125] The Business Roundtable's 2005 *Principles of Corporate Governance* is available at http://www.businessroundtable.org/pdf/CorpGovPrinciples.pdf.

responsibility of the board and senior management for setting a "tone at the top" that establishes a culture of legal compliance and integrity.

- *Director-shareholder relations*: The updated guidelines also provide that the board of directors maintains responsibility for responding to communications from shareholders and addressing issues of concern to shareholders, and contain an expanded set of best practice recommendations for boards in carrying out these responsibilities. In the Business Roundtable's May 2005 survey, 90% of participating companies reported that they have established procedures for shareholder communications with directors.

On March 31, 2003, the American Bar Association's Task Force on Corporate Responsibility released its *Report on Corporate Responsibility*, which is available at http://www.abanet.org/buslaw/corporateresponsibility/final_report.pdf. The report makes a number of recommendations for corporate governance of public companies as well as for attorneys in representing companies on corporate governance matters. The changes to the model rules of attorney conduct were approved at the ABA's 2003 annual meeting.

VI. Form 8-K Disclosure Requirements

In a release dated March 16, 2004, the SEC adopted amendments relating to current filings on Form 8-K.[126] The amendments, among other things, added eight events that require the filing of a Form 8-K and reorganized Form 8-K into topical categories. The amendments also shortened the deadline for filing most current reports on Form 8-K to four business days. These amendments became effective on August 23, 2004.

A. Form 8-K Disclosure Events

The amendments added disclosure requirements upon the occurrence of the following eight events:

1. Entry into a Material Agreement Not Made in the Ordinary Course of Business

The rules require disclosure when a company enters into a material definitive agreement not made in the ordinary course of business, any amendment to such agreements and any material amendment that causes an agreement to become a material definitive agreement. Though the Form 8-K amendments initially required the filing of a multitude of compensatory plans and contracts with directors and officers, this requirement was substantially reduced with the introduction of the SEC's new executive compensation rules, described in further detail above.

2. Termination of a Material Agreement Not Made in the Ordinary Course of Business

---

[126] Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, Release Nos. 33-8400; 34-49424, (Mar. 16, 2004), *available at* http://www.sec.gov/rules/final/33-8400.htm.

The rules require disclosure upon the termination of a material definitive agreement not made in the ordinary course of business. Exceptions to this rule include circumstances where the parties have completed their obligations or the agreement is terminated on its stated termination date.

3. Creation of a Direct Financial Obligation or an Obligation Made Under an Off-Balance Sheet Arrangement

Under the rules, companies must file a Form 8-K if they become obligated under a direct financial obligation that is material, or if the company becomes directly or contingently liable for a material obligation that arises from an off-balance sheet transaction. A direct financial obligation would include the issuance of long-term debt, the assumption of a capital lease or operating lease, or the issuance of short-term debt arising other than in the ordinary course of business.

4. Acceleration or Increase of a Direct Financial Obligation or an Obligation Under an Off-Balance Sheet Arrangement

The rules require disclosure if a triggering event occurs causing (1) the increase or acceleration of a direct financial obligation or an obligation under an off-balance sheet arrangement or (2) the company's contingent obligation under an off-balance sheet arrangement to become a direct financial obligation, provided that, in all cases, the consequences of such events are material to the company.

5. Costs Associated with Exit or Disposal Activities

The rules require disclosure if the board of directors, a board committee or an authorized officer or officers commits the company to an exit or disposal plan, or otherwise disposes of a long-lived asset or terminates employees under certain "plans of termination." If the company is not able to make a good faith estimate of the amount of the charge, it does not need to disclose an estimate at that time, but it must still file a Form 8-K describing the company's commitment to a course of action under which it will incur a material charge.

6. Material Impairments

Disclosure is required if the board of directors, a board committee or an authorized officer or officers determines that a material charge for impairment to one or more of the company's assets, including goodwill or securities, is required under GAAP.

7. Delisting or Failure to Satisfy a Continued Listing Rule or Standard, or Transfer of Listing

Under the rules, disclosure is required if (1) the company receives notice from a national securities exchange or national securities association that maintains the principal listing for the company's common stock that the company no longer satisfies a continued listing requirement, (2) the exchange has filed an application with the SEC to delist the company's securities, (3) the association has taken all necessary steps to delist the company's common stock, (4) the company becomes aware that it is in material non-compliance with a continued listing requirement, (5) the exchange or association has, in lieu of suspending trading in or delisting, issued a public reprimand letter finding that the company has violated a listing requirement or (6) the board of directors, a board committee or an authorized officer or officers has taken action to cause the listing of the company's common stock to be withdrawn, transferred or terminated, as applicable. No disclosure is required if the delisting is because of a redemption or maturity of the company's securities.

8. Non-Reliance on Financial Statements or a Related Audit Report or Completed Interim Review

The rules require disclosure when and if the board of directors, a board committee or an authorized officer or officers determines that any previously issued financial statement covering one or more years or interim periods should no longer be relied on because of an error as contemplated in Accounting Principles Board Opinion No. 20. The company must also provide disclosure if it is notified by its independent accountants that disclosure should be made or action should be taken to prevent future reliance on a previously issued audit report or completed interim review that is related to a previously issued financial statement.

B. Safe Harbor

The SEC allows a limited safe harbor from public and private claims under Section 10(b) and Rule 10b-5. The Commission recognized that the first seven items listed above under "Form 8-K Disclosure Events" might require management to make a quick assessment of the materiality of an event, and thus the triggering of a filing obligation. Therefore, a company that fails to file a timely 8-K after one of the first seven triggering events listed above will not incur Section 10(b) and Rule 10b-5 liability as long as it discloses the event on or before the due date of the company's next periodic report. For example, if the company fails to make the required timely disclosure on a Form 8-K during a particular quarter, disclosure must be provided by the filing deadline of the company's quarterly report. This safe harbor does not otherwise apply to material misstatements or omissions in a Form 8-K (which still exposes the company to potential liability).

C. Eligibility to Use Form S-3

Form S-3 is a short form registration statement that many companies prefer to file for efficiency reasons. One of the requirements to file on Form S-3 is that the company must have timely filed all required reports during the previous 12 months. The adopted rules amend Form S-3 to allow companies that do not file a timely Form 8-K after the occurrence of any of the first seven items covered under "Safe Harbor" to still file on Form S-3, provided that the company is current in its 8-K filings at the time it files on Form S-3 (including disclosures with respect to the seven "Safe Harbor" items).

D. Eligibility Under Rule 144

SEC Rule 144 provides for the resale of restricted securities in limited quantities without requiring that the securities be registered, provided that certain conditions are met. One of these conditions is that the company be current in all required Form 8-K reports. Based on reasons similar to those underlying the Section 10(b) and Rule 10b-5 safe harbor regarding the difficulty that management faces in making quick materiality determinations, the Form 8-K rulemaking provides that a company's failure to timely file a Form 8-K relating to the seven "Safe Harbor" disclosure events listed above will not prevent security holders from using Rule 144 to resell securities. This change alleviates the burdens that would otherwise be imposed on security holders if a company was not current with respect to certain Form 8-K filings.

E. Disclosure of Previously Unreported Form 8-K Events

Where a company is required to disclose information in a report on Form 8-K during the fourth quarter of a fiscal year, but fails to file that Form 8-K, Item 9B of Form 10-K and Item 8-B of Form 10-KSB require that the company disclose such information in that fiscal year's annual report.[127] Items 9B and 8-B compel the inclusion of this information regardless of whether the annual report would otherwise require the disclosure.

F. Executive Compensation Considerations Regarding Form 8-K Filings: Implications for Form 10-K and Form 10-Q Exhibits and Proxy Statement Disclosures

The implications of the Form 8-K amendments are continuing to significantly affect company disclosure practices, including executive compensation disclosures. Prior to the Form 8-K amendments, a company's proxy statement was the primary disclosure vehicle with respect to executive compensation information. However, requirements under Item 1.01 of Form 8-K to disclose material definitive agreements, combined with the Form 8-K Frequently Asked Questions ("**Form 8-K FAQs**") that the SEC staff issued in November 2004, executive compensation disclosures to be made more frequently, and, in many cases, much earlier in the year than in a company's proxy statement.

In turn, the interpretations under Item 1.01 of Form 8-K have caused a re-examination of the exhibit filing requirements for Forms 10-K and 10-Q pursuant to Item 601(b)(10) of Regulation S-K. One area that has received renewed attention as a result of the Form 8-K FAQs is the requirement under Item 601(b)(10) to file a written description of any management contract or any compensatory plan, contract or arrangement covering directors or named executive officers ("**NEOs**") if the plan, contract or arrangement is not set forth in a formal document. The SEC staff's recent interpretation of this provision, particularly with respect to what constitutes a compensatory contract, plan or arrangement, may also affect proxy statement disclosure regarding severance arrangements and retirement plans.

Below are considerations regarding evolving disclosure issues, as well as additional disclosure issues, relating to executive compensation arising from Form 8-K requirements and the interpretive guidance in the Form 8-K FAQs.

1. Executive Compensation Disclosure under Item 1.01 of Form 8-K

Item 1.01 of Form 8-K requires companies to file a Form 8-K disclosing their entry into a material definitive agreement and any material amendments to such an agreement. Under the Item, an agreement involving the subject matter identified in Item 601(b)(10)(iii)(A) or (B) of Regulation

---

[127] Staff Alert Annual Report Reminders (March 4, 2005), *available at* http://www.sec.gov/divisions/corpfin/cfalerts/cfalert030405.htm.

S-K was initially subject to these 8-K disclosure requirements, with certain narrow exceptions. However, the SEC amended Form 8-K as part of its new executive compensation rules (discussed above) to remove this requirement. The new rules remove compensation related plans, agreements and arrangements as reportable events under Items 1.01 and 1.02 of Form 8-K. Although compensation-related events are no longer reportable as "material agreements" under the Form 8-K rules, they continue to be treated as "material agreements" under the rules enumerating exhibits that are required to be filed with registration statements and Forms 10-K and 10-Q.

In turn, the amendments to the executive compensation rules expanded the executive compensation-related events that require a Form 8-K report under Item 5.02 of Form 8-K. That item is now triggered:

- when a company enters into, adopts, commences or materially modifies or amends a material compensatory plan, contract or arrangement (whether or not written) in which a principal executive officer, principal financial officer or person identified as an NEO in the company's most recently proxy statement participates; and

- whenever a company makes or materially modifies a material grant or award under any plan, contract or arrangement to or with any principal executive officer, principal financial officer or person identified as a NEO in the company's most recently proxy statement, <u>unless</u> the grant or award (or modification thereto) is "materially consistent with the previously disclosed terms of such plan, contract or arrangement," and the grant, award or modification is disclosed when required in the company's next proxy statement (or other filing reporting compensation of NEOs under Item 402 of Regulation S-K).

In addition, under amendments to other provisions of Item 5.02, a Form 8-K must be filed whenever a company calculates the amount of an NEO's salary or bonus for the previous fiscal year if that amount was not reported in the company's previously filed proxy statement (or other filing reporting compensation of NEOs under Item 402 of Regulation S-K) for that fiscal year.

Though the significance of the SEC's Form 8-K FAQ has been limited by the executive compensation rule amendments, the FAQ continues to have value with respect to certain Item 5.02 disclosure issues and should be reviewed in connection with the new Item 5.02.

2. Filing Written Descriptions under Item 601 of Regulation S-K

Under Item 601(b)(10)(iii)(A) and Instruction 2 to that Item, a company must file any management contract or any compensatory plan, contract or arrangement relating to NEOs or directors as an exhibit to its Form 10-K or Form 10-Q for the quarter in which the agreement is entered into or the plan or arrangement is established. Item 601(b)(10)(iii)(A) also requires that, if the management contract or compensatory plan, contract or arrangement is not set forth in a formal document, a "written description" of the agreement must be filed. In addition, Instruction 1 to Item 601(b)(1) states that, "[w]ith the exception of management contracts, registrants . . . need not file each individual director's or executive officer's personal agreement under the plans unless there are particular provisions in such personal agreements whose disclosure in an exhibit is necessary to an investor's understanding of that individual's compensation under the plan." Any amendment to a compensatory plan, contract or arrangement in which a director or NEO participate, whether or not material, is required under Item 601(b)(10) to be filed as an exhibit to the Form 10-K or Form 10-Q for the quarter in which the amendment occurs.

Thus, when a company concludes that a compensation action establishes what is in fact an agreement between the company and the executive or a new plan or arrangement or an amendment to a contract, plan or arrangement, then the company must file an exhibit covering that contract, plan or arrangement. One way of addressing this is to prepare and file "summary sheets," which contain basic information with respect to NEO salaries and possibly other compensation as discussed below. The contents of the summary sheet should pertain to the establishment of compensation terms, unless there have been changes. More detailed executive compensation disclosures would be provided in the proxy statement.

In the summary sheet, base salaries as established by the compensation committee or board of directors for the coming year would be included for each NEO. Companies also may wish to consider whether other elements of compensation, such as bonuses, long-term compensation arrangements and perquisites, should be disclosed. As permitted by Instruction 1 to Item 601(b)(10), the summary sheet may exclude individual NEO compensation resulting from equity compensation and cash bonus plans and applicable forms of award agreements that previously have been filed as exhibits, unless there are provisions in the NEO's award agreements that are necessary for an understanding of the NEO's compensation under the plans. For new bonus plans, the summary sheet may include, on an aggregated basis (not individualized for each NEO), the range of target amounts payable, the specific performance criteria and their respective weights and the maximum payouts under the plans. Compensation arrangements that permit the board or compensation committee to increase the amounts in future years without specification of any ranges likely would be viewed by the SEC staff as requiring amended summary sheets to be filed as exhibits when there are increases or decreases in compensation. With respect to disclosure of perquisites, the SEC staff's Manual of Publicly Available Telephone Interpretations, Interpretation No. I.84 indicates that written arrangements where officers are provided company cars and other perquisites do not need to be filed as material contracts unless the perquisites constitute a material portion of total compensation. However, given the SEC's renewed focus on perquisites, companies may wish to provide this information to the extent known.

3. Filing of Plan Documents and Related Forms of Award Agreements

In connection with preparing their Form 10-Ks, companies also should confirm that all plan documents and any applicable forms of award agreements relating to active compensation plans have been filed as exhibits or will be filed in connection with an upcoming Form 10-K. Exhibits should be filed to describe the terms of agreements, plans or arrangements that are not formalized in a written document. Individual NEO awards do not need to be reported on Form 8-K if the awards are made under a plan that has been filed, including any applicable form of award agreements, if they are materially consistent with the previously disclosed terms of such plan or agreement.

VII. Staff Accounting Bulletins

A. Introduction

Staff Accounting Bulletins are intended to address attempts by companies to disclose the value of assets that are increasingly intangible and for which there is not sufficient guidance in the traditional financial reporting model. In addition to the guidance already provided by recent Staff Accounting Bulletins, the SEC has looked at accounting issues in connection with internet activities[128] and international accounting standards,[129] and has proposed new rules to provide better disclosure regarding such accounting areas as changes in valuation and loss accrual accounts.[130] The SEC also maintains an outline entitled "Current Accounting and Disclosure Issues in the Division of Corporate Finance."[131]

B. Staff Accounting Bulletin No. 103: Update of Codification of Staff Accounting Bulletins

On May 9, 2003, the SEC released Staff Accounting Bulletin No. 103 in order to make the staff's interpretive guidance consistent with current accounting and auditing guidance and with SEC rules.[132] While offering relatively little new guidance, per se, the bulletin represents the first comprehensive recodification of the Staff Accounting Bulletins in more than 20 years. The recodification addresses, among other topics, financial statements, business combinations, senior securities, equity accounts and revenue recognition. Many of the changes rescind material no longer needed because of changes in authoritative accounting standards and new SEC rules. As a result of the recodification, the entire SAB codification will now be available on the SEC website.[133]

C. Staff Accounting Bulletin No. 104: Revenue Recognition

On December 17, 2003, the SEC released Staff Accounting Bulletin No. 104, revising or rescinding portions of the interpretative guidance included in Topic 13 of the codification of staff

---

[128] Letter from Lynn E. Turner, Former Chief Accountant, to the Financial Accounting Standards Board (Oct. 18, 1999), *available at* http://www.sec.gov/info/accountants/staffletters/calt1018.htm.

[129] International Accounting Standards, Release Nos. 33-7801, 34-42430 (Feb. 16, 2000), *available at* http://www.sec.gov/rules/concept/34-42430.htm.

[130] Supplementary Financial Information, Release Nos. 33-7793, 34-42354 (Jan. 27, 2000), *available at* http://www.sec.gov/rules/proposed/34-42354.htm.

[131] The most recent version of the outline is available at http://www.sec.gov/divisions/corpfin/acctdis120105.pdf.

[132] Staff Accounting Bulletin No. 103: Update on Codification of Staff Accounting Bulletins, Release No. SAB 103 (May 9, 2003), *available at* http://www.sec.gov/interps/account/sab103.htm.

[133] The codification is also found at Part 211 of Title 17 of the Code of Federal Regulations.

accounting bulletins in order to make the staff's interpretive guidance consistent with current accounting and auditing guidance and SEC rules.[134] The principal revisions rescind material no longer necessary because of private sector developments in U.S. generally accepted accounting principles and new SEC rules.[135] Additionally, the bulletin rescinds the Revenue Recognition in Financial Statements Frequently Asked Questions and Answers document issued in conjunction with Topic 13 and incorporates selected portions of that document into Topic 13.

D. Staff Accounting Bulletin No. 105: Application of Accounting Principles to Loan Commitments

On March 9, 2004, the SEC released Staff Accounting Bulletin No. 105, summarizing the staff's views regarding the application of generally accepted accounting principles to loan commitments accounted for as derivative instruments.[136] Under the Financial Accounting Standards Board ("**FASB**") Statement No. 133, a bank intending to sell a mortgage loan after it is funded should account for the commitment as a derivative instrument at fair market value. The bank may not consider any expected future cash flow from the associated servicing of the loan, as that would result in the immediate recognition of a servicing asset. Servicing assets may only be recognized once the servicing asset has been contractually separated from the underlying loan. Also, no other internally-developed intangible asset should be recorded. The bank should disclose its accounting policy related to the loan commitment accounted for as a derivative. For loan commitments accounted for as derivatives entered into on or before March 31, 2004, the staff allows the registrant to continue with its existing accounting policies, but any such loan commitments subsequent to that date must be accounted for in accordance with this bulletin.

E. Staff Accounting Bulletin No. 106: Application of Full Cost Method of Accounting

On September 28, 2004, the SEC released Staff Accounting Bulletin No. 106, summarizing the staff's interpretation of the impact of FASB Statement 143 on the full cost method of accounting and the calculation of depreciation, depletion and amortization ("**DD&A**").[137] Under Statement 143, a company must recognize a liability for an asset retirement obligation ("**ARO**") at fair value in the period when the liability is incurred and the associated asset retirement costs must be capitalized upon initial recognition of the ARO by increasing the long-lived oil and gas assets by the same

---

[134] Staff Accounting Bulletin No. 104: Revenue Recognition, Release No. SAB 104 (December 17, 2003), *available at* http://www.sec.gov/interps/account/sab104rev.pdf.

[135] Specifically, many of the revisions relate to EITF Issue 00-21, *Revenue Arrangements with Multiple Deliverables*.

[136] Staff Accounting Bulletin No. 105: Application of Accounting Principles to Loan Commitments, Release No. SAB 105 (March 9, 2004), *available at* http://www.sec.gov/interps/account/sab105.htm.

[137] Staff Accounting Bulletin No. 106: Application of Full Cost Method of Accounting, Release No. SAB 106 (Sept. 28, 2004), *available at* http://www.sec.gov/interps/account/sab106.htm.

amount as the liability. Such costs are subject to the full cost ceiling limitation under Rule 4-10(c)(4) of Regulation S-X. Also, costs amortized under Rule 4–10(c)(3) of Regulation S-X should include an amount for the estimated dismantlement and abandonment costs, net of estimated salvage value, from future development activities. Rule 4-10(c)(3) requires that dismantlement and abandonment costs be included as capitalized costs for computing the base for DD&A to the extent such costs have not been included in the DD&A base because they have not yet been capitalized as asset retirement costs under Statement 143. A company following these rules must provide disclosure in its financial statement footnotes and MD&A explaining Statement 143's impact on accounting for oil and gas operations.

F. Staff Accounting Bulletin No. 107: Application of FASB Statement 123R

On March 29, 2005, the Commission released Staff Accounting Bulletin No. 107 relating to the Financial Accounting Standards Board's accounting standard for stock options and other share-based payments.[138] FASB Statement 123R states that compensation costs from share-based payments be recognized in financial statements at fair value. The bulletin provides interpretive guidance related to the interaction between SEC rules and FASB Statement 123R.

The staff recognizes that reasonable issuers may employ a range of valuation methodologies to make estimates of fair value. The bulletin provides guidance on:

- disclosure in MD&A subsequent to the adoption of FASB Statement 123R;
- the use of non-GAAP financial measures;
- share-based payment transactions with nonemployees;
- the transition from nonpublic to public entity status;
- valuation methods;
- accounting for certain redeemable financial instruments issued under share-based payment arrangements;
- classification of compensation expense;
- first-time adoption of FASB Statement 123R in an interim period;
- capitalization of compensation cost related to share-based payment arrangements;
- accounting for income tax effects of share-based payment arrangements upon adoption of FASB Statement 123R; and

---

[138] Staff Accounting Bulletin No. 107, Release No. SAB 107 (Mar. 29, 2005), *available at* http://www.sec.gov/interps/account/sab107.pdf.

- modification of employee share options prior to adoption of FASB Statement 123R.

G. Staff Accounting Bulletin No. 108: Quantifying Financial Statement Misstatements

On September 13, 2006, the Commission released Staff Accounting Bulletin No. 108 (SAB 108) relating to the Commission's views regarding the process of quantifying financial statement misstatements.[139] SAB No. 108 was issued by the Commission to address the diversity in the practice of quantifying financial statement misstatements. The Commission believes registrants must quantify the impact of correcting all misstatements, including both the carryover and reversing effects of the prior years misstatement, by quantifying the error under both the "rollover" and "iron curtain" approaches. The "rollover" approach quantifies a misstatement based on the amount of the error originating in the current year income statement while the "iron curtain" approach quantifies a misstatement existing in the balance sheet based on the effects of correcting such misstatement at the end of the current year. The registrant would then determine if either approach results in a misstatement that is material. If so, the registrant would be required to make an adjustment to the registrant's financial statements.

VIII. Other SEC Rule Changes or Items of Note

A. Other Changes in SEC Rules

1. Accelerated Reporting Requirements for Form 10-K and Form 10-Q

In a September 5, 2002 release, the SEC approved the adoption of the proposed rules to accelerate the filing deadline for annual and quarterly reports under the Exchange Act, with a three-year phase-in period.[140] Pursuant to the new rules, for many companies, Forms 10-K were to be filed within 60 days of fiscal year-end and Forms 10-Q were to be filed within 35 days of quarter-end. The accelerated filing requirements were to be phased in over three years (which began at December 31, 2002), however, the SEC extended the periodic filing deadlines as discussed below.

Companies are subject to the accelerated reporting requirements if they: (i) have a domestic public float of at least $75 million; (ii) have been a reporting company for 12 months; and (iii) have previously filed at least one report with the SEC.

Based on comments made by the SEC staff at the open meeting in which the rules were adopted, it appears that financial statements of subsidiaries that are not themselves subject to the

---

[139] Staff Accounting Bulletin No. 108, Release No. SAB 108 (Sept. 13, 2006), *available at* http://www.sec.gov/interps/account/sab108.pdf.

[140] Acceleration of Periodic Report Filing Dates and Disclosure Concerning Website Access, Release Nos. 33-8128, 34-46464 (Sept. 5, 2002), *available at* http://www.sec.gov/rules/final/33-8128.htm.

accelerated filing requirements will not have to be included in the parent company's periodic reports on the accelerated schedule and may be filed by amendment at a later date. The accelerated filing deadlines do not apply to foreign private issuers.

On November 17, 2004, the SEC approved proposals to postpone, by one year, the final phase of the three-year transition period accelerating the due dates applicable to annual and quarterly reports filed by accelerated filers.[141]

The postponement afforded companies an additional year to comply with accelerated filing requirements. The purpose of the postponement was to permit companies and their auditors to focus on complying for the first time with the internal control requirements of Section 404 of the Sarbanes-Oxley Act. Under the original transition schedule, the 60-day accelerated filing deadline was scheduled to take effect with the first Form 10-K that must contain the internal control report of management, and the outside auditor's attestation on this report, mandated by Section 404.

On December 14, 2005, the Commission adopted revisions to the periodic reporting deadlines for certain large public companies. The newly adopted rules modify the final phase-in of the accelerated reporting scheme previously adopted by the SEC in 2002. The new rules retain the accelerated filing status of companies with a public float of $75 million or more, but created a new category of accelerated filers called "large accelerated filers" which are companies with a public float of $700 million or more.

Taken together, the rules effect changes to the periodic filing deadlines of both accelerated filers and large accelerated filers as follows:

- Beginning with fiscal years ending on or after December 15, 2006, the deadline for *large accelerated filers* to timely file annual reports on Form 10-K will be cut from 75 days to 60 days.

- The deadline for *accelerated filers* (not large accelerated filers) to timely file annual reports on Form 10-K will remain at 75 days.

- The deadline for *accelerated filers* and *large accelerated filers* alike to file quarterly reports on Form 10-Q will remain at 40 days.

These rules also permit an accelerated filer whose public float drops below $50 million to file an annual report on a non-accelerated basis for the *same fiscal year* that the float drops below the $50 million threshold. Similarly, a large accelerated filer will be permitted to exit large accelerated filer status if its public float should drop below $500 million.

It should be noted that the periodic report filing deadlines for all other reporting companies remain unchanged. Non-accelerated filers must file annual reports on Form 10-K or 10-KSB within

---

[141] Temporary Postponement of the Final Phase-In Period for Acceleration of Periodic Report Filing Dates, Release Nos. 33-8507, 34-50684 (Nov. 17, 2004), *available at* http://www.sec.gov/rules/final/33-8507.htm.

90 days and quarterly reports on Form 10-Q or 10-QSB within 45 days in order to be current in their reporting. The new adopted do not impact filing deadlines for Form 20-F or Form 40-F applicable to foreign private issuers.

2. Rules on Website Access to SEC Reports

A rule impacting companies that do not provide access to their SEC filings through company websites became effective on November 15, 2002. The rule requires companies that are subject to the accelerated filing requirements for Forms 10-K and Forms 10-Q (generally, companies that are eligible to use Form S-3[142]) to disclose whether they provide access to their SEC filings through their website in any Form 10-K filed for a fiscal year ending after December 15, 2002.

Specifically, under new Item 101(e) of Regulation S-K, each such company must disclose:

- the company's website address, it if has one;
- whether the company makes available, free of charge, on or through its website (if it has one) its annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and all amendments to those reports as soon as reasonably practicable after such material is electronically filed with or furnished to the SEC;[143]
- if the company does not make its filings available in this manner, the reasons it does not do so, including, where applicable, that it does not have an Internet website; and
- if the company does not make its filings available in this manner, whether the company will voluntarily provide electronic or paper copies of its filings free of charge upon request.

The rule allows companies to provide website access to their Exchange Act reports in a number of ways. For example, companies may establish hyperlinks to the reports via the SEC's website. Other options available to companies include posting hypertext links to other third-party services or posting PDF files of the reports. The SEC release also instructs companies to provide a hyperlink directly to their reports, or to a list of their reports, instead of just providing a hyperlink directly to the home page or general search page of the SEC or other third-party service.

---

[142] "Accelerated filers" are companies that: (i) have a common equity float of $75 million; (ii) have been subject to Section 13(a) or 15(d) reporting requirements for at least one year; (iii) have filed at least one annual report pursuant to Section 13(a) or 15(d); and (iv) are not eligible to use Forms 10-KSB and Forms 10-QSB.

[143] The SEC has indicated that it expects companies to post their filings on their websites on the same day they are filed. *See id.*

Although compliance with the disclosure requirement began with annual reports on Form 10-K filed for fiscal years ending on or after December 15, 2002, the disclosure relates to the company's practice during the period covered by the report.

3. Amendments to Rule 10b-18 and Disclosure of Section 12 Stock Repurchases

The SEC's amendments to Rule 10b-18, which generally became effective for U.S. issuers' quarterly reports on Form 10-Q filed for periods ending on or after March 15, 2004, created new disclosure requirements for all issuer repurchases, including repurchases that fall within the Rule 10b-18 safe harbor.[144] Under these new rules, which are stated in Item 703 of Regulations S-K and S-B, issuers must disclose all open market and private repurchases of registered equity securities that occurred during the previous fiscal quarter (or for Forms 10-K and 10-KSB, the fourth quarter); or in the case of closed-end funds, the preceding semi-annual period; or for foreign issuers, on a yearly basis in annual report Form 20-F. Specifically, issuers must disclose, for each month in the quarter, (1) the total number of shares purchased, (2) the average price paid per share, (3) the number of shares purchased as part of a publicly announced repurchase plan and (4) the maximum number of shares that may yet be purchased under the plans or programs. Finally, the amended rules require footnote disclosure of the principal terms of publicly announced repurchase programs.

The new disclosures in Item 703 apply only to repurchases of Section 12 registered securities. Thus, the SEC has determined that the Item 703 table need not report the following:

- forfeiture of restricted stock units when vesting conditions are not satisfied. The forfeitures are not reported because they are not repurchases.
- purchases of securities that may be converted into Section 12 registered securities but are not currently Section 12 registered, including repurchases of convertible debt that is not Section 12 registered.
- option exchange programs because options are not Section 12 securities.
- cash settlement of restricted stock units because the restricted stock units are not registered under Section 12.
- net settlement of restricted stock units if the number of shares actually issued upon vesting is reduced by the number necessary to pay taxes. The restricted stock units held back by the issuer are not Section 12 registered securities. In contrast, net settlement of restricted stock is reportable under Item 703 as a repurchase if the stock is treated as outstanding prior to vesting (e.g., has voting rights) and the stock is a Section 12 registered security.

---

[144] The SEC's Division of Market Regulation has issued an FAQ with regard to the Rule 10b-18 amendments. The FAQ is available at http://www.sec.gov/divisions/marketreg/r10b18faq0504.htm.

The impact of these disclosure requirements on equity securities transferred in connection with employee benefit plans is still evolving. The SEC requires different treatment for two types of "cashless" exercises of employee stock options. If an individual exercises options and the issuer withholds shares to either pay the exercise price or pay withholding taxes ("net exercises"), the shares withheld are not reportable under the amended rule. In contrast, if an individual pays the exercise price or withholding taxes by delivering to the issuer shares the individual already owns (a "stock-for-stock" or "stock swap" exercise), then the repurchase of shares by the issuer must be reported in the Item 703 disclosure table.

Additionally, stock repurchases by an employee benefit plan, including a 401(k) plan, may be reportable if the plan is an affiliated purchaser, as defined in Rule 10b-18(a)(3). Under that rule, an "affiliated purchaser" is: (i) a person acting, directly or indirectly, in concert with the issuer for the purpose of acquiring the issuer's securities; or (ii) an affiliate who, directly or indirectly, controls the issuer's purchase of such securities, whose purchases are controlled by the issuer or whose purchases are under common control with those of the issuer. It further states that an "affiliated purchaser" does not include a broker, dealer or other person solely by reason of such broker, dealer or other person effecting Rule 10b-18 purchases on behalf of the issuer or for its account and does not include an officer or director of the issuer solely by reason of that person's participation in the decision to authorize Rule 10b-18 purchases by or on behalf of the issuer.

B. The California Corporate Disclosure Act

California corporations, and corporations qualified to do business in California whose shares are publicly traded, are subject to additional information filing requirements under California legislation which became effective January 1, 2003 and was amended effective September 27, 2004. The legislation, the California Corporate Disclosure Act (the "**Corporate Disclosure Act**"), makes significant additions to the information previously required to be filed with the California Secretary of State under Sections 1502 and 2117 of the California Corporations Code, and increases the frequency of the filings from every two years to every year.

The Corporate Disclosure Act applies to each "publicly traded corporation" that is either a California corporation or qualified to do business in California. "Publicly traded corporation" is defined by the Corporate Disclosure Act to mean a corporation that (i) is an "issuer" as defined by Section 3 of the Exchange Act (that is, an entity that issues or proposes to issue securities) and (ii) has at least one class of securities listed or admitted for trading on a national securities exchange (including NASDAQ), on the OTC-Bulletin Board or on an electronic service operated by Pink Sheets, LLC. Parent corporations not incorporated or qualified to do business in California, but doing business in California through subsidiaries are apparently not required to make the filings under the Corporate Disclosure Act. Their subsidiaries are also not required to make the filings if their securities are not publicly traded.

Although the subject matter of the new disclosures is similar to what is already required to be filed with the SEC by companies reporting under the Exchange Act, apparently little attempt was made in the original bill to coordinate the two disclosure requirements. Some, but not all of these discrepancies were remedied when the Corporate Disclosure Act was amended. Compliance with the California requirements will require more than a mere "cut and paste" from information required to be prepared for filing or already filed with the SEC. Further, due to the differences in the disclosure requirements, officers' and directors' questionnaires, typically relied upon in preparing Exchange Act filings, will have to be revised if they are to be relied upon for the California filing.

Under the amended Corporate Disclosure Act, publicly traded corporations must file two forms. All California corporations must file an information statement with the California Secretary of State on an annual basis during the calendar month in which its articles of incorporation were filed or during any of the preceding five calendar months (the "**Statement of Information**"). An out-of-state corporation is required to file a Statement of Information during the equivalent period measured from the month in which the corporation filed the form needed to qualify to do business in California. The Statement of Information must contain various items of information, such as the names and addresses of certain officers and the address of the corporation's principal executive office. In addition, publicly traded corporations must file a separate statement consisting exclusively of the disclosure items discussed below (the "**Corporate Disclosure Statement**"). The Corporate Disclosure Statement must be filed within 150 days after the end of the corporation's fiscal year.

The California Secretary of State has published a form for publicly traded companies on which the information must be filed.[145] The Secretary of State is required to make the disclosed information "available and open" to the public and, by December 31, 2004, to provide access to the information by means of an on-line database.

The information filed in the Corporate Disclosure Statement and the information in the Statement of Information by a California corporation must be certified by the corporation as being true and correct. The information required to be disclosed in the Corporate Disclosure Statement is:

- **Auditor and Non-Audit Services**. The name of the independent auditor that prepared the most recent auditor's report with respect to the corporation's annual financial statements, the name of the independent auditor as of the date of the disclosure statement, if different and a description of any "other services" (presumably non-audit services) preformed for a corporation during the corporation's two most recent fiscal years and the period between the end of its most recent fiscal year and the date of the statement.

- **Directors' and Executive Officers' Compensation**. The annual compensation for the most recent fiscal year paid to each member of the board of directors and each of the five most highly compensated executive officers who are not members of the board of directors. If the chief executive officer is not among the five most highly compensated officers, the information for the chief executive officer must also be included. The amended legislation defines compensation by reference to Regulation S-K

[145] The forms for the Statement of Information and the Corporate Disclosure Statement can be downloaded from the California Secretary of State's web site, *available at* http://www.ss.ca.gov/business/corp/corp_soinfo.htm. The Secretary of State is required to mail a copy of the Statement of Information form to a corporation approximately three months before the end of the required filing period. The amended Corporate Disclosure Act does not impose any mailing requirement for the Corporate Disclosure Statement form.

under the Securities Act. In particular, the Corporate Disclosure Act now requires disclosure of all plan and nonplan compensation awarded to, earned by or paid to the person for all services rendered in all capacities to the corporation and to its subsidiaries, as the compensation is specified by Item 402 of Regulation S-K. In the typical situation where the chief executive officer is also a director, most practitioners interpret the Corporate Disclosure Act to mean that a corporation must disclose compensation for the directors (including the chief executive officer) plus five additional officers who are not also directors.

- **Definition of "Executive Officer."** "Executive officer" is defined in the amended Corporate Disclosure Act as the chief executive officer, president, any vice president in charge of a principal business unit, division, or function, any other officer of the corporation who performs a policymaking function or any other person who performs similar policymaking functions for the corporation.

- **Loans to Directors**. A description of any loans made to a director during the corporation's two most recent fiscal years at rates lower than those available from unaffiliated commercial lenders generally to similarly situated borrowers. The loan disclosure requirements of the amended Corporate Disclosure Act do not apply to advances by a corporation to directors of expenses and litigation costs or to a corporation's payment of director life insurance premiums when such advances or payments are authorized, in the case of California corporations, by particular provisions of California law or, in the case of out-of-state corporations, by the law of the corporation's state or place of incorporation.

- **Bankruptcy**. A statement indicating whether any order of relief was entered in a bankruptcy case with respect to the corporation, its executive officers or members of the board of directors within the 10 years preceding the date of the statement.

- **Fraud Convictions**. A statement indicating whether any member of the board of directors or any executive officer of the corporation was "convicted of fraud" during the 10 years preceding the date of the statement, if that conviction has not been overturned or expunged. Read literally, the language does not include judgments in civil actions or orders or decrees in regulatory proceedings. "Fraud" may be interpreted, however, to include crimes involving any kind of deliberate deception, false or misleading disclosure or failure to disclose.

- **Legal Proceedings**. A description of (i) any material pending legal proceedings, other than ordinary routine litigation incidental to the business, to which the corporation or any of its subsidiaries is a party or to which any of their property is subject, as specified by Item 103 of Regulation S-K and (ii) any material legal proceeding during which the corporation was found "legally liable" by entry of a final judgment or final order that was not overturned on appeal during the five years preceding the date of the statement. Interestingly, this provision relates only to the corporation and not to directors, executive officers or entities with which they are or have been associated.

Because the Corporate Disclosure Statement does not have to be filed until 150 days after the end of a corporation's fiscal year under the amended Corporate Disclosure Act, corporations will be less likely to have to disclose information in California filings before the information becomes publicly available through filings under the Exchange Act. However, a number of items require disclosure that is current as of the date of the filing (including disclosure of "other" services performed by the independent auditor, material legal proceedings, bankruptcy orders and fraud judgments). Under circumstances where material information is first being disclosed in the California filing, the corporation would have to consider filing a current report on Form 8-K with the SEC to ensure widespread public disclosure.

No provision of the amended Corporate Disclosure Act permits or requires a corporation to file an updated statement if any of the disclosed information changes. However, the website of the Secretary of State permits such filings. While it is arguable that corporations should make current filings to prevent information previously filed from being inaccurate or misleading, presumably the statement speaks only as of the date it is filed and the statute appears to expressly preclude any requirement of updating, with one exception described below. Also, current information that is material may be publicly available through press releases and filings under the Exchange Act. If the name or address of the designated agent for service of process changes, a current statement is required as to all of the information referred to above, and not just the information regarding the agent. Therefore, a new filing could be triggered by events outside of the corporation's control, such as a change of address of its agent for service of process.

In addition to the current filing fee of $20, the Corporate Disclosure Act imposes a new filing fee of $5.00 and provides that one-half of the $5 will be deposited into the new Victims of Corporate Fraud Compensation Fund, to be administered by the California Secretary of State and to provide restitution to victims of corporate fraud. The other half is to be used to further the disclosure provisions of the Corporate Disclosure Act, including the development and maintenance of the on-line database to be established by the Secretary of State.

C. Regulation M

1. Amendments to Regulation M: Anti-manipulation Rules Concerning Securities Offerings.

On December 9, 2004, the SEC proposed amendments to Regulation M under the Exchange Act.[146] The proposed amendments are intended to prohibit certain activities by underwriters and other distribution participants that can undermine the integrity of the offering process, enhance the transparency of syndicate covering bids, prohibit the use of penalty bids and update certain

---

[146] Amendments to Regulation M: Anti-Manipulation Rules Concerning Securities Offerings, Release Nos. 33-8511; 34-50831; IC-26691, (Dec. 9, 2004), *available at* http://www.sec.gov/rules/proposed/33-8511.htm.

definitional and operational provisions in light of market developments. The proposed amendments are as follows:

- Rule 100's definition of "restricted period" would be amended with respect to initial public offerings to extend from the earlier of: (1) the period beginning at the time an issuer reaches an understanding with a broker-dealer that is to act as an underwriter or when a person becomes a distribution participant; and (2) if there is no underwriter, the period beginning when the registration statement is filed with the SEC or a person becomes a distribution participant and ending when distribution is complete. The SEC also proposes to define an IPO in Rule 100(b) as an issuer's first offering of a security to the public in the United States and, if prior to the offering the issuer's equity securities do not have a public float value, the issuer's first offering of an equity security to the public in the United States. The rule would also be amended to expressly reflect the SEC's inclusion of the valuation and election periods in the restricted period in the context of mergers, acquisitions and exchanges offers.

- Rules 100, 101, and 102 would be amended to update the average daily trading volume ("**ADTV**") and public float value qualifying thresholds with respect to the "restricted period" definition in Rule 100, the "actively traded" securities exception (Rule 101(c)(1)) and "actively traded" reference securities exception (Rule 102(d)(1)) in order to account for inflation. The one-day restricted period would require at least $120,000 in ADTV value and $30 million for public float value, while the actively traded security and reference security thresholds would be increased to $1.2 million for ADTV and $180 million for the public float value.

- Rule 101's *de minimis* exception would be amended to require firms to create a separate record of each bid or purchase that is made in reliance on the exception. The brokers and dealers would specify the subject security, the day the restricted period commenced, the ADTV and the bids or purchases that otherwise would violate Regulation M (including time, price, quantity and market).

- Rule 104 would be amended to require that any person communicating a bid for the purpose of effecting a syndicate covering transaction identify or designate the bid as such when the bid is communicated, a procedure analogous to the identification of stabilizing bids. The rule would also be amended to prohibit penalty bids entirely. The SEC has also recommended that Rule 481(d), Item 508(l) of Regulations S-K and S-B and Rule 17a-2(c) under the Securities Act be amended to eliminate all references to penalty bids.

- Rule 104(j)(2) would be amended to include reference securities in the exception for transactions in securities eligible for resale under Rule 144A to make the subparagraph consistent with the same exception under Rule 101(b)(10) and 102(b)(7).

- A new Rule 106 would be adopted to expressly prohibit distribution participants, issuers and their affiliated purchasers from demanding, soliciting, attempting to induce or accepting from their customers any consideration in addition to the stated offering consideration.

The SEC also recommended amendments to Rule 481 and Item 508 of Regulations S-K and S-B under the Securities Act, as well as Rule 17a-2 and 17a-4 with respect to recordkeeping.

2. SEC Guidance Regarding Conduct in Connection with IPO Allocations.

On April 7, 2005, the Commission issued an interpretive release regarding Regulation M, addressing the allocation of shares for initial public offerings.[147] The guidance highlighted several activities that underwriters should avoid during restricted periods, focusing on underwriters' attempts to induce or solicit customers with regard to aftermarket bids or purchases prior to the completion of a distribution. The release provides guidance under Regulation M with respect to the process known as book-building, including the process for allocating shares in an IPO. The Commission highlighted certain prohibited activities that underwriters should avoid during restricted periods:

- inducements to purchase in the form of tie-in agreements or other solicitations of aftermarket bids or purchases prior to the completion of a distribution;

- communicating to customers that expressing an interest in buying shares in the immediate aftermarket ("aftermarket interest") or immediate aftermarket buying would help them obtain allocations of "hot" IPOs;

- prior to the completion of a distribution, soliciting customers regarding whether and at what price and in what quantity they intend to place immediate aftermarket orders for IPO stock;

- proposing aftermarket prices to customers or encouraging customers who provide aftermarket interest to increase the prices that they are willing to place orders in the immediate aftermarket;

- accepting or seeking expressions of interest from customers that they intend to purchase an amount of shares in the aftermarket equal to the size of their IPO allocation or intend to bid for or purchase specific amounts of

---

[147] Commission Guidance Regarding Prohibited Conduct in Connection with IPO Allocations, Release Nos. 33-8565; 34-51500; IC-26828; File No. S7-0305 (April 7, 2005), *available at* is http://www.sec.gov/rules/interp/33-8565.pdf.

shares in the aftermarket that are pegged to the allocation amount without any reference to a fixed total position size;

- soliciting aftermarket orders from customers before all IPO shares are distributed or rewarding customers for aftermarket orders by allocating additional IPO shares to such customers;

- communicating to customers in connection with one offering that expressing an interest in the aftermarket or buying in the aftermarket would help them obtain IPO allocations of other "hot" IPOs.

D. Employee Stock Options

1. Disclosure of Equity Compensation Plan Information

On December 21, 2001, the SEC adopted amendments to its disclosure requirements relating to equity compensation plans to require additional information to be provided in annual reports filed on Forms 10-K and 10-KSB, and in proxy and information statements when the company is submitting a compensation plan for shareholder approval.[148] The SEC's amendments to its equity compensation plan information disclosure rules were prompted, at least in part, by a concern that as the use of equity compensation, particularly stock options, continues to grow, and as companies issue more shares of stock to their employees, the ownership interests of current shareholders may become diluted. Because the distribution of additional shares may result in a significant reallocation of ownership between existing shareholders and management and employees, the SEC believed that investors have a strong interest in understanding companies' equity compensation programs and that therefore, additional, and more clear, disclosure was necessary.

a. Content of the Disclosure

The amended disclosure requirements apply to all equity compensation plans in effect as of the end of a company's last completed fiscal year that provide for the award of company stock or options, warrants or rights to purchase stock.[149] An equity compensation plan is "in effect" as long as securities remain available for future issuance under the plan, or as long as previously granted options, warrants or rights remain outstanding. Disclosure is required regardless of whether the plan participants are company employees, including officers, or non-employees, such as directors, consultants, vendors, or customers. Under the amended disclosure requirements, public companies must disclose, in tabular format:

- the number of securities to be issued upon the exercise of any outstanding options, warrants and rights;

---

[148] Disclosure of Equity Compensation Plan Information, Release Nos. 33-8048, 34-45189 (Dec. 21, 2001), *available at* http://www.sec.gov/rules/final/33-8048.htm.

[149] *Id*.

- the weighted-average exercise price of such outstanding options, warrants and rights; and
- the number of securities remaining available for future issuance under equity compensation plans, excluding those securities reflected above.

The above information must be divided into two categories, based on whether or not the compensation plan was approved by shareholders. Within these two categories, information may be aggregated; it is not necessary to disclose information on a plan-by-plan basis. Information regarding individual equity compensation arrangements and "assumed" plans (i.e., cases in which the company assumed an equity compensation plan in connection with a merger, consolidation, or other acquisition and will be making subsequent grants and awards under this plan) also must be included in the disclosure, in the appropriate category.[150] In the case of individual options, warrants and rights that are assumed, companies must disclose the number of shares underlying the assumed options, warrants and rights, and the related weighted-average exercise price information on an aggregated basis in a footnote to the table.

If any plan included in the table is a so-called "evergreen plan," containing a formula that automatically increases the number of shares available for issuance by a percentage of the number of shares outstanding, the company also must describe this formula in a footnote to the table.[151]

In addition, for each compensation plan that was adopted without shareholder approval, companies must provide a brief narrative description of the material features of the plan. Companies may satisfy this disclosure requirement by cross-referencing to the financial statement footnote disclosures required by FASB Statement 123R ("**Standard 123**") containing the relevant information.[152] The cross-reference should identify the specific plan or plans in the Standard 123 disclosure that were not approved by shareholders, as companies are not required to distinguish between shareholder approved and non-shareholder approved plans in their Standard 123 disclosures.

b. Location of the Disclosure

The amendments require the table to be included in a company's annual report on Form 10-K each year. In addition, it must be included in a proxy statement when a company is submitting a compensation plan for shareholder approval. To avoid redundancy, the amendments permit companies that are required to include the information in both a Form 10-K and in a proxy statement to satisfy their Form 10-K disclosure requirements by incorporating the information by reference to their definitive proxy statements (if that proxy statement involves the election of directors and is filed not later than 120 days after the end of the fiscal year covered by the Form 10-K). The disclosure is not required in Securities Act registration statements.

---

[150] *Id.*

[151] *Id.*

[152] *Id.*

c. When Disclosure is Not Required

The disclosure requirements do not apply to plans that issue warrants or rights to all shareholders on a pro rata basis or to any qualified employee benefit plan.

d. Filing of Non-Shareholder Approved Plans

The amendments also revise the exhibit requirements contained in Item 601 of Regulation S-K to require companies to file with the SEC a copy of any non-shareholder approved equity compensation plan in which any employee participates, unless the plan is immaterial in amount or significance.[153] Existing non-shareholder approved plans are subject to this requirement, and copies of such plans must be filed as an exhibit to the Form 10-K for the company's first fiscal year ending on or after March 15, 2002.

e. Guidance for Companies

- First, companies should gather the required information regarding all equity compensation plans. Companies should note that the SEC considers both individual arrangements and assumed plans to be subject to the disclosure rules. Individual arrangements are "plans" that apply to only one person within the company, for example, a corporate officer. Assumed plans are those that a company acquired in connection with a merger, consolidation, or other form of acquisition. Information regarding both individual arrangements and assumed plans is to be aggregated with the information pertaining to other equity compensation plans, and divided into the two categories of shareholder approved and non-shareholder approved.
- Second, companies should review the required information and prepare a mock-up of the table, as it would appear in an annual report or a proxy statement. This step will provide companies with a concrete image of how shareholders will be presented with the information.
- Third, based on the requirements of the table, companies should consider how shareholders will perceive their plans, and whether it is in their best interests to modify or terminate any plans before disclosure is required. Note that disclosure is required with respect to any compensation plan "in effect" as of the end of the company's last completed fiscal year. As mentioned earlier, a plan is "in effect" as long as securities remain available for issuance under the plan, or as long as options, warrants or rights previously granted under the plan remain outstanding.

[153] *Id*. at 23.

2. Repricing of Stock Options

The SEC has informally stated that it believes that exchange offers involving option repricings may involve a tender offer subject to Rule 13e-4 as well as Regulation 14E, and may require the filing of a Schedule TO-I at the time the exchange offer commences. On March 21, 2001, the Division of Corporate Finance issued an exemption order under the Exchange Act for issuer exchange offers that are conducted for compensatory purposes.[154] The order exempts such exchange offers, typically stock option exchange offers, from the "all holders" and "best price" provisions reflected in Rules 13e-4(f)(8)(i) and (ii) of the Exchange Act, as long as all of the following conditions are met:

- the issuer is eligible to use Form S-8, the options subject to the exchange offer were issued under an employee benefit plan as defined in Rule 405 under the Securities Act, and the securities offered will be issued under such an employee benefit plan;
- the exchange offer is conducted for compensatory purposes;
- the issuer discloses the essential features and significance of the exchange offer in the offer to purchase, including risks that option holders should consider in deciding whether to accept the offer; and
- except as exemption in the order, the issuer complies with Rule 13e-4.

In its interpretive guidance with respect to the exemptive order,[155] the Division also stated that such disclosure should contain financial information about the issuer, which is generally material to the investment decision of the option holder, but that such financial information may be in summary form if the issuer incorporates its financial statements by reference. The Division has taken the position that a tender offer is involved unless the offer is limited to executive or senior officers of the issuer, the exchange is a privately negotiated compensation arrangement, and the exchange only involved the lowering of the option exercise price of outstanding stock options with no other changes, or such change can be unilaterally effected without option holder consent.

3. Registration under Section 12(g)

Many issuers that granted stock options to employees in anticipation of an initial public offering and that subsequently failed to go public now find themselves confronting the registration requirements of Section 12(g) of the Exchange Act. Section 12(g) requires any issuer having 500 or more holders of record of a class of equity securities, and more than $10 million in assets at the end of its most recent fiscal year to register the class of equity securities. Under the Exchange Act, the

---

[154] Exemptive Order (Mar. 21, 2001), *available at* http://www.sec.gov/divisions/corpfin/repricing.htm.

[155] Division of Corporation Finance, Securities and Exchange Commission, Current Issues and Rulemaking Projects Quarterly Update (Mar. 31, 2001), *available at* http://www.sec.gov/divisions/corpfin/cfcrq032001.htm.

definition of “equity securities” includes options.[156] Consequently, for issuers that granted options to 500 or more employees, the prospect of registration has caused concern. Although these issuers have no public investors, and no market for trading the options or the underlying stock, upon registration under Section 12(g), these issuers would become subject to the reporting requirements of the Exchange Act and must furnish the same disclosures as any publicly-held company. These disclosures would include annual and quarterly reports, including audited financial statements. In addition, registration under Section 12(g) would place other burdens on these issuers. Registration would, among other things, subject the issuer’s stockholders to Section 13(d) of the Exchange Act, regarding the reporting of ownership above 5%, and would also subject the issuer to the proxy rules under the Exchange Act.

On March 29, 2001, the SEC’s Division of Corporation Finance revised and loosened the conditions that issuers must satisfy in order to obtain relief from registering employee stock options under Section 12(g).

In the past, the SEC had granted no-action relief to issuers who would otherwise have been required to register because they had more than $10 million in assets and 500 or more employees who held stock options, provided that the following conditions were met:

- options would be granted under a stock option plan only to employees;
- options would be granted without consideration, and at fair market value exercise prices, for the purposes of incentivizing employees to work to improve share value;
- holders of options would be under no obligation to exercise options and options would not become exercisable until a future public offering or at some other relatively distant date;
- options would be non-transferable;
- the issuer would have the right to cancel options under various circumstances in return for a cash payment based on an annual appraisal of the underlying common stock, but there would be no other market or methodology by which an option holder could receive anything of value for an option prior to its exercise, and accordingly no trading interest in the options would exist;
- the issuer would undertake to provide option holders with certain material information about the options; and
- the no-action relief requested would be limited to options granted under the stock option plan.[157]

---

[156] Section 3(a)(11) of the Exchange Act defines “equity security” to include any warrant or right to subscribe for or purchase any stock or similar security.

[157] *See* Mitchell Int’l Holding, Inc., SEC No-Action Letter, 2000 SEC No-Act LEXIS 1033 (Dec. 27, 2000); General Roofing Services, Inc., SEC No-Action Letter, 2000 SEC No-Act LEXIS 496

In its March 31, 2001 quarterly update to its Current Issues and Rulemaking Projects Outline,[158] the Division of Corporation Finance indicated that it would relax the conditions for relief from registration in several ways. Issuers must still apply to the SEC for no-action relief from the registration requirements of Section 12(g), but they may either satisfy the conditions listed above or provide more disclosure to option holders, but satisfy the conditions subject to the following modifications:

- the options can be immediately exercisable;
- former employees may retain their vested options;
- the options may be transferable upon the employee's death or disability;
- the stock received upon exercise of the options may not be transferable except back to the issuer or in the event of the employee's death or disability; and
- consultants may participate in an option plan if they would be able to participate under Securities Act Rule 701.

An issuer may only take advantage of these relaxed conditions if it provides its employee option holders with the same level of information that would be available if the issuer were in fact subject to the reporting requirements of the Exchange Act. This information includes the information that would be found in an initial registration statement, annual and quarterly reports, including audited annual financial statements and unaudited quarterly financial statements prepared in accordance with GAAP. The preparation of equivalent disclosure will impose substantial costs on issuers and may necessitate the disclosure of financial and proprietary information to employee option holders.[159]

4. Accounting for Stock Based Compensation

(Apr. 13, 2000); Kinkos, Inc., SEC No-Action Letter, 1999 SEC No-Act LEXIS 928 (Nov. 30, 1999); WRQ, Inc., SEC No-Action Letter, 1997 SEC No-Act LEXIS 1100 (Dec. 31, 1997); BSG Corp., SEC No-Action Letter, 1995 SEC No-Act LEXIS 617 (Aug. 1, 1995); Superior Services, Inc., SEC No-Action Letter, 1994 SEC No-Act LEXIS 374 (Mar. 18, 1994); Starbucks Corp., SEC No-Action Letter, 1992 SEC No-Act LEXIS 483 (Apr. 2, 1992).

[158] Division of Corporation Finance, Securities and Exchange Commission, Current Issues and Rulemaking Projects Quarterly Update (Mar.31, 2001), *available at* http://www.sec.gov/divisions/corpfin/cfcrq032001.htm.

[159] In most cases, issuers that are in this situation will have issued more than $5 million in options during the applicable 12-month periods under Rule 701 of the Securities Act. Consequently, even in the absence of the more onerous disclosure requirements imposed by the SEC, Rule 701 requires that the issuer distribute the financial information required by Part F/S of Form 1-A to option holders. Such information, however, while still raising the same issues about disclosure of proprietary information, would not have to be audited, nor would it have to be accompanied by all of the other information required in annual and quarterly reports.

In December 2004, the FASB issued FASB Statement 123R with regard to the accounting treatment of equity-based compensation plans.[160] FASB Statement 123R amended FASB Statement 123R, Accounting for Stock-Based Compensation, to require companies to recognize the cost of stock-based compensation for employee services. More frankly, FASB Statement 123R eliminated the "intrinsic value" method for accounting for stock options that was previously allowed and requires companies to expense most stock option plans.

Under FASB Statement 123R, companies are required to measure the cost of stock-based compensation on the grant date of the equity instrument. The cost is then recognized over the vesting period of the instrument and no compensation cost is registered for instruments that do not vest. The cost of employee services is measured initially at fair value of liabilities and is re-measured subsequently at each reporting date through the settlement date of the instrument. The fair value at the grant date is measured using an option pricing model, such as the Black-Scholes method. If a stock-based award is modified over the vesting period, the company also needs to recognize any difference equal to the excess of the fair value of the modified stock award.

Employee stock purchase plans that grant employees additional rights or benefits over other holders of the same class of securities, as well as plans that do not allow participation by all employees, also need to be recognized as costs under FASB Statement 123R.

Companies also are required to provide additional disclosure, as necessary, in the notes to their financial statements to provide users of the financial statements information necessary to understand the nature of the stock-based compensation and how the stock-based compensation affects the overall financial statements.

FASB Statement 123R was an effort to both simplify U.S. GAAP and to conform U.S. GAAP with international accounting standards. The International Accounting Standards Board, whose standards are followed by a number of countries around the world, requires a company to expense stock-based compensation. FASB Statement 123R was also a response to growing concern in the United States that the intrinsic value method does not accurately reflect the cost of stock-based compensation on a company's financial statements. FASB Statement 123R eliminated alternative disclosure methods for stock-based compensation and provides for more comparable financial statements among different companies.

On April 15, 2005, the Commission adopted a new rule deferring the date for compliance with the Financial Accounting Standards Board's requirement that companies expense stock options.[161] The new rule extended the compliance date for FASB Statement 123R to the beginning of the next fiscal year that begins after June 15, 2005, or December 15, 2005 for small business issuers. The Commission determined that deferring the implementation of FASB Statement 123R until the

---

[160] Statement of Financial Account Standards No. 123 (revised 2004), *available at* http://www.fasb.org/pdf/fas123r.pdf.

[161] Amendment to Rule 4-01(a) of Regulation S-X Regarding the Compliance Date for Statement of Financial Accounting Standards No. 123 (Revised 2004), Share-Based Payment, Release No. 33-8568 (April 21, 2005), *available at* http://www.sec.gov/rules/final/33-8568.pdf.

beginning of a fiscal year would lower compliance costs for the affected companies, make comparisons less confusing for investors and allow auditors to conduct a more consistent audit.[162]

E. Selected SEC Enforcement Actions Concerning Regulation FD

The SEC has taken a number of enforcement actions concerning Regulation FD, focusing on selective intentional disclosures by an issuer to securities professionals and other "enumerated persons" that differ from its disclosures to the public.

1. *Siebel Systems, Inc. I*

In *In re Siebel Systems, Inc.*,[163] the SEC found that the CEO of Siebel Systems, Inc. ("**Siebel**") had selectively made optimistic business disclosures at an invitation-only conference hosted by Goldman Sachs. These disclosures contrasted sharply with a public announcement made by Siebel weeks earlier. In that previous announcement, Siebel had disclosed that it was experiencing an "exceptionally soft market" and anticipating a "tough" quarter. The Commission found that the CEO was aware, prior to the conference, that the attendees included broker-dealers, investment advisers, investment companies and institutional shareholders, and that the information provided at the conference was based on internal information that would not be web-cast or otherwise disseminated to the public. Accordingly, the SEC concluded that the conference disclosures were material "selective disclosures [that] benefited those investors at the conference who 'were privy to the information beforehand [and] were able to make a profit or avoid a loss' and disadvantaged those who were kept in the dark."[164] Finding that the disparate distribution of information was a violation of both Section 13(a) of the Exchange Act and Regulation FD, the SEC issued a cease and desist order prohibiting further violations as part of a settlement with Siebel.

2. *Raytheon Co.*

In *In re Raytheon Co. and Franklyn A. Caine*,[165] the SEC found that Raytheon Co. ("**Raytheon**") and its CFO, Franklyn Caine, violated Regulation FD by selectively providing Raytheon's quarterly earnings guidance to sell-side equity analysts and failing to simultaneously disclose the same information to the public. In February 2001, Raytheon disclosed only its annual earnings estimates and failed to disclose that, according to the estimates, the bulk of its earnings

---

[162] The SEC has also issued Staff Accounting Bulletin No. 107 on the application of FASB Statement No. 123R. *See* Section VII.F. above.

[163] Order Instituting Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease and Desist Order, Release No.34 46896 (Nov. 25, 2002), *available at* http://www.sec.gov/litigation/admin/34-46896.htm.

[164] *Id.*

[165] Order Instituting Public Cease and Desist Proceedings, Making Findings, and Imposing a Cease and Desist Order Pursuant to Section 21C of the Securities Exchange Act of 1934, Release No. 34-46897 (Nov. 25, 2002), *available at* http://www.sec.gov/litigation/admin/34-46897.htm.

would accrue in the second half of the year. However, Mr. Caine later disclosed Raytheon's quarterly earnings estimates to selected analysts in a series of "one-on-one calls," causing each of the analysts to lower first quarter earnings estimates for Raytheon. As a result, Raytheon's own estimates "beat the Street" in the first quarter of 2001. The SEC determined that this disparate distribution of information was a violation of both Section 13(a) of the Exchange Act and Regulation FD, and issued, as part of a negotiated settlement, cease and desist orders against Raytheon and Mr. Caine prohibiting further violations.

3. *Motorola, Inc.*

In November 2002, the SEC issued a report in which it found that Motorola, Inc. ("**Motorola**") violated Regulation FD after one of its senior officials selectively told sell-side analysts in one-on-one communications that Motorola's sales and orders were down by 25% even though Motorola had previously disclosed publicly that its sales and orders were simply experiencing "significant weakness."[166] Despite these findings, the Commission failed to pursue an enforcement action against Motorola because of its "good faith reliance" on its in-house counsel's legal advice that the disparity in information was not material for purposes of Regulation FD. Although no enforcement action was taken, the SEC issued the report to "remind issuers of their obligations under Regulation FD not to selectively disclose material and nonpublic information to securities professionals."[167] Further, the Commission warned that "senior officials of issuers should be particularly cautious during private conversations with analysts" and "may not use 'code' words" to explicitly avoid imparting material nonpublic information.[168]

4. *Schering-Plough Corporation*

On September 9, 2003, the SEC announced it had settled a Regulation FD complaint against Schering-Plough Corporation.[169] The SEC had charged that former Schering-Plough chairman and chief executive officer had met privately a number of times during September and October of 2002 with different analysts and portfolio managers at institutional investment firms, which were among Schering-Plough's largest investors. At these meetings, Kogan disclosed "through spoken language, tone, emphasis and demeanor" material negative, non-public information regarding Schering-Plough's earnings estimates.[170] The private meetings caused a sell-off of Schering-Plough stock by

---

[166] Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: Motorola, Inc., Release No. 46898 (Nov. 25, 2002), *available at* http://www.sec.gov/litigation/investreport/34-46898.htm.

[167] *Id.*

[168] *Id.*

[169] SEC Files Settled Regulation FD Charges Against Schering-Plough Corporation and its Former Chief Executive, Litigation Release No. 18330 (Sep. 9, 2003), *available at* http://www.sec.gov/litigation/litreleases/lr18330.htm.

[170] *Id.*

the investors. In the midst of the sell-off, the SEC alleged that Kogan held a private meeting with approximately 25 analysts where he told them that Schering-Plough's earnings estimates for 2003 would be "terrible."[171] After this meeting, Schering-Plough issued a press release that provided earnings estimates for 2002 and 2003 that were materially below analysts' previous estimates for the company. Schering-Plough did not admit or deny the SEC's charges, but consented to the entry of a final judgment that would require it to pay a $1 million civil penalty. Kogan also agreed to pay a $50,000 civil penalty.

5. *Flowserve Corporation*

On March 24, 2005, the SEC announced that it issued an order finding that Flowserve Corporation violated Regulation FD by reaffirming previous earnings guidance with an analyst in a private meeting.[172] Flowserve and its CEO agreed to pay fines of $350,000 and $50,000, respectively, and consented to the SEC's issuance of a cease-and-desist order. In addition, Flowserve's director of investor relations consented to the order. According to the release, this was the first Regulation FD case filed by the SEC involving a reaffirmation of earnings by an issuer and the first settled enforcement action against a director of investor relations for violating this rule. On November 19, 2002, forty-two days before the end of Flowserve's fiscal year, its CEO and director of investor relations met privately with analysts from four investment and brokerage firm and discussed various aspects of Flowserve's business, including recent acquisitions, debt covenants, and free cash flow. At one point, one of the analysts asked about the Company's earnings guidance for the year. In response to the question, Flowserve's CEO reaffirmed previous guidance, which had been issued on October 22, 2002, and provided additional material nonpublic information. Flowserve's director of investor relations, having heard this exchange, was silent and did nothing to explain the statements or to reiterate Flowserve's policy as to earnings guidance.[173]

6. *Siebel Systems, Inc. II*

On June 29, 2004, the SEC again charged Siebel with violating Regulation FD in connection with the release of certain material non-public information in one-on-one meetings with institutional investors. In its complaint, the SEC also charged Siebel with a failure to maintain adequate disclosure controls and procedures. In a stunning loss for the SEC, the U.S. District Court for the Southern District of New York dismissed the SEC's suit against Siebel on August 31, 2005.[174] In rejecting the SEC's allegations, the court criticized the Commission's overly-aggressive enforcement of Regulation FD. In determining whether the CFO's statements violated Regulation FD, the court found that the private statements conveyed the same substantive information as that in the public

---

[171] *Id.*

[172] SEC Files Settled Regulation FD Charges Against Flowserve Corporation, its Chief Executive Officer, and Director of Investor Relations, Litigation Release No. 19154 (March 24, 2005), *available at* http://www.sec.gov/litigation/litreleases/lr19154.htm.

[173] *Id.*

[174] *SEC v. Siebel Systems, Inc.*, 2005 U.S. Dist. LEXIS 18794 (Aug. 31, 2005).

statements, so that Regulation FD was not violated. The court noted that Regulation FD was not intended to be used in the way that the SEC had in this case. In particular, the SEC had scrutinized, at an extremely heightened level, each particular word used in the CFO's statement, including verb tense and the general syntax of each sentence. The court stated that no support for such an approach could be found in Regulation FD itself, and, in fact, the SEC proposing and adopting releases for Regulation FD had cautioned against any "chilling effect" on disclosure of information. Moreover, the court stated that such an approach "places an unreasonable burden on a company's management and spokepersons to become linguistic experts, or otherwise live in fear of violating Regulation FD should the words they use later be interpreted by the SEC as connoting even the slightest variance from the company's public statements." The court also dismissed the SEC's claim that Siebel violated the disclosure controls and procedures provisions in Section 13(a) of the Exchange Act and Rule 13a-15 thereunder on the basis that the SEC had not provided particular factual allegations pertaining to inadequate disclosure controls and procedures.[175]

F. PCAOB Enforcement Actions

On May 24, 2005, the newly-formed PCAOB initiated its first enforcement actions against several accountants who were alleged to have concealed information requested in a forthcoming PCAOB inspection of their firm. Separately, the Board's Division of Enforcement and Investigations has commenced several investigations of audits of subsequently restated financial statements.

1. How the PCAOB Staff Proceeds

The Board's investigative process has been very similar to SEC enforcement investigations. The Staff of the Enforcement and Investigations Division issues document requests (called "Accounting Board Demands " or "ABDs" for short) and requests for testimony from partners and managers of the audit firms that have "the look and feel" of SEC subpoenas. The Staff will proceed pursuant to a Board "formal order" of investigation, that also resemble those issued by the SEC. Although the Board's "formal order" of investigation may refer to the audit of one client, the Staff may choose to investigate work done for other clients of the audit firm whose financial statements have similar issues. Thus, the Division may be looking at issues across the client base of the audit firm.

2. Jurisdiction

The Staff believes that the PCAOB has jurisdiction for any financial statement that is included within financial statements that are filed after the audit firm registered with the PCAOB in 2003. This position raises the issue of an impermissible and retroactive imposition of sanctions on accountants for work completed before the firm was registered with the PCAOB or even before the passage of the Sarbanes/Oxley Act in 2002. It is unclear whether the PCAOB will press for claims for financial statements issued prior to the creation of the PCAOB.

---

[175] The SEC subsequently decided not to appeal the court's decision in *SEC v. Siebel Systems, Inc. See* "SEC Decides Not to Appeal Dismissal of Regulation FD Action Against Siebel," BNA, Inc. Securities Regulation & Law Report (Nov. 14, 2005) at 1877.

3. Coordination with Parallel SEC Matters

At a May 6, 2005 Practicing Law Institute meeting entitled "The PCAOB Speaks in 2005," speakers from the Enforcement and Investigations Division stated that the PCAOB will coordinate with the SEC and that the PCAOB Staff meets frequently with the SEC Staff. It appears there is significant overlap between PCAOB investigations and those conducted by the SEC; the PCAOB has asked many witnesses the same questions that they were previously asked by the SEC. At "PCAOB Speaks," Enforcement and Investigations Director Claudius Modesti stated that the dynamic of the interview setting is difficult when there are two regulators on the record. Staff of the Enforcement and Investigations Division made clear that they would allow the SEC to sit in on PCAOB testimony without asking questions. The PCAOB Staff has advised that they are willing to attend SEC testimony of auditors, but will not ask questions and will reserve the right to call a witness for investigative testimony before the PCAOB Staff to ask the same questions. Thus, it is evident that the PCAOB Staff is reluctant to engage in a joint investigation, creating the risk of a greater burden on accountants

4. Expert Assistants to Lawyers in Testimony

PCAOB Rule 5102 gives the Staff flexibility regarding whether to permit counsel to bring experts to assist counsel in representing a client during testimony. At the "PCAOB Speaks" seminar, the panelists from the Enforcement and Investigations Division stated that under certain circumstances they might allow it, but they have been unwilling to do so even when the accounting issues in question are exceedingly complex. The Staff does not believe that counsel for an auditor should need the assistance of an expert during testimony. The PCAOB's position conflicts with the SEC process, which was resolved in a pair of decisions issued by the United States District Court for the District of Columbia in 1985. Those decisions, *SEC v. Whitman*, 625 F. Supp. 96 (D.D.C. 1985), *reconsideration denied*, 613 F. Supp. 48 (D.D.C. 1985), allow counsel to bring expert assistants to SEC testimony. According to the PCAOB Staff, these decisions do not apply to the PCAOB because they are based on an interpretation of the Administrative Procedure Act, which does not, in their view, apply to the Board, a "private" body. Whether the Staff's position, which appears to limit counsel's ability to adequately represent a client, is valid, will ultimately depend on whether the PCAOB is a "state actor" and, as such, is required to comply with federal law and the United States Constitution.

5. Remediation

During the "PCAOB Speaks" seminar, Mr. Modesti stated that firms must address remediation of audit failures in a prompt fashion. The PCAOB will want to know what the firm has done to address issues. In the Staff's view, it is "incumbent upon the firms to cure the problems" and identify "what steps have been taken to cure" the problems.

6. Wells Submission

Upon the completion of an investigation, the Staff typically will communicate its views of alleged violations in writing. At the "PCAOB Speaks" seminar, the Staff stated that a potential respondent will have two weeks to provide a written response.

7. Attorney-Client Privilege

The Staff asserted that it intends to test assertions of privilege to make sure that they are valid; privilege logs will be carefully scrutinized. If mistakes are discovered, a party will get a reasonable opportunity to cure, however, if the Staff believes that privilege is not properly being asserted, then a non-cooperation proceeding will be brought.

8. Document Requests

Accounting Board Demands frequently call for the audit firm to produce documents that have been previously given to or made available to the Board's Division of Inspections. At the "PCAOB Speaks" seminar, the Staff made clear that responses to document requests from the Investigations and Enforcement Division and the Inspections Division are separate obligations. Although many documents are turned over to the PCAOB as part of the annual inspections process, the Staff of the Investigations and Enforcement Division may request these same documents later.

G. Court Rulings

1. Underwriters' Fiduciary Duty: EBC I, Inc. v. Goldman Sachs & Co.

During the week of June 10, 2005, the New York Court of Appeals, the highest state court in New York, issued a decision recognizing that advice provided by underwriters on "market conditions" may give rise to a fiduciary duty.[176] The decision, joined by five of the six judges, imposes a common law overlay to the already highly-regulated securities industry and is likely to create additional uncertainty as to what duties and obligations underwriters and others in the industry have.

In *EBC I, Inc. v. Goldman Sachs & Co.*, the Official Committee of Unsecured Creditors of the now defunct internet retailer eToys, Inc. brought suit against Goldman Sachs, the lead managing underwriter of the eToys IPO in 1999. The eToys IPO, like most IPOs, was brought to the market through a firm commitment underwriting, whereby a syndicate of underwriters agreed to purchase the entire allotment of eToys shares to resell to the public. As part of the underwriting contract between eToys and Goldman Sachs, eToys agreed to sell stock to Goldman Sachs for $18.65 per share and Goldman Sachs agreed to offer eToys stock to the public at an initial offering price of $20.00 per share so that Goldman Sachs' profit would be $1.35 per share or approximately 7% of the offering proceeds. On the first day of trading on the market, eToys stock closed at $76.56 per share. Just seven months later, eToys stock was trading at $25.00 per share. Eventually, eToys filed for bankruptcy and a Creditors Committee was appointed. The Creditors Committee brought suit claiming that Goldman Sachs had underpriced the eToys IPO because it allegedly had entered into secret side deals with preferred customers under which it allegedly was paid a portion of any profits that the customers made on aftermarket sales of eToys stock allocated to them by Goldman Sachs in the IPO. The Creditors Committee claimed that Goldman Sachs' alleged side deals constituted an

[176] The majority and dissenting opinions in *EBC I, Inc. v. Goldman Sachs & Co.* are available online at http://www.courts.state.ny.us/ctapps/decisions/jun05/61opn05.pdf.

undisclosed conflict of interest and asserted numerous causes of action against Goldman Sachs, including a cause of action for breach of fiduciary duty.

Though acknowledging that eToys and Goldman Sachs negotiated the terms of the underwriting contract at arms-length and that the contract itself did not create any fiduciary duty on the part of Goldman Sachs, the majority of the New York Court of Appeals held that Goldman Sachs could nonetheless be found, independent of the underwriting contract, to have owed a fiduciary duty to eToys in connection with the alleged expert advice that it provided on the pricing of the IPO:

> [A] cause of action for breach of fiduciary duty may survive, for pleading purposes, where the complaining party sets forth allegations that, apart from the terms of the contract, the underwriter and issuer created a relationship of higher trust than would arise from the underwriting agreement alone. Here, the complaint alleges an advisory relationship that was independent of the underwriting agreement.
>
> Specifically, plaintiff alleges eToys was induced to and did repose confidence in Goldman Sachs's knowledge and expertise to advise it as to a fair IPO price and engage in honest dealings with eToy's best interest in mind. Essentially, according to the complaint, eToys hired Goldman Sachs to give it advice for the benefit of the company, and Goldman Sachs thereby had a fiduciary obligation to disclose any conflict of interest concerning the pricing of the IPO. Goldman Sachs breached this duty by allegedly concealing from eToys its divided loyalty arising from its profit-sharing arrangements with clients.

This majority opinion arguably represents a significant departure from prior case law in which New York courts have been loathe to recognize fiduciary duties in arms-length transactions between sophisticated parties. Indeed, in dissent, Judge Read remarked that "this new fiduciary obligation wars against our precedent." She observed that the "eToys' prospectus acknowledged that the initial public offering price for the common stock has been negotiated among eToys and the representatives of the underwriters" and criticized the majority for "disregard[ing] that eToys was a sophisticated, well-counseled business entity." The majority nonetheless held that a fiduciary duty could be found to exist if, as alleged, it was agreed that Goldman Sachs' profit in the IPO would be fixed at 7% of the offering proceeds and eToys "believed its interests and those of Goldman Sachs were aligned" because "the higher the price, the higher Goldman Sachs's 7% profit." In dissent, Judge Read questioned how a fiduciary duty regarding the pricing of any IPO could ever be found between an issuer/seller and underwriter/buyer in a firm commitment underwriting: "How may a buyer ever owe a duty of the highest trust and confidence to a seller regarding a negotiated purchase price? The interests of a buyer and seller are inevitably not the same. Indeed, it is a longstanding principle of contract law that a buyer may make a binding contract to buy something that it knows its seller undervalues."

Though the majority noted that the fiduciary duty it was recognizing was "limited" on the facts to "requiring disclosure of Goldman Sachs's compensation arrangements with its customers," the majority opinion also contains language that arguably suggests common law fiduciary duties could be implied by courts in other circumstances: "to the extent that underwriters function, among other things, as expert advisors to their clients on market conditions, a fiduciary duty may exist." As underwriters may be seen to be in the business of providing advice on "market conditions," the majority decision is likely to create additional uncertainty as to what duties and obligations underwriters and others have in the already highly-regulated securities industry. As Judge Read noted: "The excesses of the market in the days of the internet high-tech mania did not go unnoticed by regulators. . . . How our new fiduciary duty for underwriters may fit into or conflict with the developing regulatory scheme is impossible to predict. We have, however, at the very least introduced uncertainty into a complex subject."

The majority opinion of the New York Court of Appeals in *EBC I* compounds an already complex regulatory environment with additional concerns about what fiduciary duties might be found to exist under common law. In light of the majority's recognition in *EBC I* of a fiduciary duty in an arms-length transaction, we recommend that underwriters and others in the securities industry include, where appropriate, express disclaimers of fiduciary relationships in underwriting agreements, engagement letters and other business agreements.

2. Responsibilities of Corporate Directors: The Walt Disney Case

In his long-awaited decision in the case involving The Walt Disney Company's hiring and termination of Michael Ovitz in 1995 and 1996, Chancellor Chandler of the Delaware Chancery Court has provided a breath of relief to corporate directors while reminding them of their responsibility to consider "all material information reasonably available" in making business decisions.[177]

The Court held that the defendant directors did not breach their fiduciary duties or commit waste in connection with Ovitz's hiring and termination. Moreover, while the Court found that "many aspects of the defendants' conduct...fell significantly short of the best practices of ideal corporate governance", it stated that "Delaware law does not...hold fiduciaries liable for a failure to comply with the aspirational ideals of best practice." The opinion also recognizes that "the essence of business is risk" and that where "decision-makers act as faithful servants,...[t]he redress for failures...must come from the markets, through the actions of shareholders and the free flow of capital, and not from this Court." Of most comfort to directors, perhaps, is the Court's statement that under our corporate law, corporate decision-makers are held strictly to their fiduciary duties, but within the boundaries of those duties are free to act as their judgment and abilities dictate, free of *post hac* penalties from reviewing courts using perfect hindsight.

Nevertheless, boards and their advisors should not lose sight of the fact that the Court criticizes and comments upon a number of the practices followed by Disney, its CEO, Michael Eisner, and its Board, including:

- **The Boardroom culture**: "[T]he unwholesome boardroom culture at Disney" in which "ornamental, passive directors contribute[d] to

---

[177] *In re Walt Disney Co. Derivative Litig.*, 2005 Del. Ch. LEXIS 113 (Aug. 9, 2005).

sycophantic tendencies among directors and how imperial CEOs can exploit this condition for their own benefit, especially in the executive compensation and severance area."

- **The imperial CEO**. "Eisner stacked his (and I intentionally write 'his' as opposed to 'the Company's') board of directors with friends and other acquaintances who, though not necessarily beholden to him in a legal sense, were certainly more willing to accede to his wishes and support him unconditionally than truly independent directors."

- **Board involvement**. "[A] reasonably prudent CEO would not have acted in as unilateral a manner as did Eisner when essentially committing the corporation to hire a second-in-command, appoint that person to the board, and provide him one of the largest and richest employment contracts ever enjoyed by a non-CEO."

- **Compensation committee activity**. "Although it would have been ideal if the other members of the compensation committee were more substantively involved in those negotiations, it would certainly be unwieldy as a practical matter to require the entire committee, together and as a whole, to negotiate on the Company's behalf."

- **Expert advice**: "Nor is it necessary for an expert to make a formal presentation at the committee meeting in order for the board to rely on that expert's analysis, although that certainly would have been the better course of action."

Thus, while the Court provided the directors relief from potential liability, adherence to better processes and practices could have spared the individual directors years of litigation and many hours of depositions.

The decision also contains an insightful discussion of the fiduciary duties owed by directors of a Delaware corporation. The question of a director's duty of good faith had been the subject of much discussion following the earlier decision in the motion to dismiss stage of this litigation. The *Disne*y Court held that, in the end, "it makes no difference whether the words 'fiduciary duty of' are placed in front of 'good faith' because acts not in good faith (regardless of whether they might fall under the loyalty or care aspects of good faith) are in any event non-exculpable [under Section 102(b)(7) of the Delaware General Corporation Law] because they are disloyal to the corporation." In terms of the standard for determining whether directors have acted in good faith, the Court held that "the concept of *intentional dereliction of duty, a conscious disregard for one's responsibilities*, is an appropriate (although not the only one) standard." The Court also made clear that there is a distinction between standards of conduct for directors and standards of liability and that both standards may change over time. Thus, the liability standard for actions or omissions by directors today may be different from that applied to the Disney Board in light of corporate governance developments of the last ten years.

H. NASD Proposed Rules on Fairness Opinions in Corporate Control Transactions

On June 22, 2005, the National Association of Securities Dealers, Inc. ("**NASD**") filed proposed rules with the SEC that would mandate a number of disclosures to be included in fairness opinions that will be included in a proxy statement and would also require its members to follow specific procedures in issuing fairness opinions.[178]

Under the proposed rules, fairness opinions rendered by NASD members must:

- disclose the member's advisory and other material relationships with the companies involved in the subject transaction;
- disclose compensation or further advisory opportunities that the member will receive for rendering the opinion or that are contingent upon the successful completion of the transaction;
- disclose any information received from the company requesting the opinion that formed a substantial basis for its fairness opinion; and
- confirm whether the fairness opinion was approved by a fairness committee that followed procedures outlined in the proposed rules.

The proposed rules also require NASD members to establish procedures for approving fairness opinions, including:

- the types of transactions and circumstances in which the member will use a fairness committee;
- the process for selecting fairness committee members and the necessary qualifications for such members;
- the process to ensure a balanced review, including review and approval by committee members not involved with the transaction;
- the process to determine the appropriateness of the valuation analyses in the fairness opinion; and
- the process to determine whether the compensation from the transaction for individual officers, directors or employees, when compared with the benefits to the shareholders of the company, should be a factor in reaching a fairness determination.

I. Public Release of Staff Comment Letters

---

[178] The text of the proposed rule may be viewed at: http://www.nasd.com/web/groups/rules_regs/documents/rule_filing/nasdw_014558.pdf.

On June 24, 2004, the SEC announced it would begin publicly releasing comment letters and filer responses relating to disclosure filings under the Securities Act and the Exchange Act, reviewed by the SEC's Division of Corporate Finance and Division of Investment Management.[179] Comment letters and responses for filings by registered investment companies made under the Investment Co. Act of 1940, as amended (the "**Investment Co. Act**"), will also be made publicly available under the new policy. Currently, comment letters and responses for all filings are released only pursuant to requests under the Freedom of Information Act ("**FOIA**").

Filings made after August 1, 2004 and selected for review by the staff will be made available for public review, however correspondence will not be made public less than 45 days after completion of a staff review. Only portions of response letters that are not subject to Rule 83 confidential treatment requests will be made available. Parties seeking access to information that is the subject of a confidential treatment request will need to request release of the information under FOIA. Citing technological issues, senior SEC staff members have indicated publicly that there will be a delay in the availability of comment letters and responses on the SEC's website.

In connection with releasing public comments, the SEC also announced it would ask issuers whose filings are reviewed for a "Tandy" letter, in which the issuer represents that it will not use the comment process as a defense in any securities related litigation against them.

On May 9, 2005, the SEC announced it would begin the process of publicly releasing comment letters and response letters relating to disclosure filings made after August 1, 2004 on May 12, 2005.[180] The letters related to the oldest eligible filing will be released first but, as the process continues, letters will be release no earlier than 45 days after the review of the disclosure is complete. The SEC stated it believes it is appropriate to "expand the transparency of our comment process by making this information available, free of charge, to an unlimited audience." Comment letters and response letters related to reviewed filings are available through the EDGAR system at www.sec.gov.[181]

J. Interactive SEC Reports

The SEC has launched a pilot program which offers companies the opportunity to furnish their financial information filed with the SEC in a computer-readable interactive data format known as eXtensible Business Reporting Language, or "XBRL". As of August 30, 2006 there were 24

---

[179] SEC Staff to Publicly Release Comment Letters and Responses, Release No. 2004-89, (June 24, 2004), *available at* http://www.sec.gov/news/press/2004-89.htm.

[180] SEC Staff to Begin Publicly Releasing Comment Letters and Responses, Release No. 2005-72 (May 9, 2005), *available at* http://www.sec.gov/news/press/2005-72.htm.

[181] For further information on how to search for comment letters and response letters, see http://www.sec.gov/answers/edgarletters.htm. Note that as of June 15, 2006, the date of this outline, all comment letters being issued and responded to are subject to the disclosure requirement, but the SEC has not yet made most of these letters publicly available, due to technical difficulties.

participating companies submitting interactive data which allows individual investors and analysts to quickly search for items of information from financial reports, such as net income, executive compensation, or mutual fund expenses. The XBRL reports also enable individual investors and analysts to download selected information directly into financial software. Interactive data holds the promise of transforming the static, text-only documents companies furnish with the SEC into dynamic financial reports that can be quickly and easily accessed and analyzed by millions of users.

The Commission will host a series of roundtables through 2006 in an attempt to use the lessons learned from the pilot program to help speed the implementation of Internet-based tools for investors and analysts. Public comments on the process are welcomed and can be sent by e-mail to rule-comments@sec.gov, referencing File No. 4-515 in the subject line. Finally, on August 14, 2006, the Commission issued a Request for Proposal announcing plans to develop web-based tools for data analysis, and inviting the software industry to submit proposals. When ready, the new tools will allow investors and analysts to use interactive data encoded in companies' XBRL submissions.

K. SEC Approval of NYSE Rule

On August 21, 2006, the SEC approved a New York Stock Exchange proposal that eliminates the requirement that listed companies physically distribute their annual reports and audited financial statements to shareholders, as long as companies make their annual financial statements available on their websites. NYSE contended that Rule 14a-3 of the Securities Exchange Act of 1934 made the requirement redundant for most NYSE-listed U.S. companies, since it requires companies subject to the proxy rules to distribute annual audited financials to shareholders with or prior to the distribution of the annual meeting proxy statement. The rule amends Section 203.01 of the Listed Company Manual to allow a listed company to satisfy the annual financial statement distribution requirement by making its annual report on Form 10-K, 20-F, 40-F, or N-CSR available on its corporate website. Companies must also issue a press release informing investors that the annual report filed with the SEC is available online, and must inform shareholders they can receive a paper copy free upon request. While the change will not have much effect on domestic companies subject to the proxy rules, NYSE-listed foreign private issuers exempt from the proxy rules will benefit.[182]

[182] The fuller text of the SEC approval order is available at: http://www.sec.gove/rules/sro/nyse/2006/34-54344.pdf