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**BARBARA L. ELIAS**
Senior Sales Representative
Global Capital Markets

215.561.8658 Tel
267.251.7838 Cell
215.564.3220 Cust. Service
215.561.8676 Fax
barbara.elias@rrd.com
www.realcorporatelawyer.com
www.rrdonnelley.com

Two Logan Square
Suite 1800
Philadelphia, PA 19103-6933

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# CORPORATE RESPONSIBILITIES OF PUBLIC COMPANIES

**Edwards Angell Palmer & Dodge LLP**
D. Roger Glenn • Nancy M. Lee Dellaria

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# CORPORATE RESPONSIBILITIES OF PUBLIC COMPANIES IN 2006

D. Roger Glenn
Nancy M. Lee Dellaria

Edwards Angell Palmer & Dodge LLP

RR Donnelley Global Capital Markets

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## About This Publication

This publication has been written to acquaint public companies in the United States about their obligations under the corporate governance regulatory scheme that exists after the enactment of the Sarbanes-Oxley Act of 2002. It also informs companies and their officers, directors and shareholders about their SEC reporting obligations, the restrictions on trading in the companies' stock and the rules related to document retention. Finally, this publication seeks to familiarize companies with the process of going private or going dark in the event of a determination that the costs and burdens of being a reporting public company listed on an exchange or Nasdaq outweigh the benefits of being a reporting company.

The opinions expressed in this publication are those of the authors and do not necessarily reflect the views of Edwards Angell Palmer & Dodge LLP or any other person.

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## About the Authors

**D. Roger Glenn** is a partner and **Nancy M. Lee Dellaria** is an associate at Edwards Angell Palmer & Dodge.

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# INTRODUCTION

Before 2002, issues related to corporate governance were left almost exclusively to the state in which a company was organized. State law regulated the composition of the board of directors, transactions between a company and its management and the need for stockholder approval. The only gloss on state regulation came in the form of listing requirements of Nasdaq and the stock exchanges. These listing standards did not have the force of law, however. There was no private right of action for violating listing standards, and the only remedy available to the stock markets was delisting the company, a drastic action that the markets were understandably reluctant to take.

In 2001 and 2002, corporate giants like Enron, Global Crossing and Worldcom were forced to declare bankruptcy, and massive accounting and other irregularities were revealed at those companies as well as at others. In response to the public outcry that ensued, the Sarbanes-Oxley Act of 2002 was enacted by the U.S. Congress and signed into law by President Bush on July 30, 2002.

This was the U.S. Congress's first significant foray into the realm of corporate governance. Sarbanes Oxley contained some provisions that apply directly to companies. Some of its provisions required the Securities and Exchange Commission to adopt rules to implement them before they became effective. Some provisions apply only to listed companies and others apply to all companies. In some cases, the SEC adopted rules that require listing standards, which prompted the exchanges and Nasdaq to promulgate stricter listing requirements that in some cases were more demanding than those required by the SEC's rules. Thus, Sarbanes Oxley has brought about a web of laws, SEC rules and listing requirements that have to be considered together to appreciate the regulatory environment in which companies must operate in 2006 and beyond.

This book seeks to explain this web and how it affects companies. It also covers the regulatory provisions that predate Sarbanes Oxley, which are still in effect and address such subjects as disclosure of non-public information, periodic reporting and trading in shares in the open market. Many of these existing provisions were enhanced by Sarbanes Oxley.

THE SARBANES-OXLEY ACT OF 2002

Sarbanes Oxley contained a number of provisions that became law automatically without any further action. Other provisions required the SEC to adopt rules to implement the law or to supplement it. Those rules have now been adopted.

Much of Sarbanes Oxley was focused on the accounting profession and created a whole new quasi-governmental entity to regulate accountants that audit the financial statements of public companies. The legal profession also was the subject of Sarbanes Oxley. These provisions do not affect companies directly and are not discussed in this publication.

The portions of Sarbanes Oxley that do affect companies directly are discussed immediately below and elsewhere in this book as appropriate. Where noted, certain provisions of Sarbanes Oxley apply only to companies that have their shares listed on a national securities exchange or an automated inter-dealer quotation system of a national securities association, referred to as "listed companies." Presently, Nasdaq is the only quotation system that qualifies and it will soon become a national securities exchange. The other provisions of Sarbanes Oxley apply to all public companies, which means all companies with securities registered, or that are required to file reports, under the Securities Exchange Act of 1934, as amended, or that have filed a registration statement with the SEC under the Securities Act of 1933, as amended, and not withdrawn it (even though it has not become effective).

## Prohibition on Loans to Directors and Executive Officers

Sarbanes Oxley prohibits companies from extending, maintaining, arranging for or renewing a personal loan to or for any director or executive officer or his or her affiliates. This provision applies to all public companies whether or not listed. Loans outstanding on the date of enactment of the Sarbanes Oxley are exempt, but any material modification of their terms or their renewal is prohibited. Depending upon how this provision of Sarbanes Oxley is finally interpreted by courts, financial arrangements not traditionally thought of as loans may be prohibited. For example, the prohibition may extend to loans made by third parties at the request or with the cooperation of the company. Clearly, a company may not guarantee the repayment of a loan to any of its directors or executive officers.

There is an exception from this prohibition for companies that are in the business of making loans. Margin loans by registered broker-dealers, consumer credit, charge cards, open end credit plans, and home improvement and manufactured home loans are permitted if the credit is extended in the ordinary course of business, is of a type generally offered to the public and is made either on market terms or on terms no more favorable than those offered to the general public. Any loan by an insured U.S. depository institution is similarly permitted, but only if it is subject to the restrictions on loans to officers or directors by member banks of the Federal Reserve System. The latter exemption does not cover non-U.S. financial institutions, even if they are subject to similar home-country regulation. Nor does the exemption for margin loans extend to non-U.S. institutions, unless the non-U.S. financial institution is registered with the SEC as a broker-dealer. On April 26, 2004, the SEC adopted rules exempting certain foreign banks from this provision.

Loans to directors and executive officers by private companies are not prohibited. But any such loans made after Sarbanes Oxley was passed would have to be repaid before the company could file a registration statement to go public.

On December 1, 2005, the SEC brought the first charges alleging violations of the prohibition on loans to directors and executive officers. The SEC stated that in the fall of 2003, two executive officers of Stelmar Shipping Ltd. received interest-free loans from the company in contravention of Sarbanes Oxley. Even though they attempted to label the loans as "advances," the officers agreed to settle the charges and the SEC issued cease and desist orders against them.

## Standards for Audit Committees

Sarbanes Oxley required the SEC to adopt rules to regulate the composition and operation of audit committees of the boards of directors of listed companies. In response, the SEC requires that stock exchanges and the Nasdaq impose certain standards on companies that have securities listed and traded on or quoted by these organizations that are at least as stringent as those adopted by the SEC, which are described below. Thus, to determine the strictures applicable to a listed company, one needs to go beyond the SEC's rules and consult the requirements of the exchanges or Nasdaq, as appropriate. The requirements of the New York Stock Exchange and Nasdaq are discussed in the next chapter.

The SEC rules apply to audit committees of the boards of directors of listed companies. If a listed company has not designated an audit committee, then the rules apply to the entire board of directors.

### *Standards for Audit Committee Members*

The SEC's rules require that audit committees of listed companies consist entirely of independent directors except for certain narrow exceptions described below. In order to be considered independent, a person must satisfy a two-part test:

- First, an audit committee member may not receive *any* consulting, advisory or compensatory fee from the company (other than compensation as a director). This prohibition extends to any indirect receipts, and therefore proscribes any payments to spouses, minor children or stepchildren or children or stepchildren sharing a home with the member, as well as payments to an entity in which the member is a partner, member or principal or occupies a similar position, including entities that provide accounting, consulting, legal, investment banking, financial or other advisory services or any similar services to the company.
- Second, an audit committee member may not be an "affiliated person" of the company or any of its subsidiaries. A person is affiliated with another if it directly or indirectly

controls, is controlled by or is under common control with the other person. Control means the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract or otherwise. Obviously, these definitions require that a determination be made on a case-by-case basis after considering the particular facts in any given situation. In order to introduce some certainty in the area, however, the SEC has provided a safe harbor under which any person who is not an executive officer or 10% stockholder of a company is deemed not to control the company. Executive officers, employee-directors, general partners and managing members of affiliated persons are themselves deemed to be affiliated persons.

For U.S. companies, there are only two narrow exemptions from the rules requiring that all audit committee members be independent. The first of these applies to companies immediately after they have gone public.

Because the boards of private companies typically consist of insiders and representatives of large stockholders such as venture capital funds, and because it is difficult to recruit directors for companies about to go public (because of, among other things, the personal liability for the registration statement and the uncertainty about whether the public offering will occur), the SEC has required only that one audit committee member be independent at the time a company goes public, that a majority of audit committee members be independent within 90 days thereafter and that all members be independent within one year. The second exemption permits an audit committee member of a parent to sit on the board of directors of a subsidiary despite the affiliated person prohibition so long as the other independence requirements are met for both the parent and the subsidiary.

The tests for independence first apply at the time a director becomes a member of the audit committee. There is no look-back period for which they must be satisfied.

For foreign private issuers, the SEC has adopted additional exemptions to its independence criteria for audit committee members. If a company's home country laws require that a non-management employee be appointed to the board, that person is allowed to sit on the audit committee. Also, a foreign government representative would be permitted to sit on an audit committee so long as the "no compensation" test is met and the representative is not an executive officer. The SEC has also stated that for foreign private issuers with two-tier boards—one management and the other, upper tier supervisory—only the supervisory tier is considered to be the board of directors. Finally, the independence and (as described below) auditor-oversight requirements do not apply to foreign private issuers that have separate boards of auditors or statutory auditors under local law.

The SEC's rules require listed companies to disclose in their Forms 10-K and proxy statements whether the members of their audit committee are independent using the definition of independence included in the listing standards applicable to the company. Non-listed companies with audit committees must disclose whether their audit committee members are independent using any definition that has been approved by the SEC.

The SEC also imposes the requirement that any company disclose in its Form 10-K or proxy statement whether, in the opinion of its board of directors, it:

- has at least one audit committee financial expert serving on its audit committee; or
- does not have an audit committee financial expert serving on its audit committee, in which case it must explain why it does not.

The SEC did not require that a company have an audit committee financial expert on its audit committee because Sarbanes Oxley did not go that far. Sarbanes Oxley only required a company to disclose whether it had one, and so the SEC limited itself to using disclosure as a not-so-subtle means of encouraging companies to have an audit committee member with the requisite qualifications.

In order to qualify as an audit committee financial expert for SEC purposes, one must possess the following attributes:

- an understanding of generally accepted accounting principles in the United States, known as GAAP, and financial statements;
- the ability to assess the application of GAAP to the accounting for estimates, accruals and reserves;
- experience in preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are comparable to the breadth and complexity of issues that can be expected to be raised by the company's financial statements, or experience actively supervising one or more persons engaged in such activities;
- an understanding of internal controls and procedures for financial reporting; and
- an understanding of audit committee functions.

These attributes must have been acquired 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, audit or evaluation of financial statements; or
- other relevant experience (which may not be merely educational). If this means is relied upon to support the qualifications of an audit committee financial expert, then the company must disclose what the relevant experience was.

*Engagement of Accounting Firm and Approval of Fees and Services*

If an outside auditor of a company were to view its management, rather than its board of directors or audit committee, as its employer with hiring, firing and compensatory powers, then the auditor might have an incentive not to raise concerns about management or the financial reporting by management, and their objective review might be jeopardized. Even the appearance of this situation would undermine investor confidence. In order to prevent this from occurring, the SEC, as required by Sarbanes Oxley, has required that the audit committee be solely responsible for hiring, firing and compensating the company's auditors, overseeing their work and resolving any differences between them and management. As part of this responsibility, the audit committee has the power and responsibility to approve audit engagement fees and terms as well as all significant non-audit engagements of the auditors.

These rules do not affect any requirement that a company's auditors by elected, approved or ratified by the company's stockholders. Rather, they relate only to the allocation of responsibility between the management and the audit committee. If a company seeks a stockholder vote on the issue, however, the recommendation that the stockholders elect, approve or ratify the auditor should come from the audit committee.

*Procedures for Hearing Complaints*

Company employees are often in the best position to report questionable practices and irregularities but may fear management reprisal if they do. Accordingly, audit committees are required to establish procedures to receive, retain and treat complaints regarding accounting, internal controls or auditing matters and to provide a method for employees to report the same anonymously usually through a telephone hotline. This is intended to bolster the other provisions of Sarbanes Oxley that specifically protect whistle-blowers, as described below. However, this requirement has proved troublesome for companies that are listed in the United States and have European subsidiaries.

Anonymous reporting conflicts with long-established principles under EU data protection and labor laws. Anonymous reports to the hotline potentially could damage employees' reputations, regardless of whether accusations are determined to be true. Depending on how a hotline is implemented, employees might not have a meaningful opportunity to challenge a report that concerns them. Further, information that identifies EU-resident employees could be sent to the U.S. corporate parent in violation of international data transfer restrictions.

In 2005, the French subsidiaries of U.S.-based McDonald's Corporation and Exide Technologies sought approval of their hotlines from the French data protection authority, the Commission Nationale de l'Informatique et des Libertés (CNIL). These companies' plans attempted to meld Sarbanes Oxley requirements with French privacy and labor laws by requiring prompt notice to employees named in anonymous reports and opportunities for self-defense. Nonetheless, CNIL rejected their proposals. A German court in Wuppertal ordered the local subsidiary of Wal-Mart Stores Inc. to suspend its anonymous telephone hotline for reporting wrongdoing because German labor laws required the prior consent of local workers' representatives. And a

French court in Libourne (which is a separate authority from the CNIL) ordered the French subsidiary of U.S.-based Owens-Illinois, Inc., to dismantle its hotline, accepting the argument of local workers' representatives that it was disproportionate to misconduct that could be uncovered through anonymous tips.

European authorities and the SEC have recently begun a dialogue toward resolving the conflict between legal regimes. However, the SEC refused to agree to a CNIL request to suspend enforcement of the anonymous reporting provisions with respect to French companies for three months while discussions occur.

*Engaging Advisors and Funding*

To be effective, an audit committee must have adequate funding and the ability to hire advisors to guide it. The SEC therefore has required that the audit committee have the authority to engage such outside advisors, including counsel, as it determines necessary, and that the company be required to provide for appropriate funding as determined by the audit committee for it to function and pay any public accounting firm or other advisor employed by the audit committee.

*Potential Liability*

The SEC has indicated that it will hold audit committee members accountable for failing to perform their required duties. In a high-profile example, in late 2005, the SEC notified three audit committee members of Hollinger International Inc. that it may bring a civil suit for failing to spot fraud that management of the company is accused of committing. One of the members notified had resigned from the Hollinger board over two years ago.

The SEC's notice is out of the ordinary for several reasons. Holding independent directors liable for not being proactive or diligent enough in their audit committee roles is unusual. In addition, none of the audit committee members received any benefit from the alleged management fraud.

### Requirement For Disclosure Controls and Procedures and Internal Control Over Financial Reporting

Sarbanes Oxley imposed certain requirements on companies regarding their disclosure controls and procedures and internal control over financial reporting. To understand these provisions, it is important to focus upon the difference between the meanings of those two terms. "Disclosure controls and procedures" are controls and procedures of a company that are designed to ensure that all the information required to be disclosed by the company in the reports filed with the SEC is recorded, processed, summarized and reported within the periods specified. Although there is substantial overlap, the information that is the subject of disclosure controls and procedures is broader in nature than the information covered by internal control over financial reporting in that it includes non-financial information that is required to be included in SEC filings. "Internal control over financial reporting" is limited to a company's financial reporting and control of its assets. This concept predates Sarbanes Oxley and is derived from accounting literature.

Sarbanes Oxley required that the SEC prescribe rules requiring annual reports to contain an internal control report that would:

- state the responsibility of management to establish and maintain an adequate internal control structure and procedures for financial reporting, and
- assess the internal control structure and procedures of the company for financial reporting as of the end of the year.

Sarbanes Oxley also required, without the need for SEC action, that any public accounting firm that audits a company attest to and report on the assessment of the internal control structure and procedures referred to above.

The final rules promulgated by the SEC regarding internal control reports were broader than Sarbanes Oxley called for in that the reports were required to cover disclosure controls and procedures and not just internal controls, and required that the report appear not only in annual filings but in quarterly ones as well. The SEC's rules require that:

- a company's annual report include:
  - a statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company;
  - a description of the framework used by management to evaluate the effectiveness of internal control;
  - management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year including any disclosure of any "material weaknesses" in the company's internal control over financial reporting identified by management. A material weakness is a significant deficiency (or a combination of significant deficiencies) that results in a more-than-remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. The Public Company Accounting Oversight Board has clarified that an auditor should properly identify and aggregate control deficiencies to determine whether a significant deficiency exists constituting a material weakness. Management is not permitted to conclude that the internal control over financial reporting is effective if there are one or more material weaknesses;
  - a statement that the company's public accounting firm has attested to and reported on management's evaluation of the company's internal control over financial reporting; and

- the public accountant's attestation and report on management's evaluation of the company's internal control over financial reporting.

- a company's quarterly report include any change in the company's internal control that occurred during the quarter that materially affected or is reasonably likely to materially affect the company's internal control.

These rules dovetail with the officer certification requirements adopted by the SEC pursuant to Sarbanes Oxley, as described below.

Public companies were already required by the Exchange Act to maintain adequate internal control. In addition, no accounting firm could render an audit opinion without having evaluated a company's internal control and found them to be adequate. The SEC's rules, however, go much further and require comprehensive documentation and evaluation that is required to support management's conclusions on disclosure controls and procedures and to form a basis for the accountants' finding. To comply, management must:

- understand the definition of disclosure controls and procedures;
- organize a project team to conduct the evaluation;
- conduct the evaluation at the overall entity level and lower, such as at the process, transaction, or application levels; and
- at all levels, evaluate the overall effectiveness of internal controls, identify matters for improvement and establish monitoring systems.

Once control standards are properly designed and documented, they should be tested by management using suitable criteria, such as the COSO framework. The COSO framework provides evaluation standards for a company's internal control and was provided by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"). Other frameworks exist but the COSO framework is currently the most broadly accepted in the United States. Under the COSO framework, there are five parts to a company's internal control: (1) control environment through discipline and structure, (2) identify and assess risks to achieving predetermined objectives, (3) control activities through policies and procedures to mitigate risks and achieve management objectives, (4) provide information and communicate with employees and (5) monitor internal controls.

A sample disclosure controls and procedures policy is included as Exhibit A.

The SEC has extended the compliance date for non-accelerated filers to fiscal years ending on or after July 15, 2007. For a description of what an accelerated filer is, see "Periodic and Current Reporting" below.

**Rules for Disclosing Non-GAAP Information**

Sarbanes Oxley required the SEC to adopt rules governing the disclosure of non-GAAP financial measures. The SEC did so by adopting Regulation G, which applies to all public companies. Regulation G supplements and codifies portions of the SEC's December 2001 "cautionary advice" on non-GAAP disclosures and should also be read together with *Trump Hotels & Casino Resorts, Inc.*, the first enforcement action on the subject, which was brought by the SEC in 2002.

*Types of Disclosures Affected*

The rules apply to all public disclosures of information that include material non-GAAP financial measures, including earnings and other press releases, investor calls and webcasts, investor conferences, Exchange Act reports, annual report to stockholders (including the CEO's letter) and the slide shows presented at non-private investor conferences or meetings of stockholders. The specific requirements vary with the manner of disclosure. As described below, the use of non-GAAP financial measures in SEC filings is subject to stricter rules than their use in other public disclosures. In the case of oral, webcast and similar presentations there are ways to simplify compliance.

The requirements do not apply to *pro forma* disclosures about a proposed business combination because those are governed by other SEC rules.

A "non-GAAP financial measure"

- is a numerical measure of historical or future financial performance, financial position or cash flows that excludes or includes amounts (or is subject to adjustments that have the effect of excluding or including amounts) that are not excluded or included in the most directly comparable GAAP measure in the financial statements; that
- is not:
  - an operating or other statistical measure (such as unit sales, numbers of employees, numbers of subscribers or numbers of advertisers);
  - a ratio or statistical measure calculated using only:
    - financial measures calculated in accordance with GAAP or
    - operating measures or other measures that are not non-GAAP financial measures;
  - financial measures that do not have the effect of providing numerical measures different from the comparable GAAP measure (such as expected indebtedness amounts); or
  - any financial measure required to be disclosed by GAAP, SEC rules, or any other applicable governmental or self-regulatory organization requirements.

The following are examples of non-GAAP financial measures:

- a measure of operating income that excludes one or more expense or revenue items that are identified as "non-recurring;"
- EBITDA, which could be calculated using elements derived from GAAP financial presentations but, in any event, is not presented in accordance with GAAP; and
- a ratio that is calculated by dividing one measure by another, where either measure, or both, were not calculated in accordance with GAAP.

The SEC does not intend the rules to capture *all* measures of operating performance or financial measures. In addition to operating and other statistical measures, the following are examples of what the SEC does *not* consider non-GAAP financial measures:

- disclosure of amounts of expected indebtedness, including contracted and anticipated amounts;
- disclosures of amounts of repayments that have been planned or decided upon but not yet made;
- disclosure of estimated revenues or expenses of a new product line, so long as such amounts were estimated in the same manner as they would be computed under GAAP;
- measures of profit or loss and total assets for segments required to be disclosed in accordance with GAAP;
- ratios and measures such as sales per square foot or same store sales (in each case, assuming the sales figures were calculated in accordance with GAAP); and
- a ratio that is calculated by dividing one measure by another, where both measures are calculated in accordance with GAAP.

In addition, the SEC staff has stated informally that:

- the ratio of earnings to fixed charges (using GAAP calculations) is not a non-GAAP financial measure within the meaning of the new rules, since disclosure of this measure is required by SEC rules; and
- disclosure of revenues generated by a particular product line will not be considered as a non-GAAP financial measure, so long as the company also discloses total revenues.

*Reconciliation and Explanation Requirements For Non-GAAP Financial Measures*

The following requirements apply each time a material non-GAAP financial measure is publicly disclosed in any fashion, even if it has been previously disclosed in another context.

Disclosure of material non-GAAP financial measures must be accompanied by:

- the most directly comparable financial measure calculated and presented in accordance with GAAP, *and*

- a quantitative reconciliation of the differences between the non-GAAP financial measure and the most comparable GAAP financial measure.

While companies have flexibility in deciding which is the "most directly comparable financial measure calculated and presented in accordance with GAAP," the SEC's position is that:

- non-GAAP measures of cash generated from operations should be balanced with disclosure of amounts from the statement of cash flows, and
- non-GAAP measures that depict performance should be balanced with net income, or income from continuing operations, taken from the statement of operations.

If the non-GAAP financial measure is *forward-looking* and the respective GAAP equivalent is not available without unreasonable effort, a company must identify the information that is unavailable and its probable significance and provide whatever reconciling information is available.

The reconciliation must be by a schedule or other clearly understandable method. In the case of ratios or measures calculated using non-GAAP financial measures, a reconciliation for each non-GAAP financial measure used in the calculation must be provided. In addition, the ratio or measure as calculated using the most directly comparable GAAP financial measure or measures must be presented.

The SEC release did not elaborate on the requirement that the comparable GAAP measure and reconciliation "accompany" the non-GAAP financial measure. The overriding standard is that the disclosure not be misleading. If the disclosure is in a document that will be filed or furnished with the SEC, the comparable GAAP measure must be presented with a prominence equal or greater to that of the non-GAAP measure.

Of course, a non-GAAP financial measure may not be used if, taken together with the accompanying information and discussion, it contains an untrue statement of a material fact or omits to state a material fact necessary in order to make its presentation, in light of the circumstances under which it is presented, not misleading. Companies will be well advised to:

- avoid allowing non-GAAP financial measure to obscure GAAP results;
- make sure there is a sound rationale for using the non-GAAP financial measure;
- maintain consistency (for example if unusual charges are excluded, exclude unusual credit items as well);
- follow the more detailed requirements of new Item 10(e) of Regulation S-K (described below) even if it does not technically apply;
- disclose any change in the method of calculating or presenting a particular non-GAAP financial measure from one period to another and why it was made; and

- calculate any per share measure on a fully diluted as well as a primary basis.

The SEC had expressed concern about non-GAAP information being false or misleading before Sarbanes Oxley. In December 2001, it issued "cautionary advice" about disclosures that it believed made it hard for investors to compare a company's financial information with other reporting periods and with other companies. The SEC's concerns and guidance are summarized below:

- Presentation of a non-GAAP financial measure raises particular concerns and misleads investors when the company does not clearly disclose the basis of its presentation. Investors cannot understand, much less compare, this information without an indication of the principles that underlie its presentation. For example, when a company purports to disclose earnings before unusual or nonrecurring transactions, it should describe the particular transactions that are omitted and apply the methodology consistently when presenting purportedly comparable information about other periods.
- Statements about a company's financial results that are literally true nonetheless may be misleading if they omit material information. For example, investors are likely to be deceived if a company uses a non-GAAP presentation to recast a loss as if it were a profit, or to obscure a material result of GAAP financial statements, without clear and comprehensible explanations of the nature and size of the omissions.

The *Trump Hotels and Casino Resorts, Inc.* enforcement action involved an earnings release that was materially misleading, in the SEC's opinion, because it created the false and misleading impression that the company had exceeded earnings expectations primarily through operational improvements, when in fact it had not. The release expressly stated that the net income figure excluded a one-time charge. This statement implied, the SEC concluded, that no other significant one-time items were included in stated net income. Contrary to that implication, however, the net income figure in fact included a material undisclosed one-time gain. A company may not include or exclude only items that make its results of operations look good, according to the SEC.

*Compliance for Oral Releases*

For disclosures of non-GAAP financial measures orally, telephonically, by webcast or broadcast or by similar means, Regulation G allows the use of the company website to provide the required disclosures so long as:

- the Regulation G disclosures appear on the website at the time the non-GAAP financial measure is presented, and
- the presentation directs the audience to the location of the website.

This provision will apply, for example, to remarks at annual stockholder meetings or to an investor conference call to discuss an earnings release. Obviously, to take advantage of it a company must plan ahead to make sure that the disclosures have been posted by the time of the call.

This provision will *not* apply, however, to a slideshow or written handout that accompanies an oral presentation. Slideshows, handouts and similar material must contain the required Regulation G disclosures if they present material non-GAAP financial measures.

There are two important caveats associated with using this provision:

- If any oral disclosure relates to results for a prior, completed fiscal period and has not previously been made public, the press release announcing the time of the disclosure must include instructions on when and how to access the Regulation G information on the web site. Otherwise, the Regulation G information must be filed on Form 8-K. In this circumstance, it is not sufficient to wait until the call itself to announce the location of the Regulation G material on the company's website.
- In contrast to the treatment of inadvertent disclosures by Regulation FD (which is discussed below), it is not possible to make an inadvertent disclosure of a material non-GAAP financial measure and still comply with Regulation G after the fact. The Regulation G information must either be already posted to the website or it must be provided on the spot.
  - This is true even if you are in compliance with Regulation FD because the conference call was previously announced.
  - This differs from the Form 8-K's Item 7.01 requirement for disclosure of material non-public information (as discussed below).

*Earnings Releases*

Quarterly or annual earnings releases containing a non-GAAP financial measure (whether or not material) must contain the disclosures described above and *also* comply with the following when that release is filed with the SEC on Form 8-K. (For a full discussion of Item 2.02 of Form 8-K, which brings earnings information within the SEC's current reporting requirement, see below.)

- the most directly comparable GAAP financial measure (as discussed above) must be presented with a prominence equal or greater to that of the non-GAAP financial measure.
  - As a practical matter, this means that this presentation must be used in the original earnings release as well. For example, a headline in the earnings release that contains a non-GAAP financial measure would also need to contain the corresponding GAAP figure.
  - Unless included in the most recent Form 10-K the following information must be disclosed:

- the substantive reasons why management believes that presentation of the specific non-GAAP financial measure, in the context in which it is presented, provides useful information to investors (not just industry analysts) about the company in light of its business and industry; and
- to the extent material, any additional purposes for which management uses the non-GAAP financial measure.

A company that anticipates frequent use of non-GAAP financial measures should include this information in its Form 10-K to avoid restating it in each release.

*SEC Filings*

Non-GAAP financial measures (whether or not material) that are included in filings with the SEC are subject to all the presentation, reconciliation, explanation and non-misleading requirements described above.

In addition, Item 10(e) of Regulation S-K must be complied with. This provision, which codifies some of the SEC's historical views on non-GAAP information, prohibits any filing from:

- 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. EBIT and EBITDA are not covered by this prohibition but, if used, must be accompanied by the appropriate GAAP reconciliation;
- including a non-GAAP performance measure to eliminate or smooth items identified as non-recurring, infrequent or unusual, when the nature of the charge or gain is such that it is reasonably likely to recur within two years, or there was a similar charge or gain within the prior two years;
- presenting a non-GAAP financial measure on the face of GAAP financial statements or in the accompanying notes;
- presenting non-GAAP financial measures in any *pro forma* financial information required to be disclosed by SEC rules relating to business combinations; or
- 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.

**Disclosure of Off-Balance Sheet Financing**

The Enron debacle is generally thought to have resulted at least in part from its use of derivatives and off-balance sheet financings under which Enron was liable for certain obligations that were not disclosed to investors. In response, Sarbanes Oxley required the SEC to adopt rules to require that reports filed by a company disclose all material off-balance sheet transactions, arrangements, obligations (including contingent obligations) and other relationships with unconsolidated entities or other persons. The SEC adopted the rules described below to implement this law.

Companies are now required to disclose in any registration statement, annual report and proxy that requires financial statements, in a separately-captioned section, their off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on their financial condition, revenues, expenses, liquidity, capital expenditures or capital resources that would be material to investors. The disclosure must include:

- the nature and business purpose of the off-balance sheet arrangements;
- the importance of the off-balance sheet arrangements to liquidity, capital resources, market risk or credit risk or other benefits of the arrangements;
- the amounts of revenues, expenses and cash flows arising from the arrangements;
- the nature and amounts of any interests retained, securities issued and indebtedness incurred in connection with the arrangements;
- the nature and amounts of any other obligations or liabilities (including contingent obligations or liabilities) arising from such arrangements that are or are reasonably likely to become material and the triggering events or circumstances that could cause them to arise; and
- any known event, demand, commitment, trend or uncertainty that is reasonably likely to result in the termination, or material reduction in availability, of the off-balance sheet arrangements, and the course of action that will be taken in response.

The term "off-balance sheet arrangement" means any transaction, agreement or other contractual arrangement to which an entity that is unconsolidated with a company is a party, under which the company has:

(A) any obligation under a guarantee contract that has any of the characteristics identified in paragraph 3 of FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (November 2002) and that is not excluded from the initial recognition and measurement provisions of that Interpretation pursuant to paragraphs 6 or 7 of it;

(B) a retained or contingent interest in assets transferred to the unconsolidated entity or a similar arrangement that serves as credit, liquidity or market risk support to that entity for those assets;

(C) any obligation, including a contingent obligation, under a contract that would be accounted for as a derivative instrument, except that it is both indexed to the company's own stock and classified in stockholders' equity in the company's statement of financial position, and therefore excluded from the scope of FASB Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities (June 1998), pursuant to paragraph 11(a) of that Statement, as may be modified or supplemented; or

(D) any obligation, including a contingent obligation, arising out of a variable interest, as referenced in FASB Interpretation No. 46, Consolidation of Variable *Interest Entities* (January 2003) in an unconsolidated entity that is held by, and material to, the company, where such entity provides financing, liquidity, market risk or credit risk support to, or engages in leasing, hedging or research and development services with, the company.

In addition to the disclosure referred to above, companies are now required to disclose in any registration statement, annual report and proxy that requires financial statements, in a tabular format, the amount of its known contractual obligations divided into the following categories:

- Long-term debt,
- Capital lease obligations,
- Operating lease obligations,
- Purchase obligations, and
- Other long-term liabilities on the balance sheet.

On June 15, 2005, the SEC released a staff report addressing off-balance sheet arrangements, special purposes entities and related issues. As mandated by Sarbanes Oxley, the staff reviewed companies' filings to determine whether financial statements properly reflect the economics of off-balance sheet transactions and special purpose entities. The staff made various recommendations to further improve the transparency of financial statements through changes in accounting and reporting requirements. Although no such changes have been adopted to date, companies should be aware that changes in disclosure requirements may be forthcoming.

## Codes of Ethics

Sarbanes Oxley required the SEC to adopt rules requiring a company to disclose whether or not it has a code of ethics for its senior financial officers, and if it has no code to explain why. In response, the SEC adopted rules requiring any public company to disclose whether it has adopted a code of ethics that applies to the company's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions. If a company has not adopted a code of ethics, it must explain why it has not done so. Note that the SEC expanded the requirement so that the code must also cover the chief executive officer in addition to the company's financial officers in order to qualify.

An acceptable code for SEC purposes must consist of written standards that are reasonably designed to deter wrongdoing and to promote:

- honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;

- full, fair, accurate, timely, and understandable disclosure in reports and documents that a company files with the SEC and in other public communications made by the company;
- compliance with applicable governmental laws, rules and regulations;
- the prompt internal reporting to an appropriate person or persons identified in the code of violations of the code; and
- accountability for adherence to the code.

A company may have separate codes of ethics for different types of officers and other personnel. Also, the five requirements set forth above may be embedded in a broader code that addresses additional subjects and applies to additional persons.

The code of ethics must be filed as an exhibit to the Form 10-K or posted on the company's web site, provided that the address of the web site and notice that it is posted there are disclosed in the Form 10-K, or a company may undertake in the Form 10-K to provide a copy of the code to any person that requests it without charge. Any amendment to, or waiver from, any of the five elements set forth above in a company's code of ethics must be disclosed on Form 8-K (Item 5.05) filed within four business days.

A sample of a code of ethics is included as Exhibit B.

### Liability for Improper Influence on the Conduct of Audits

Sarbanes Oxley directed the SEC to adopt rules prohibiting officers or directors from taking any action to mislead any accountant for the purpose of making the company's financial statements materially misleading. The SEC's rules prohibit any action to coerce, manipulate, mislead or fraudulently influence the auditor of the company's financial statements if that person knew or should have known that such action, if successful, could result in rendering the financial statements materially misleading. Conduct is actionable even if it did not have the desired effect on the audit or review. The rules apply to any director or any officer, and also cover any person acting under their direction. For example, customers, vendors or creditors who, under the direction of a director or officer covered by the rules, provided false or misleading confirmation or other information to an auditor are covered by the rules.

The rules require that a person know or be unreasonable in not knowing that the action taken could result in rendering a financial statement materially misleading in order to be culpable.

The rules pertain during the entire professional engagement period of the auditor and thereafter when the auditor is considering whether to consent to the use of the audit report. It could even begin before the auditors engagement in some circumstances, for example if a director offers to engage an accounting firm on the condition that it will issue an unqualified report on financial statements that do not conform to GAAP.

The SEC has sole jurisdiction to bring an action under its rules; there is no private right of action. Violation of the rules may result in cease and desist orders, injunctions and/or civil or criminal penalties.

### Forfeiture of Bonuses and Profits in the Event of a Restatement

Sarbanes Oxley provides that if a company is required to restate its financial results due to material noncompliance with any financial reporting requirement under the securities laws resulting from misconduct, then the chief executive office and chief financial officer must reimburse the company for any bonus or other incentive-based or equity-based compensation received and any profits realized from the sale of company securities during the year following the first publication of the financial document being restated. This law applies without the need for SEC-implementing rules. Although the SEC may exempt persons from this law as it deems appropriate it has not done so to date.

In September 2005, a federal judge ruled that this Sarbanes Oxley provision does not give stockholders the right to sue former and current officers and directors of a company after a series of accounting restatements. The court's statements gave the impression that only the SEC (not even the company) has the right to pursue violations, but this remains to be determined.

### Officer and Director Bars and Penalties

Sarbanes Oxley lowered the standard for determining when a person is unfit to serve as an officer or director of a public company. The SEC will be able to, without court approval, issue an order in any cease and desist proceeding prohibiting any person who violated certain provisions of the Exchange Act or the Securities Act of 1933 from acting as an officer or director of a public company if the person's conduct demonstrates "unfitness" to serve in such positions. This important change, which became effective with the enactment Sarbanes Oxley, makes it easier to bar individuals from future positions in public companies.

### Whistleblower Protections

Sarbanes Oxley contained two separate provisions to protect individuals who assist in investigations from suffering retaliatory acts. They are both presently in effect. The first makes it a crime to take intentional retaliatory action against any person for providing to a law enforcement officer any truthful information related to the possible commission of any federal offense. The second prohibits any officer, employee, contractor, subcontractor or agent of a public company from taking any adverse actions against an employee because the employee provided information regarding or assisted with an investigation or proceeding for alleged violations of SEC rules or federal securities fraud laws. A civil damages remedy, including attorney's costs, is further provided for aggrieved employees.

### Other Provisions

Sarbanes Oxley contained several other provisions, which are discussed elsewhere below. These include:

- Requiring that the chief executive officer and chief financial officer certify the accuracy of periodic reports filed with the SEC;
- Accelerating the time by which certain filings under the Exchange Act must be made;
- Making it a crime to alter, destroy or conceal a document to impede an investigation or bankruptcy case;
- Allowing the SEC to freeze payments by a company to its executives if they are being investigated;
- Making penalties for fraud and securities law violations not dischargeable in bankruptcy; and
- Requiring the SEC to adopt a rule that requires current reporting of material events.

## LISTING REQUIREMENTS

On the heels of Sarbanes Oxley, the primary stock exchanges in the United States and Nasdaq adopted tougher listing requirements. In some cases, the requirements went beyond the demands of Sarbanes Oxley and the SEC's rules. The final requirements are summarized in this section.

Obviously, these new requirements apply only to companies that are listed. Most listed companies have their shares traded on either the New York Stock Exchange or the Nasdaq. There is another robust market called the OTCBB. Companies whose shares are listed on the OTCBB are not considered listed, and so that market can provide a refuge for companies that want to avoid the listing requirements of the NYSE or Nasdaq (or do not qualify for them) and are not troubled by the lack of prestige that comes from not being on a major exchange or Nasdaq. They must, however, to be traded on the OTCBB, have the class of securities registered under the Securities Exchange Act of 1934 and file reports with the SEC. Another alternative for a company that does not qualify for listing or desires to avoid listing requirements is to trade its shares on the Pink Sheets.

### New York Stock Exchange

The corporate governance aspects of the NYSE listing requirements are set forth below:

*Full Board of Directors*

A majority of all the directors on the full board must be independent (except in the case of "controlled" companies). In addition to an audit committee, the board is required to have compensation and nominating/corporate governance committees composed entirely of independent directors. For these purposes, the definition of independence is not as strict as the one that applies to members of the audit committee. In order for a director to be considered independent for purposes of the full board and these two committees, the board would be required to determine that the director has no material relationship with the listed company (either directly or as a partner, stockholder or officer of an organization that has a relationship with the company). In addition, a director cannot be considered "independent" for NYSE purposes if:

- the director is, or has been within the past three years, an employee of the company, or an immediate family member is, or has been within the past three years, an executive officer;
- during any 12 month period during the last three years, the director or an immediate family member has received more than $100,000 in direct compensation from the company (other than director and committee fees or deferred compensation for prior service);
- the director or an immediate family member is a current partner of a firm that is the company's auditor;
- the director is a current employee of the company's auditor;

- the director has an immediate family member who is a current employee of the company's auditor and who participates in the firm's audit, assurance or tax compliance practice;
- the director or an immediate family member was within the past three years (but is no longer) a partner or employee of the company's auditor and personally worked on the company's audit during that time;
- the director or an immediate family member is, or has been within the past three years, employed as an executive officer of another company where any of the company's executive at the same time served on such other company's compensation committee;
- the director is a current employee, or an immediate family member is a current executive officer of another company that has made payments or received payments in any of the last three fiscal years that exceed the greater of $1 million or 2% of such other company's consolidated gross revenues.

In making independence determinations, boards are required to consider all facts and circumstances relevant to determining whether a director is independent of company management, and technical compliance with the standards does not ensure that the independence requirements have been met. A board would be permitted to adopt bright line standards to assist it in making determinations of independence. For example, a board could determine that affiliation with a customer whose purchases account for less than a specified percentage of the company's revenues did not impair independence. All such standards would need to be disclosed in the annual proxy statement, and a company would be permitted to disclose that the independent directors meet the standards set by the board without detailing particular aspects of any immaterial relationships permitted by the standards. Any determination of independence for a director who does not meet such categorical standards would have to be specifically explained in the proxy statement.

In November 2005, NYSE filed proposed amendments to its corporate governance listing standards with the SEC for approval. The proposals affect disclosures related to director independence, in response to what the NYSE characterized as confusing disclosures in companies' proxy statements. NYSE proposed two alternatives for proper disclosure:

- A company's board determines that certain types of relationships are categorically immaterial and the company discloses these types of relationships in its proxy statement. No additional disclosure is required with respect to immaterial relationships. Boards are not permitted to determine that a related party transaction is immaterial.
- A company may disclose in its proxy statement that an independent director has no relationships with the company (other than as a director and/or a stockholder) or has only immaterial relationships. In the event of an immaterial relationship, the company would be required to disclose a specific description of the relationship and the reason why the board believes it is immaterial.

The NYSE proposals would require the disclosures in the proxy statement and would prohibit a summary of or an incorporation by reference to another document or a company's website.

Other NYSE proposed amendments involve, among other things, mandatory maintenance of a public website, written notification to NYSE if any executive officer becomes aware of any non-compliance with NYSE corporate governance listing standards (not just material non-compliance) and disclosures in annual reports to shareholders regarding CEO and CFO certifications.

*Audit Committees*

Companies are required to have an audit committee composed entirely of independent directors. For this purpose, "independent" means that a director is compliant with the general independence standards for all directors and with the SEC's more stringent rules applicable to audit committee members, as discussed above under "Standards for Audit Committees."

Audit committees must have a written charter, which must be posted on the company's website. A sample audit committee charter is included as Exhibit C. Among other things, the charter must address the audit committee's duties and responsibilities, such as reviewing all relationships between the auditing firm and the company and discussing with the independent auditor any audit problems or difficulties and management's response. The charter must also include a procedure for an annual performance evaluation of the audit committee.

*Nominating/Corporate Governance Committee*

Companies are required to have a nominating/corporate governance committee composed entirely of independent directors that are responsible for director and board committee nominations as well as developing and overseeing the corporate governance policies of the company. This committee is required to have a written charter that includes the purpose, goals and responsibilities of the committee and an annual performance review. The charter should describe the committee's criteria for selecting new directors and give the committee the sole authority to authorize search firms used to identify potential directors.

If a company is legally required by contract or otherwise to provide third parties with the ability to nominate directors, the selection and nomination of those directors need not be subject to the nominating committee process.

A sample nominating/corporate governance committee charter is included as Exhibit D.

*Compensation Committee*

Companies are required to have a compensation committee composed entirely of independent directors that are responsible for determining compensation for executive officers.

This committee is required to have a written charter that includes the purpose, goals and responsibilities of the committee and an annual performance review. With respect to CEO compensation, the compensation committee should, outside of the presence of the CEO, approve corporate goals and objectives, evaluate the CEO's performance based on those goals and objectives and approve the CEO's compensation based on this evaluative process. The committee should also make recommendations to the board with respect to non-CEO executive officer compensation and incentive compensation and equity-based plans that are subject to board approval.

The compensation committee is also responsible for submitting a report to be included in the company's proxy statement. Recognizing the increased attention on executive compensation in recent years, the SEC has indicated that it will be reviewing these reports carefully to determine whether the company is following the compensation committee's report and whether committee members participated in preparing the report. See also the discussion of the *In re The Walt Disney Co. Derivative Litigation* case under "Conducting Board Meetings" below.

A sample compensation committee charter is included as Exhibit E.

*Controlled Companies*

If a majority of the voting power of a listed company is held by an individual, group or entity, that company is not required to have a majority of independent directors on its full board and is not required to have a compensation or nominating/corporate governance committee. In order to utilize this exemption, the company is required to disclose in its proxy statement that it is a controlled company and the basis for that determination. In addition, the controlling individual, group or entity must file a Schedule 13D with the SEC. See "Reporting and Other Obligations of Stockholders and Insiders" below for additional information.

The NYSE's November 2005 proposed amendments to its corporate governance listing standards seek to 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, group or entity. A company would be required to have a majority of independent directors on its full board within one year from the date it ceases to be a controlled company and would be required to have at least one independent director on its compensation and nominating/corporate governance committee on the date it ceases to be a controlled company, a majority of independent directors on such committees within 90 days and fully independent committees within one year.

*Internal Audit Function*

Listed companies are required to have an internal audit function. This does not necessarily mean that a company is required to establish a separate internal audit department or dedicate employees to the task full-time. A company may have an appropriate control process for reviewing and approving its internal transactions and accounting and may outsource this function to a firm other than its independent auditor. This requirement obviously bolsters the Sarbanes Oxley requirement that a company's principal executive and financial officers review and report on disclosure controls and procedures and internal control over financial reporting.

*Stockholder Approval of Certain Actions Required*

The NYSE requires that all equity compensation plans and any material revisions to the terms of such plans (including repricing existing options) be subject to stockholder approval except for employment inducement awards, plans acquired in mergers or acquisitions and certain ERISA qualified benefit plans.

Also, stockholder approval is necessary (subject to certain exceptions) for issuances that are to a related party, amount (or could amount) to more than 20% of a company's outstanding stock or change (or could change) the control of the company.

*Corporate Governance Guidelines and Codes of Conduct*

The NYSE requires that a company adopt and disclose codes of conduct and corporate governance that between them address all the following subjects:

- Director qualification standards;
- Director responsibilities;
- Director access to management and independent advisors;
- Director compensation;
- New director orientation and continuing education for the board;
- Management succession;
- Annual self-evaluation by the board;
- Conflicts of interest;
- Corporate opportunities;
- Confidentiality;
- Fair dealing;
- Protection of company assets;
- Compliance with laws; and
- Encouraging the reporting of illegal or unethical behavior.

The NYSE's November 2005 proposed amendments to its corporate governance listing standards would require that any modification or waiver of any of the provisions be promptly disclosed to stockholders within four business days. Previously, the NYSE stated that two to three business days would constitute prompt notice to stockholders of a waiver. The change to four business days would align the NYSE's requirements with the SEC's Form 8-K filing timetable.

A sample form of "Corporate Governance Guidelines" is included as Exhibit F.

*CEO Certifications and Public Reprimands*

A listed company's CEO is required to certify to the NYSE each year that the company has not violated any of the NYSE corporate governance listing standards. The NYSE has proposed as part of its November 2005 amendments that, unlike the CEO/CFO certifications required to be filed with the SEC regarding the quality of the company's public disclosure (discussed below), the NYSE certification would no longer have to be disclosed in the listed company's annual report. In addition to the NYSE's ability to enforce its standards by delisting non-compliant companies, the NYSE is authorized to issue a public reprimand letter to any listed company that violates a listing standard.

## Nasdaq

The corporate governance aspects of the Nasdaq listing requirements are set forth below:

*Full Board of Directors*

Under the Nasdaq rules, a majority of the entire board must be independent. For this purpose, independence means a person who is not an employee of the company and does not have a relationship that would in the opinion of the board interfere with the exercise of independent judgment. The following persons are not independent:

- one who was an employee, or who had a family member who was an executive officer, of the company during the last three years;
- one, or a family member of one, who received more than $60,000 from the company in any of the past three years other than as compensation for board service (but family members of employees are not disqualified so long as the employee is not an executive officer);
- a partner, controlling stockholder or executive officer of any organization that received payments from the company in any of the last three years exceeding the greater of five percent of the organization's revenues or $200,000;
- a director of a company who is an executive officer of another company if, during the last three years, any executive officer of the company has served on the compensation committee of the other company; or
- an employee or partner of the company's auditor during the last three years.

The full board is required to make a finding of whether or not the individual directors are independent.

*Audit Committee*

The Nasdaq rules require the audit committee to have at least three members, all of whom are independent under the requirements applicable to all directors and the special SEC requirements applicable to members of the audit committee, as described above under "Standards for Audit Committees."

*Nominating and Compensation Committees*

Nominating and compensation committees composed entirely of independent directors are not required, but if they do not exist then a majority of the independent directors must nominate new directors and review the compensation of the CEO.

*Controlled Companies*

The independence requirements for the full board do not apply to companies with a controlling stockholder or group of stockholders, but the audit committee provisions do apply fully.

*Stockholder Approval of Certain Actions Required*

The Nasdaq rules generally contain the same stockholder approval provisions as for the NYSE, as described above.

### Going Dark or Going Private

In response to the increased obligations of public companies post-Sarbanes Oxley and the associated costs of compliance, a number of companies have contemplated "going dark" or "going private." Going dark generally means that a company that meets certain requirements discussed below files a Form 15 with the SEC stating that it will no longer comply with reporting requirements. The shares of the company may still be traded on the Pink Sheets but not on any exchange or Nasdaq or on the OTCBB. Going private, in contrast, means that a group or individual buys all outstanding shares of a company so that the shares are no longer publicly held or traded.

A company thinking about going dark must first determine whether it qualifies to do so. Depending on the circumstances, the company must have fewer than 300 (or 500 if total assets have not exceeded $10 million) shareholders "of record" – which would be street name holders such as brokers as opposed to beneficial owners. Once the SEC declares the Form 15 effective, a company's Exchange Act reporting obligations are suspended. The company would again be subject to the Exchange Act if, at the beginning of any subsequent fiscal year, the company has either (a) 300 or more stockholders of record and more than $10 million total assets at the end of at least one of the three preceding fiscal years or (b) 500 or more stockholders of record. Concerns related to the number of stockholders often arise because of the possibility of a "broker kick-out" in which a broker (who counts as one stockholder of record) decides to transfer the shares held by it into multiple street or nominee names. When this occurs, the stockholders of record for the company may increase dramatically and end the company's suspension of its Exchange Act obligations.

Like going dark transactions, which require the filing of a Form 15 with the SEC, companies desiring to go private must also make filings with the SEC depending on the structure chosen by the company to implement the going private transaction.

The board of directors and management of a company considering going dark or going private must be mindful of its fiduciary duties under applicable state law. Going dark necessarily means that less information will be publicly available to stockholders, which may involve litigation risks. Going private means that a per share purchase price needs to be established to buy the outstanding shares. A company should ensure that the price being paid to its stockholders is fair. Furthermore, because management may be members of the group buying the outstanding shares of the company going private, directors and officers must be careful to avoid improper conflicts of interest.

### Conducting Board Meetings

Under the NYSE requirements, non-management directors are required to hold regularly scheduled "executive sessions" without management and independent directors are required to meet at least once a year without non-independent directors. The NYSE's November 2005 proposals would permit companies to hold regular executive sessions of independent directors only instead of non-management director meetings. Either a single presiding director for these executive sessions needs to be designated and disclosed in the company's proxy statement, or the procedure by which he or she is designated must be so disclosed. NYSE listed companies are required to disclose a method for "interested parties" to communicate directly with the presiding director or with the non-management directors as a group. This policy should be established with the involvement of the company's audit committee, include the receipt, retention and treatment of complaints regarding accounting, internal accounting controls or auditing matters and permit confidential and anonymous submissions by employees regarding questionable accounting or auditing matters (although this provision allowing anonymity conflicts with EU laws and rules, as noted above under "Standards for Audit Committees"). The Nasdaq rules contain a similar, though more general, provision. Under the Nasdaq rules, independent directors are required to meet in executive session at least twice a year. While the additional requirements of the NYSE are not included in the Nasdaq policy, companies should give strong consideration to adopting them as part of their governance and internal controls. There are other measures concerning board meetings that should be adopted by companies as well.

Aside from the laws and requirements adopted by Congress or adopted by the exchanges within the past few years, there must be a change of attitude on the part of directors of public companies. The great public outcry and adverse press that followed the Enron and other debacles should impress upon directors the importance of their roles and should result in a change in the way directors' meetings are conducted.

Part of the criticism surrounding the Enron collapse was directed at the meetings of the directors of that company. The shortness of these meetings and the limited nature of the directors' probing into the affairs of the company were said by many to be proof that the directors had failed to satisfy their fiduciary duties. There is now a feeling that directors must play a more active role in overseeing management and must take more care to ensure that the disasters seen in 2002 are not repeated.

A common practice for U.S. public companies holding directors' meetings in the past had been for directors to travel to the city in which the company is located the night before a meeting and to gather the next morning for a few hours to discuss a limited agenda with directors eager to get back to the airport in time to get back home that day. Now and in the future, directors must do things differently.

Committees (especially the audit committee with its expanded role as described above) should meet the day before the meeting of the full board and be prepared to work into the evening if necessary to prepare for the full meeting. The agenda for the full meeting should be expanded, and the directors' review of matters should be more in-depth. Any discussion of issues should be fully and thoroughly documented.

Thought should also be given to annual or semi-annual retreats for directors and senior management. During these two or three-day affairs, there could be a full review of the company's financial statements, policies and long and short-term strategies. A good time for a retreat would be after a company's annual financial statements are available but before they are required to be filed with the SEC. A retreat would also give the directors a chance to get better acquainted with senior management.

There has been a renewed interest in the responsibilities of boards of directors, especially in the context of executive compensation, as a result of the litigation *In re The Walt Disney Co. Derivative Litigation*. In *Disney*, shareholders of the company alleged that the board breached its fiduciary duties when it approved an employment agreement with former President Michael Ovitz and allowed CEO Michael Eisner to terminate Ovitz without cause, triggering a severance package worth almost $140 million.

Ovitz's employment agreement was negotiated by Eisner without much involvement of the directors. Only after the parties had agreed on the key terms did the compensation committee of the board meet to discuss the agreement. The committee met for about one hour and approved the agreement, even though the committee members had limited information. The agreement was then submitted and approved by the full board of directors.

Although the court indicated that the directors were negligent in the performance of their duties, it determined that the directors were not "grossly negligent" and therefore, protected under the "business judgment rule." This rule provides that directors who make business decisions based on reasonably adequate information will be protected if they believe, in good faith, that their decisions are in the best interests of the company and its shareholders. The court relied on evidence showing that the directors relied on outside experts and made some effort to inform themselves to conclude that the Disney directors acted in good faith and had reasonably adequate information when they made their decisions.

The court was critical of the Disney directors even though it did not find them liable. To provide additional guidance for companies, the court included some suggestions regarding decission-making processes. In particular, the *Disney* court suggested that:

- management communicate effectively with the board;
- the board provide the appropriate authorization for management to act;
- the board hold formal meetings to actively discuss matters of importance to the company, and not rely on casual conversations to obtain critical information;
- directors receive materials to be discussed at meetings well in advance to facilitate careful consideration of matters; and
- compensation committees retain their own outside experts to help understand the compensation to be paid to management.

## DISCLOSING NON-PUBLIC INFORMATION

In October 2000, Regulation FD became effective and changed dramatically the way in which a company must disseminate information about itself. Regulation FD was intended to place small investors on a level playing field with market professionals by proscribing selective disclosure.

### The Pre-Regulation FD Framework

Before Regulation FD, the federal securities laws had been interpreted by the U.S. Supreme Court, in a case involving the well-known analyst Raymond Dirks, as permitting a company under certain circumstances to disclose material, non-public information to analysts and other market professionals even if they then recommended trading to their customers. The Court's reasoning was based upon the role that it concluded analysts played in discovering unknown information about companies and making it public. The Court viewed this role as important to achieving the public dissemination of information about companies.

The SEC, however, believed that this informational disparity eroded investor confidence and impugned the integrity of the public securities markets. It was also perceived by some that the dependence on non-public information from companies made analysts too cozy with the companies' management, causing analysts to refrain from making negative comments that should have been made in their reports in order to avoid being cut off from the flow of this information.

Thus, the SEC adopted Regulation FD in order to negate the perceptions that small investors were at an unfair disadvantage to market professionals, and that analysts' reports were less than candid.

### Regulation FD Framework

Under Regulation FD, a company is required to disclose information broadly to the public at the same time as it is intentionally conveyed to a market professional or a stockholder. Communications to the following persons are covered by Regulation FD and they are referred to as "covered persons":

- brokers, dealers and analysts,
- investment advisors and investment companies,
- stockholders of the company if it is reasonably foreseeable that they will trade on the basis of the information, and
- in each case the persons associated with them.

The conveyance will be considered intentional if the person making it knows or should know that the information is material and non-public.

Persons to whom selective disclosure may be made without disseminating the information widely include:

- members of the media,
- those who owe a duty of trust or confidence to the company (such as employees, lawyers and accountants) even if they are also stockholders,
- those who agree (orally or in writing) to keep it confidential,
- credit rating agencies, and
- those who receive a communication in connection with a public offering (usually at a "road show" to promote the offering) because the Securities Act already contains provisions governing these communications.

Public dissemination of information must occur before or concurrently with its intentional disclosure to a covered person. In the case of an inadvertent disclosure, public dissemination may occur within 24 hours or before the commencement of the next day's trading on the NYSE, whichever is later following a senior official's learning of the inadvertent disclosure. Information is deemed by the SEC to have been publicly disseminated if it is contained in a Current Report on Form 8-K (see the discussion of a company's obligations to file that form below for an analysis of using Item 7.01 or Item 8.01). A press release that is picked up and published by the wire services or a webcast or conference call that is publicly accessible will also suffice for public dissemination for purposes of Regulation FD so long as in the case of a webcast or conference call reasonable notice of the event is given by issuing a press release or filing a Form 8-K. What constitutes reasonable notice depends upon particular facts and circumstances. For a quarterly earnings announcement that a company makes on a regular basis, notice of several days would be reasonable. When unexpected events occur and the information is critical or time sensitive, the period of notice may be shorter. Merely posting information on a website without more does not constitute public dissemination. A stockholders' meeting is not public merely because it is open to the public, so news announced there is not publicly disseminated unless there is a properly noticed public broadcast of the meeting, such as by internet webcast.

For its part, the NYSE believes that a press release is the best means for releasing information and so is less flexible as to the form of public disclosure. Its timely disclosure policy requires that a press release be issued to disclose information or to announce a conference call or webcast at which news is to be announced. A Form 8-K filing, which would otherwise satisfy Regulation FD for this purpose, will not satisfy the NYSE policy. If the information is to be released during market hours, the policy requires that the NYSE be given ten minutes' notice of it in order to determine whether to halt trading pending its full dissemination. In contrast, the Nasdaq recognizes all Regulation FD compliant methods of disclosure including Forms 8-K and broadly disseminated press releases and, provided the public is given notice of and access to them, conference calls, press conferences and webcasts. Like the NYSE, Nasdaq requires advance notice of announcements.

Regulation FD only requires the public dissemination of news that is material to a company. Selective disclosure of immaterial information is not prohibited. Regulation FD does not define materiality, but instead relies upon current judicial formulations. In general, these hold that information is material:

- if it would be viewed by a reasonable investor as changing the total mix of information available, or
- if it is reasonably certain to have a substantial effect on the market price of the company's securities, or
- if there is a substantial likelihood that a reasonable person would consider it important in deciding whether to buy or sell a companies' securities.

Categories of information that are likely to be material and therefore warrant special attention include:

- Earnings information, including historical reports or forecasts, whether favorable or unfavorable (the SEC regards any selective disclosure about earnings as a violation of Regulation FD, including that earnings will be higher than, lower than or even the same as what analysts have been forecasting or the company has predicted; in addition, it might now be a violation of the obligation to file a Form 8-K, as described below),
- Acquisitions or dispositions of assets or businesses and joint ventures,
- Developments regarding significant customer orders or backlog or arrangements with suppliers,
- Changes of control,
- Changes in auditors, and
- Defaults on or redemptions or repurchases of, or changes to the rights of holders of, outstanding securities, or issuances of additional securities.

### Practices and Practical Considerations to Comply with Regulation FD

In order to comply with Regulation FD, a company should take the following measures:

1. Develop a written disclosure policy encompassing the company's practices. This policy should reflect the company's disclosure culture. It should be a statement of what to do in the face of issues that arise that are affected by Regulation FD. An example of a policy may be found at Exhibit G.
2. Limit the number of persons authorized to speak to persons covered by Regulation FD and inform other persons that they are not to speak to analysts or other covered persons except when authorized to do so.
3. Issue earnings guidance each quarter by press release (accompanied by an Item 2.02 Form 8-K filing of the text of the press release) which also gives at least five business

days' notice of a webcast conference call that is fully accessible and non-exclusionary. In the press release and in the call, disclaim any obligation to update the material presented. If the material changes materially, however, the company should issue an update. Other than these releases and calls, refuse to comment on earnings.

4. Refuse to review analysts' earnings forecasts other than for the purpose of correcting factual inaccuracies. In any review, do not correct a forecast in such a way as to reveal any non-public information and take care to avoid becoming entangled with or being deemed to have adopted the forecast by changing it too extensively or by becoming publicly associated with it.

5. Take special care if one-on-one meetings with covered persons are held. If these meetings are held, focus discussions exclusively on non-earnings related information such as: long-term strategy, missions, goals, management philosophy in running the company, strength and depth of management, general business trends, competitive advantages and disadvantages and previously disclosed information. Someone completely familiar with the company's disclosure record must attend these meetings to interrupt if questions could elicit a material disclosure or to determine if an inadvertent material disclosure was made so it can be publicly released promptly.

6. Limit the remarks of company officials at broker or industry sponsored or other conferences to the information that can be discussed at a one-on-one meeting as set forth in 5 above, or disseminate the presentation script and slides to be used at the conference publicly. Any such presentation should be carefully scripted and the presenter must be careful to stay within the bounds of the script.

7. Protect any forward-looking information that is disclosed to the public by satisfying the requirements for the safe harbor from litigation contained in Section 21E of the Exchange Act. Clearly identify all forward-looking statements, state that actual results may vary from the forecasts and set forth in detail the reasons that a variance may occur. Avoid merely reciting boilerplate risk factors in describing the possible reasons for a variation; use plain and clear cautionary language.

8. Disclaim any duty to update any forward-looking statements because of new developments or otherwise.

9. Use written non-disclosure agreements with persons who for business or other reasons are given non-public information. These agreements should also prohibit trading in the company's securities until the information is made public.

10. Comply with the rules, described above, regarding the disclosure of non-GAAP financial measures.

11. Post the company's Regulation FD disclosure policies on its web site. A sample posting is included as Exhibit H.

## The Consequences of Violating Regulation FD

Failure to make public disclosure required by Regulation FD cannot in and of itself be a violation of Rule 10b-5. There is no private right of action under Regulation FD; only the SEC may bring an action in the event of its violation.

On November 25, 2002, the SEC announced its first enforcement actions for violations of Regulation FD. The SEC imposed cease-and-desist orders on Raytheon Company and its CFO, Siebel Systems, Inc., and Secure Computing Corporation and its CEO. The SEC also fined Siebel $250,000. The SEC issued an investigation report that addressed conduct by Motorola, Inc., but did not take formal action against Motorola.

Subsequent to these enforcement actions, the SEC has continued to be somewhat aggressive in holding companies and management accountable for Regulation FD violations. A summary of a few cases are set forth below.

*Raytheon Company: Improper Disclosures of Earnings Guidance to Analysts*

In February 2001, Raytheon held an investor conference call available to the public by webcast, during which Raytheon reiterated the company's annual earnings guidance but did not provide quarter-to-quarter guidance. Following the call, analysts that covered Raytheon projected first quarter earnings for it that were higher than its own internal estimates. Raytheon's CFO reviewed these forecasts and then initiated one-on-one calls with 11 analysts. Although Raytheon had not publicly provided first quarter earnings guidance, the CFO told the analysts that:

- the company's seasonal distribution of earnings in 2001 would likely be the same as the distribution in 2000, and
- only one-third of the company's earnings would be generated in the first half of the year.

The CFO specifically told a few analysts that their first quarter estimates were too high or too aggressive. All the analysts contacted by the CFO lowered their first quarter and second quarter estimates and increased their estimates for the second half of the year. Those analysts not contacted by the CFO did not revise their first quarter forecasts.

The SEC considered these disclosures to be material, taking into account that:

- the topic was earnings guidance,
- the CFO communicated with individual analysts, and
- the 11 analysts contacted by the CFO reacted consistently to the disclosures.

Since the disclosures were material and were made selectively to covered persons, the SEC concluded that Raytheon and its CFO had violated Regulation FD. The lessons to be learned from Raytheon include:

- Selective disclosure of any earnings guidance information is a recipe for violating Regulation FD.
- Do not review analysts' forecasts other than to correct factual inaccuracies. If forecasts are reviewed, do not correct them if doing so will reveal non-public information.

*Flowserve Corporation: Reaffirmation of Earnings Guidance Should Not be Done Privately and Unintentional May Not be What it Seems*

On March 24, 2005, the SEC issued a cease and desist order against Flowserve, its CEO and its director of investor relations for Regulation FD violations. Flowserve and its CEO also entered into settlements with the SEC that involved the payment of civil penalties.

Like many companies, in 2002, Flowserve forecasted its annual earnings per share. After twice lowering its guidance, in October 2002, Flowserve publicly reaffirmed its earnings estimate in its third quarter Form 10-Q filing with the SEC. Approximately one month later, and about six weeks before the end of the fiscal year, the company's CEO and investor relations officer met with a group of analysts during which Flowserve reconfirmed its earnings guidance. The next day, one of the analysts issued a report available to subscribers stating that Flowserve had reconfirmed its earnings guidance. The following day, after a rise in its stock price and the markets had closed, Flowserve filed a Form 8-K publicly disclosing the reaffirmation.

The Flowserve case illustrates that reconfirmation of earnings guidance may constitute material non-public information depending on the circumstances (such as the amount of time between the original forecast and the reaffirmation). The SEC also stated that a company's investor relations officer must be actively involved in Regulation FD compliance matters. The Flowserve IR officer did not make any statements relating to the reaffirmation of earnings guidance, but the SEC took the view that he violated Regulation FD by failing to stop the CEO from making such statements or taking subsequent action to remedy the situation. In addition, the SEC took the position that the company officials should have known that they were providing material non-public information and therefore the disclosure was intentional and not to be corrected by the subsequent filing.

*Siebel Systems, Inc.: The Perils of the Invitation-Only Investor Conference*

During Siebel's public earnings call on October 17, 2001, its CEO stated that the market for information technology products had been soft and was expected to remain so through the end of 2001. On November 5, 2001, the CEO participated in an invitation-only technology conference that Goldman Sachs organized for investment professionals and institutional stockholders. A Goldman Sachs representative told Siebel's director of Investor Relations before the conference that a stockholder who held a significant short position in the company's stock would be attending the conference and might purchase stock to establish a long position. Goldman Sachs also provided Siebel with a list of questions that its analyst planned to ask the CEO. This list included a question about whether the software market was improving or getting worse. Siebel's IR director prepared a talking points list for the CEO so that he would not disclose material non-public information at the conference. This list did not contain a response to the analyst's question regarding the current state of the software market.

By the time of the November 5 Goldman Sachs conference, Siebel's sales were improving and the CEO knew this. At the conference the CEO stated that he was "optimistic" and "seeing a return to normal behavior in IT buying patterns" when asked about the current state of the software market. The CEO mistakenly believed that the conference was being webcast. The company did not disclose the CEO's statements via press release or Form 8-K, even though the IR director knew that the conference had not been webcast.

Siebel's stock price and trading volume increased significantly during the conference and rose even more by the time the CEO's statements reached the media later that day. Attendees of the conference traded in the company's stock immediately following the CEO's presentation, and Goldman Sachs was the most active firm trading the stock on the day of the conference.

According to the SEC, Siebel violated Regulation FD because the conference was not open to the public and the disclosures made by the CEO at the conference were material. The SEC determined that the disclosures were material because:

- the disclosures related to trends in the company's business,
- the disclosures contrasted sharply with the public statements made on the company's earnings call, and
- the new disclosures appeared to have prompted trading by attendees at the conference.

The lessons to be learned from Siebel include:

- prior to any non-public conference, new information about material trends should be disclosed on a Form 8-K or in a press release,
- arrange for (and pre-announce) a webcast of the company's presentation at the conference, or
- create a carefully worded script that answers anticipated questions in a way that will not disclose material non-public information or notes and directs the speaker to decline to answer troublesome questions.

*Siebel Systems, Inc. Part II: Clarification on What Constitutes Material Non-Public Information*

On June 29, 2004, the SEC announced that it was charging Siebel again with violations of Regulation FD, Exchange Act Rule 13a-15 and the November 2002 SEC cease and desist order issued in connection with the first Siebel case described above. In addition, the SEC charged

Siebel with violating the books and records provisions of the Exchange Act for failure to file the Regulation FD required Form 8-K. The SEC also charged Siebel's CEO and its IR director with aiding and abetting Siebel's violations.

The SEC alleged that Siebel's CEO made selective disclosures at private meetings with industry professionals and investors that differed materially from disclosures made to the public. The public disclosures stated that deals in the company's pipeline had slipped and that the lagging economy contributed to Siebel's disappointing first quarter 2003 results. The SEC alleged that in private, however, Siebel's CEO stated that new deals were coming back into the pipeline and that the business outlook had improved even though, the SEC alleged, the CEO and the IR director knew about the differing public statements.

Several institutional investors who were present at the private meetings began purchasing Siebel stock, causing it to increase in trading volume and in price. The SEC charged that Siebel should have filed a Form 8-K or used some other Regulation FD method to disseminate the information the CEO covered during the private meetings. In particular, the SEC appeared disturbed that despite its earlier cease and desist order, Siebel had continued to selectively disclose material information and did not have any formal policy on Regulation FD compliance.

In September 2005, a federal judge dismissed the SEC's complaint in its entirety. The court stated Regulation FD does not require companies to repeat prior public disclosures word for word and that "nit-picking should not become the name of the game." Although it found that there were differences between Siebel's public and private statements, the court held that all statements were substantially consistent. Because there was no disclosure of material non-public information by Siebel during the private meetings, the court held that there was no Regulation FD violation.

Even though the court in *Siebel II* disagreed with the SEC's interpretation of what constitutes material non-public information, the basic rule of Regulation FD – that material non-public information cannot be selectively disclosed – was not altered.

*Secure Computing Corporation: "Prompt" Disclosure of Unintentional Disclosure Means "Same Day"*

The SEC brought an action against Secure Computing and its CEO after the CEO made disclosures about a significant new contract in two one-on-one calls. First, in a March 6, 2002 conference call, the CEO of Secure Computing disclosed to a portfolio manager at an investment advisory firm and a salesperson at a brokerage firm that the company had entered into a significant original equipment manufacturing agreement. The CEO mistakenly believed that Secure Computing had publicly disclosed the existence of the OEM agreement. The company's IR director later advised the CEO that the existence of the OEM agreement was not public information. Secure Computing's trading volume and stock price rose significantly following the selective disclosure of the existence of the contract.

Second, on March 7, even as Secure Computing prepared a press release, the CEO again disclosed the existence of the OEM agreement to another portfolio manager. The company issued the press release three hours later, following market close. The company's stock price and trading volume increased throughout that day.

The SEC concluded that the first disclosure of the OEM agreement's existence was not intentional. Regulation FD requires a company to make *prompt* public disclosure of material non-public information where the selective disclosure of that information was *unintentional* (but not later than 24 hours on the commencement of the next day's trading on the New York Stock Exchange). If Secure Computing had issued a press release on March 6 soon after the disclosure, it presumably would not have been subject to an SEC enforcement action. However, the SEC concluded that the CEO's March 7 disclosure was an intentional disclosure that violated Regulation FD as the CEO made the disclosure knowing that the information was non-public and before the company had issued the press release. In the case of *intentional* selective disclosure of material non-public information, Regulation FD requires a company to disclose the information publicly *prior to or simultaneous with* the selective disclosure. Because Secure Computing's press release was issued three hours after the alleged intentional March 7 disclosure of the agreement, the SEC concluded that the company had violated Regulation FD. See also *Flowserve* described above. The lessons to be learned from Secure Computing include:

- Make prompt "same day" public disclosure if material non-public information is unintentionally disclosed.
- Publicly disclose material non-public information prior to or simultaneous with intentional selective disclosure.

*Motorola, Inc.: The Benefits of Good Faith*

In February 2001, Motorola stated publicly that the company's first quarter sales and orders were experiencing "significant weakness" and that it likely would not achieve its earnings estimates. Following this disclosure, the company reviewed analysts' forecasts and research notes and concluded that the analysts did not fully appreciate just how bad the first quarter results would be. The company's IR director asked inside legal counsel whether he could contact analysts in private telephone calls and quantify the company's earlier statement. Counsel determined that the investing public already understood the term "significant" and that, in any event, providing a quantitative definition of the term "significant" was not material. Counsel therefore advised the IR director that he could make the calls. The IR director then placed a series of one-on-one telephone calls in March 2001 to analysts and clarified that "significant weakness" meant that the company's sales and orders would drop by at least 25 percent. Motorola's stock price dropped by more than 15 percent, and trading volume in Motorola's stock increased significantly at the firms contacted by the IR director.

The SEC determined that the information provided by the IR director was both material and not generally understood by the investing public, and that Motorola's inside counsel had given incorrect advice. However, the SEC declined to take formal action against Motorola because the company sought and relied upon legal advice before making the selective disclosure. The SEC noted that the legal advice, although erroneous, was given in good faith. It indicated, however that this may not protect companies in the future. The lessons to be learned from Motorola include:

- Seek advice and proceed thoughtfully when making a decision on disclosing non-public information that could be material.
- Be wary of concluding that anything is not material, particularly any information that has to do with earnings, which will almost always be material.

*Schering-Plough Corporation: Information Advantages for Selected Analysts are Prohibited*

In September 2003, the SEC announced that it had entered into a settlement with Schering-Plough and its former chairman and CEO relating to Regulation FD violations. Schering-Plough agreed to pay a $1 million civil penalty and the CEO paid $50,000. The SEC also issued cease and desist orders against both the company and the CEO.

The SEC found that in September 2002, Schering-Plough's CEO and senior vice president of investor relations met privately with four institutional investors, three of which were among the company's largest shareholders. During the meetings, the CEO, "through a combination of spoken language, tone, emphasis, and demeanor," disclosed material non-public information related to the company's third quarter earnings, as well as earnings for 2003. After the meetings, the investors sold off their shares of Schering-Plough, which contributed to a 17% decline in the company's stock price.

Thereafter, on October 3, 2002, the CEO met privately with certain analysts and portfolio managers and again disclosed that the company's 2003 earnings would be "terrible." Later that same day, the company issued a press release providing earnings guidance that was materially below expectations.

The Schering-Plough enforcement action reaffirmed that the SEC will not permit selective disclosure of material non-public information to analysts or institutional investors. The action is also notable because the SEC used both verbal and nonverbal disclosures made by the CEO to demonstrate Regulation FD violations.

## PERIODIC AND CURRENT REPORTING

The Securities Exchange Act of 1934 requires that public companies disclose information about themselves so that investors can evaluate their securities. Public companies must file reports with the SEC that contain certain prescribed information at prescribed intervals. The mere occurrence of an event, even if it is material, does not necessarily require that it be disclosed. Instead, the event must be described in the next periodic or current report due to be filed. An exception to this rule applies if a company has a history of always disclosing events of a certain nature that creates a market expectation, in which case it may become obligated to continue that tradition unless it announces that it will no longer do so. Also, if a company discloses information that turns out to have been incorrect when disclosed, it should immediately announce a correction.

Listing standards of the stock exchanges and Nasdaq have been more demanding than the law in this area. These standards have long required a company to disclose the occurrence of a material event immediately even if no report is then required to be filed by the Exchange Act. But these standards contain a loophole that excuses disclosure in cases where a company believes that it would harm its business or prospects, and listed companies that have wished to avoid disclosing something have often relied upon this ready and flexible exception. Moreover, listing standards are not laws and have never been viewed with the same deference.

Before 2002, there were only a handful of events that would trigger a disclosure obligation under SEC rules before a company's next quarterly or annual report (assuming the company was not offering its securities at the time). A fundamental change in this system was commenced in 2002 by Sarbanes Oxley, which required the SEC to adopt a rule triggering current reporting of material events as they occur. Effective August 23, 2004, the SEC implemented new rules that resulted in the obligation to disclose a wide array of material events on a current basis.

Public companies are required to file periodic reports with the SEC. These reports include: Form 10-K, an annual report containing audited financial statements; and Form 10-Q, a quarterly report containing unaudited financial statements. In addition, they must file with the SEC current reports on Form 8-K, a report that is required to be filed upon the occurrence of a certain enumerated events and that a company may elect to file to make voluntary disclosures. Historically, the SEC paid little attention to reports filed under the Exchange Act. These reports were seldom reviewed, and any examination of a company's Exchange Act reports that did occur was almost always in connection with the review of a registration statement filed by that company under the Securities Act. Sarbanes Oxley changed this practice, however, by requiring the SEC to review the Exchange Act reports of public companies regularly and systematically. Sarbanes Oxley requires the SEC to review the Exchange Act reports of all public companies at least once every three years. Thus, companies clearly can expect their reports to receive more attention in the future than they have in the past, even if the extent of attention is unclear, and should budget more time and effort for their preparation.

## Annual Report on Form 10-K

Form 10-K is an annual report that discloses comprehensive information about a company. Historically, Form 10-K has been due 90 calendar days after the end of the company's fiscal year. To provide investors with information on an accelerated timetable, the SEC changed this deadline for some companies. Companies that have a $75 million public float, that have been subject to the Exchange Act's reporting requirements for at least one year and that have filed at least one Form 10-K are generally considered "accelerated filers" by the SEC. Currently, accelerated filers with a public float of $700 million or more (so-called "large accelerated filers") must file their Form 10-K 75 days after year end. For fiscal years ending on or after December 15, 2006, the filing deadline for large accelerated filers will be 60 days. Accelerated filers with a public float between $75 million and $700 million will continue to have a 75 day filing deadline. For non-accelerated filers, the filing deadline is 90 days after year end. If the due date is not a business day, the report is due on the next business day. There is no fee required to file a Form 10-K.

Form 10-K must include audited balance sheet information for the company's last two year-ends and audited income statement information for the last three years. It must also provide a narrative description of the company's business, properties, management, principal stockholders, remuneration of management, certain market information and stockholder information, transactions between the registrant and management or principal stockholders, and other material events including pending legal proceedings. Form 10-K must also include a narrative analysis of the company's liquidity, capital resources and results of operations and such other information that the company believes necessary to an understanding of its financial condition, changes in financial condition, results of operations and sources and uses of capital. This discussion should permit readers to view the company "through the eyes of management." In addition, the company is required to disclose any noncompliance by insiders with respect to their reporting obligations under Section 16(a) of the Exchange Act.

For fiscal years ending on or after December 31, 2005, all companies must also include in their Form 10-K significant risk factors applicable to the company. In addition, if an accelerated filer or "well known seasoned issuer" (as described below) has received written comments from the SEC to its periodic or current reports under the Exchange Act and such comments were issued more than 180 days before the end of the fiscal year to which the Form 10-K relates, any unresolved and material comments must be disclosed. The company's position with respect to such comments may also be included. A "well known seasoned issuer" is generally a company that has been timely filing its period reports under the Exchange Act and either has a $700 million public float or has issued $1 billion in non-convertible securities (other than common equity) in registered offerings for cash in the preceding three years.

There are optional provisions for the integration of the Form 10-K with the Annual Report to Stockholders. In order to take advantage of such integration provisions, the Annual Report to Stockholders must be mailed to stockholders and filed with the SEC prior to the filing of the Form 10-K. If the Form 10-K is integrated with the Annual Report to Stockholders, then disclosures included in the Annual Report to Stockholders, including the audited financial statements, may be omitted from the Form 10-K. In addition, certain information about management and directors, large shareholders and audit fees may also be omitted if it is included in a proxy statement that is sent to stockholders within 120 days after year end.

The Form 10-K must be signed by the company and by its principal executive officer, principal financial officer, principal accounting officer and a majority of its directors. Accordingly, it is important that officers and directors be given the opportunity to review the document and to make revisions prior to its filing on EDGAR. All directors have liability for the Form 10-K's accuracy, so all directors, not only those who intend to sign, should review it before filing. In addition to being signed, the Form 10-K must be certified by the company's principal executive and financial officers as described below as required by Sarbanes Oxley.

### Quarterly Report on Form 10-Q

Form 10-Q is a quarterly report containing unaudited financial statements, a discussion of the company's quarterly financial results and certain other information. Events such as commencement of significant litigation, votes of stockholders, securities repurchases or sales of securities without registration, which occur during the quarter, must also be reported on Form 10-Q. Companies must include in their Form 10-Q any material changes to the risk factors previously disclosed in their Form 10-K. Historically, the report has been due 45 calendar days after the end of each of the first three fiscal quarters. However, large accelerated filers and accelerated filers have filing deadlines of 40 days after quarter end. Non-accelerated filers continue to have a 45 day filing deadline. There is no filing fee for a Form 10-Q filing.

Form 10-Q must be signed by the principal financial or chief accounting officer of the company. The financial nature of Form 10-Q usually dictates that its initial draft be prepared by the company and its accountants. In addition to being signed, Form 10-Q must be certified by the company's principal executive and financial officer as described below as required by Sarbanes Oxley.

### Certification of Annual and Quarterly Reports

Two of the most celebrated provisions of Sarbanes Oxley require that a company's top officers provide certifications for its annual and quarterly reports. While the two provisions require certifications that are similar in substance, one is a criminal provision which falls under the jurisdiction of the Department of Justice and the other is civil which is administered by the SEC. The civil certification is required to be filed in the report, while the criminal certification is merely required to "accompany" the report. In practice, both are attached as exhibits. All annual and quarterly reports must have both certifications, each of which must be signed by the company's chief executive officer and its chief financial officer.

The SEC has amended Forms 10-Q and 10-K to include the exact form of civil certification required. It requires that the chief executive officer and chief financial officer each certify that:

- he has reviewed the report;

- based on his 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,
- based on his 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 issuer as of, and for, the periods presented in the report;
- he:
  - is responsible for establishing and maintaining "disclosure controls and procedures" and "internal control over financial reporting";
  - has designed such disclosure controls and procedures to ensure that material information is made known to him particularly during the period in which the periodic report is being prepared;
  - has designed such internal control 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 generally accepted accounting principles;
  - has evaluated the effectiveness of the issuer's disclosure controls and procedures as of a date within 90 days prior to the filing date of the report; and
  - has presented in the report his conclusions about the effectiveness of the disclosure controls and procedures based on the required evaluation as of that date;
- he has disclosed to the company's auditors and to the audit committee of the board of directors (or persons fulfilling the equivalent function):
  - 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 has identified for the company's 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; and
- he has disclosed in the report any change in internal control over financial reporting that has materially affected or is reasonably likely to materially affect the company's internal control over financial reporting.

As discussed above in "Requirement for Disclosure Controls and Procedures and Internal Control Over Financial Reporting," the date for non-accelerated filers to comply with the requirements related to internal control over financial reporting has been extended to fiscal years ending on or after July 15, 2007.

The criminal certification dictated by Sarbanes Oxley requires that each Form 10-K and 10-Q be accompanied by a written statement of the chief executive and chief financial officers to the effect that:

- the report fully complies with the requirements of the Exchange Act, and that
- the information contained in the report fairly presents, in all material respects, the financial condition and results of operations of the company.

The SEC's rules set forth the exact wording for both certifications and require that both certifications be made exhibits to the filings they accompany. In acknowledgement of the goal of avoiding Securities Act liability for incorporation by reference, the rule provides that the criminal certification is considered "furnished" to the SEC and not filed, which prevents it from being incorporated by reference into registration statements unless the company takes some separate action to bring about that result.

In March 2003, the SEC brought its first case alleging that certifications filed by a chief executive officer were inaccurate. The SEC filed accounting fraud charges against HealthSouth Corporation, the nation's largest provider of outpatient surgery, diagnostic and rehabilitative healthcare services, and its CEO. HealthSouth was alleged to have overstated its earnings by at least $1.4 billion in order to meet Wall Street expectations. Its CEO was alleged to have certified the accuracy and completeness of the company's financial statements when he knew or should have known that they were materially false and misleading.

The SEC was dealt a setback when the HealthSouth CEO was acquitted of all fraud charges in June 2005. The Birmingham, Alabama jury did not believe that the government's case linked the CEO strongly enough to the accounting improprieties of the company. The CEO still faces civil charges by the SEC.

*California Certification Requirement*

Effective January 1, 2003, the California Corporate Disclosure Act became effective to require publicly traded companies that are incorporated or qualified to do business in California to file a statement each year with its secretary of state that discloses:

- the name of the independent auditor, including a description of any other services performed by the auditor during the past 24 months to the company,
- compensation to directors and executive officers,
- whether the company or its directors or executive officers have declared bankruptcy in the last ten years,
- loans made to directors at a preferential rate during the last two years (which, unless made before Sarbanes Oxley was adopted, would be precluded by it in any event), and

- convictions of any director or executive officer for fraud or violations of federal securities laws or California securities or banking laws during the last ten years.

The statement is required to be filed on a form prescribed by the secretary of state of California.

### Current Report on Form 8-K

Form 8-K is a report that is required to be filed when certain specified reportable events occur and that a company may elect to file to make voluntary disclosures. Reportable events that require a filing include the following, which are described in the Items in Form 8-K as indicated (except Items 7.01 and 8.01, which are used for voluntary disclosures at the election of the company):

- Item 1.01: Entry into a material definitive agreement or amendment to a material definitive agreement. A copy of the agreement or amendment need not be filed as an exhibit until the company's next Form 10-K or Form 10-Q filing;
- Item 1.02: Termination of a material definitive agreement;
- Item 1.03: Bankruptcy or receivership of the company;
- Item 2.01: Completion of acquisition or disposition by the company of a significant amount of assets other than in the ordinary course of business;
- Item 2.02: Results of operations and financial conditions;
- Item 2.03: Creation of a material direct financial obligation or an obligation under an off-balance sheet arrangement;
- Item 2.04: Triggering events that accelerate or increase a direct financial obligation or an obligation under an off-balance sheet arrangement;
- Item 2.05: Commitment to an exit or disposal plan, disposal of a long-lived asset or termination of employees under a plan of termination;
- Item 2.06: Required material charge for impairment to a company's assets;
- Item 3.01: Notice of delisting from a national securities exchange or national securities association or failure to satisfy a continued listing rule or standard or a transfer of listing. Companies listed on OTCBB or the Pink Sheets are not subject to this Item 3.01;
- Item 3.02: Sales of equity securities that are not registered under the Securities Act;
- Item 3.03: Material modifications to rights of security holders of any class;
- Item 4.01: Changes in a company's certifying accountant;
- Item 4.02: Determinations that previously issued financial statements no longer should be relied upon;

- Item 5.01: Changes in control of a company;
- Item 5.02: Departure of directors or principal officers, appointments of new officers or elections of new directors;
- Item 5.03: Amendments to articles of incorporation or bylaws or changes in fiscal years;
- Item 5.04: Temporary suspensions of trading under a company's employee benefit plans;
- Item 5.05: Amendments to or waivers of a company's code of ethics;
- Item 5.06: Change in shell company status;
- Item 6.01: ABS informational and computational material;
- Item 6.02: Change of servicer or trustee;
- Item 6.03: Change in credit enhancement or other external support;
- Item 6.04: Failure to make a required distribution;
- Item 6.05: Securities Act updating disclosure;
- Item 7.01: Voluntary Regulation FD disclosures (considered only furnished, not filed);
- Item 8.01: Other events; and
- Item 9.01: Financial statements and exhibits. Financial statements may be filed by amendment 71 days after the date that the initial report on Form 8-K must be filed.

Generally, a Form 8-K must be filed with the SEC within four business days of the occurrence of the events described above. If a Form 10-K or Form 10-Q will be filed within four days of an event (other than disclosures under Item 4.01 or 4.02), the disclosure may be made in the Form 10-K or Form 10-Q, as applicable, in lieu of filing a separate Form 8-K. The deadline for filings pursuant to Item 7.01 is determined in accordance with Regulation FD (generally one day unless the disclosure to covered persons under that regulation is intentional).

Because companies must quickly determine whether a reportable event has occurred in order to comply with applicable filing deadlines, certain events which involve more subjective judgments are subject to a limited safe harbor from public and private claims for late filings. Those events include the entry into, amendment of or termination of a material definitive agreement, creation of a direct material financial obligation or an obligation under an off-balance sheet arrangement and determinations that previously issued financial statements no longer should be relied upon. The safe harbor extends, however, only until the next Form 10-K or 10-Q is due, so that the event must be reported in the Form 10-K or 10-Q filing, as appropriate, depending on when the event occurred.

Item 7.01 disclosures are deemed to be "furnished" and not to be filed. This means that, unless expressly stated as filed, the disclosures are not automatically incorporated by reference in registration statements on Form S-3 and other Securities Act filings that incorporate Exchange

Act filings by reference, which means that the liability provisions of the Securities Act (which can impose strict liability) are not applied to the disclosures. While this result is favorable, the detriment of non-incorporation by reference is that if the information is not included in the Securities Act filing it may be false and misleading for failing to state a material fact.

Item 2.02 requires companies to furnish each oral or written release of quarterly or annual financial information to the SEC on Form 8-K, even if it has been widely disseminated by press release or otherwise. As described below, advance preparations may be necessary to avoid having to file a second Form 8-K for any additional material information disclosed during a company's investor conference call, even if the call-in or webcast information was publicized in compliance with Regulation FD.

Most companies follow their earnings release with an investor conference call, which is publicly accessible by call-in or webcast, the details of which are published in advance. This ensures compliance with Regulation FD's public dissemination mandate for any additional material information that may be disclosed in the call and avoids the need for another press release for the new information under Regulation FD. Under the requirements under Item 2.02 of Form 8-K, however, avoiding an additional Form 8-K filing for any new information disclosed in the call will require the following:

- Any additional, complementary financial or statistical information that may be disclosed on the call must be identified and posted on the company's web site.
- The press release announcing the investor call (or the earnings release) must include instructions on when and how to access the information on the web site.
- Before the investor call occurs:
  - the original earnings release must have been furnished to the SEC on Form 8-K; and
  - the additional information must have been posted on the web site.
- The investor call must occur within 48 hours after the original earnings release. (Web site accessibility or taped replays may continue thereafter.)

If any of those steps is not followed, or if more information is disclosed on the call than anticipated, an additional Form 8-K with the information disclosed in the phone call that was not in the original Form 8-K will have to be furnished promptly to the SEC, and any steps needed to comply with Regulation FD will have to be taken. In addition, as discussed above under "Rules for Disclosing Non-GAAP Information," earnings releases containing a non-GAAP financial measure require an Item 2.02 Form 8-K filing with specific disclosures.

If a Form 8-K is being furnished to the SEC under Item 2.02 and it is also used to comply with Regulation FD, it should be indicated that the information is also being filed or furnished under Item 7.01 or Item 8.01, as the case may be.

## The Proxy Rules

State laws, as well as the rules of the major exchanges and stock markets, require an annual meeting of stockholders. In such meetings, stockholders vote on the election of directors and any other actions, such as the appointment of auditors which may be submitted to stockholders for approval. Action may only be taken at a meeting at which a quorum of outstanding shares is present as set forth in the company's by-laws. In order to ensure a quorum and to take the desired action, proxies are solicited from stockholders regarding the issues that are to be voted upon at the upcoming meeting so that the shares will be deemed present and able to vote at the meeting even though the stockholders are not. Any solicitation of proxies from stockholders must he made in compliance with the SEC's Proxy Rules. Foreign issuers are generally exempt from these rules.

The SEC's Proxy Rules seek to ensure adequate disclosure of material information about any matter to be voted upon by stockholders and dictate certain requirements for proxy contests. Generally, state law allows a stockholder to require, in certain circumstances, that a matter requested by a stockholder be voted on at a meeting. Under the Proxy Rules, the company is obligated to include in its proxy statement any proposals submitted in a timely manner by stockholders who meet certain minimum ownership thresholds unless the proposal fits within certain narrow exceptions. Handling stockholder proposals is discussed more fully below.

The three key dates involved in drafting a proxy statement and planning for the annual meeting of stockholders are: (1) the record date, (2) the mailing date and (3) the meeting date. The relevant legal requirements governing those dates will be found in the SEC's Proxy Rules, the company's governing corporate statute, certificate of incorporation and by-laws and the rules of the applicable stock exchange or Nasdaq.

Proxy disclosure material must be filed with the SEC at least ten calendar days prior to its distribution to the stockholders unless the only matters to be acted upon at the annual meeting are: (1) the election of directors; (2) the election, approval or ratification of accountants; (3) approval of certain employee benefit plans; and (4) stockholder proposals. If the SEC has comments to the proxy statement, an amended proxy statement responding to those comments must be filed with the SEC. To allow for SEC comments and ensure a timely distribution, the company should file preliminary proxy materials with the SEC approximately six weeks prior to the anticipated mailing date. If the proxy materials contain complex proposals, a substantially longer period should be allowed. Additionally, with respect to the selection of a record date for the annual meeting, the company will need to notify record holders at least 20 business days prior to the proposed record date. This allows the record holders time to inform the company of the actual number of beneficial owners of the company's stock and, accordingly, the number of proxy materials that will have to be prepared. Matters on which record holders may vote shares without consulting beneficial owners are discussed below.

On November 29, 2005, the SEC voted to propose changes to the requirements in the Proxy Rules regarding distribution of proxy statements and annual reports by companies. Companies are currently required to deliver paper copies of their proxy materials to their stockholders unless a stockholder consents to electronic delivery. The SEC proposed a "notice and access" system where a company would post its proxy materials on an Internet web site and send a notice to its stockholders at least 30 days in advance of the date of the meeting informing them how to access the proxy materials. Parties other than a company (such as insurgents or dissenting stockholders) may also use the "notice and access" system in a similar manner. Stockholders who prefer would still have the option of requesting paper proxy materials. Companies would be able to save printing and mailing costs associated with the distribution of paper proxy materials. In addition, companies would have the ability to communicate directly with their "street name holders." Under the current system, companies mail their proxy materials to banks, brokers or other agents who in turn distribute the proxy materials to street name holders. The SEC's proposal, if approved, will likely come into effect for 2007. These proposed changes would not affect the stockholders' proposals process described below.

*Stockholders' Proposals*

State corporate law generally provides the right of stockholders to vote with respect to any matter properly brought before a stockholder meeting. Stockholders may properly bring certain proposals before a meeting. Most companies' by-laws outline procedures to be followed by stockholders to do this. Because stockholders typically vote by proxy, the right to bring proposals before a meeting would be meaningless if the stockholder did not have a right to cause proxies to be solicited with respect to the proposal. The federal proxy rules permit stockholders to require a company to include stockholder proposals in its proxy statement that solicits proxies for management's proposals. In order to prevent (or at least limit) abuse, the rule sets minimum qualification standards for the stockholders to meet, limits the number of proposals a stockholder can make, restricts the subject matter of a proposal, permits the company to include a response to the proposal, and contains certain other protections.

Generally speaking, a company which receives a properly drafted proposal from a qualifying stockholder will need to request a "no-action" letter from the SEC in order to exclude the proposal from its proxy statement.

*Requirements for Stockholder Requests.* Stockholders seeking to submit a proposal must first demonstrate that they are qualified to do so. In order to qualify, a stockholder must have owned either 1% of the stock entitled to vote at the meeting or $2,000 in market value of stock, in either case for one full year *continuously* before the date he or she submits the proposal. The market value of the stock is deemed to be the highest price of the stock in the 60-day period immediately before the stockholder submitted the proposal. A stockholder who is the beneficial owner but not the record holder of stock can demonstrate this ownership to the company with a letter from the record holder of the shares, which would typically be a broker or a bank, verifying that the account holder (the stockholder) had continuously held the securities for at least a year. The stockholder is also required to submit his or her own statement verifying that he or she intends to continue to hold the securities through the date of the stockholders' meeting.

Proposals for a regularly scheduled annual meeting must be received at the company's principal executive offices not less that 120 calendar days before the anniversary of the release date of the previous year's annual meeting proxy statement (or, if the meeting is moved more than 30 days from the prior year, within a reasonable time). Both the release date and the deadline for receiving proposals for the next annual meeting should be identified in that proxy statement.

The SEC interprets the timeliness requirement literally, and will allow a company to exclude a proposal if it is even one day late. If timely submitted, however, a proposal that does not meet the substantive requirements discussed below may be amended after the deadline for submission so that it meets those requirements unless the changes would be so dramatic that the proposal as so amended would be radically different from the one timely submitted.

A stockholder may submit only one proposal per stockholders' meeting. The proposal may be accompanied by a supporting statement of up to 500 words, which must also be included in the proxy statement.

*Responding to the Stockholder Request.* If a company believes that a stockholder's proposal as submitted fails to meet the procedural requirements of the rules or of the company's bylaws, or if the stockholder has failed to demonstrate that he or she qualifies to submit the proposal, then the company must notify the stockholder of the alleged defect within 14 calendar days of receiving the proposal unless the defect cannot be remedied, for example if the stockholder has indicated that he or she has not owned a sufficient number of shares for a period of one year, or if the stockholder fails to submit the proposal before the company's deadline. The stockholder has 14 calendar days to cure the defect after he or she receives the company's notice. If the stockholder fails to respond, or responds but fails to cure the defect, then the company may exclude the proposal.

In addition to allowing exclusion of a proposal on procedural or qualification grounds, the SEC will permit a company to exclude a stockholder proposal from its proxy statement if the subject matter of the proposal falls under one or more of thirteen categories. The thirteen grounds for exclusion are:

1. The proposal relates to a topic that is not a proper subject for action by stockholders under the laws of the jurisdiction of the company's organization.
2. The proposal would, if implemented, cause the company to violate any state, federal or foreign law to which it is subject.
3. The proposal or supporting statement is contrary to any of the SEC's proxy rules, including the prohibition on false or misleading statements in proxy soliciting materials.
4. The proposal relates to the redress of a personal claim or grievance against the company or any other person, or is designed to result in a benefit to the stockholder, or to further a personal interest, which is not shared by the other stockholders at large.

5. The proposal relates to operations that account for less than five percent of the company's total assets at the end of its most recent fiscal year, and account for less than five percent of its net earnings and gross sales for its most recent fiscal year, and is not otherwise significantly related to the company's business. (The SEC interprets "otherwise significantly related" broadly so that exclusion of a proposal under this clause is often more difficult than it may first appear.)
6. The company lacks the power or authority to implement the proposal.
7. The proposal deals with a matter relating to the company's ordinary business operations.
8. The proposal relates to an election for membership on the company's board of directors.
9. The proposal directly conflicts with one of the company's own proposals to be submitted to stockholders at the same meeting.
10. The company has already substantially implemented the proposal.
11. The proposal substantially duplicates another proposal previously submitted to the company by another stockholder that will be included in the company's proxy materials for the same meeting.
12. The proposal deals with substantially the same subject matter as another proposal that previously was included in the company's proxy materials within a specified time and did not receive a specified percentage of the vote.
13. The proposal relates to specific amounts of cash or stock dividends.

When considering whether a proposal is excludable because of its subject matter, a few points are worth noting:

- The SEC recognizes that stockholder proposals that would require the company to take or forebear from taking some action are more likely to be excludable as relating to a topic that is not a proper subject for action by stockholders under state law than proposals that are cast as mere recommendations. The SEC will routinely permit a stockholder to revise a proposal to recast it as a recommendation in order to avoid exclusion.
- A procedurally adequate proposal that merely recommends that a company's board of directors eliminate the company's poison pill may not be excluded.
- The most common objection raised by companies to stockholder proposals is that a proposal relates to a company's "ordinary business operations." The SEC has taken the position that an ordinary business matter may, however, be the proper subject of a stockholder proposal if it focuses on "significant social policy issues," because such proposals would "transcend day-to-day business matters."

- Until July 12, 2002, the SEC had uniformly allowed the exclusion of proposals to require that equity compensation plans be submitted to a stockholder vote because they were deemed to be related to general employee compensation, an ordinary business matter. In light of perceived public interest, however, the SEC changed its position on that date to forbid the exclusion of proposals that relate to equity plans that may be used to compensate only senior executive officers and directors or that may result in material dilution to existing stockholders. As noted above, the new stock exchange and Nasdaq listing rules require that all equity compensation plans be submitted to a stockholder vote anyway, and as discussed below an affirmative vote on those plans will be harder to obtain given the proposed new prohibition on record holders' voting in favor of them without the direction of the beneficial owner.
- Because of difficulties in administering the ordinary-business-operations standard, especially in changing corporate governance climates, and a growing number of proposals relating to executive compensation and similar matters, then-SEC Chairman Harvey Pitt announced that it was his position that the ordinary business exception should be eliminated entirely. So far, however, the SEC has not adopted the former Chairman's recommendation.

If a company seeks to exclude the stockholder proposal from its proxy statement, it must submit a no-action request to the SEC no later than 80 days before it files its definitive proxy statement with the SEC, unless it can demonstrate "good cause" for missing the deadline. The company must at the same time provide the stockholder with a copy of its no-action request, so that the stockholder will have a chance to submit a response.

The SEC will respond to the request for exclusion either affirmatively or negatively, or it may give the stockholder a limited amount of time to amend the request to comply with the requirements of the rule, where appropriate. Note that a no-action response from the SEC which indicates that it will take no enforcement action against a company if the company excludes the stockholder's request will not prevent the stockholder from going to court if the company does so, although this rarely happens.

If a company does not seek to exclude a stockholder proposal, or if the SEC does not give the requested no-action relief to a company, then the company will need to include the proposal in its proxy statement. However, the company will have the right to include a "statement in opposition" to the proposal, explaining why it feels that stockholders should reject the proposal. Generally, the company is required to provide a stockholder with its statement in opposition to the stockholder's proposal no later than 30 calendar days before it files its definitive proxy statement. (If the SEC requires the stockholder to revise his or her proposal, the deadline is five days after the company receives the revised proposal.)

If the stockholder believes that the company's statement in opposition to his or her proposal contains any false or misleading statements that may violate the SEC's anti-fraud rules, the stockholder can raise the issue by delivering a letter to the SEC explaining why he or she believes the statements to be false or misleading. The SEC encourages companies and stockholders to work out their differences without contacting it.

*Nominating Committees*

In November 2003, the SEC adopted new proxy statement disclosure requirements related to nominating committees and the director nomination process. The requirements are summarized below:

- A company must continue to disclose whether it has a standing nominating committee or a committee that performs similar functions. If not, the company must explain why the lack of a committee is appropriate and identify each director who participates in the nomination process.
- A company is also required to state whether the nominating committee has a charter and if it does, whether the charter may be found on the company's web site. If the charter is on the web site, the company must disclose the web site address. If it is not on the web site, a copy of the charter must be included as an exhibit to the proxy materials at least once every three years.
- If the company's stock is subject to the nominating committee independence requirements of NYSE or Nasdaq, the company must state whether its committee members are independent, as defined by the applicable exchange.
- If the nominating committee has a policy regarding director candidates nominated by stockholders, the company must provide the material elements of the policy. If the company has no such policy, it must disclose that fact and explain why the board believes the lack of a policy is appropriate.
- The proxy statement must include a description of the nominating committee's process for identifying and evaluating nominees for director, including those nominated by stockholders. The description must include any specific, minimum qualifications that the committee requires and whether the process differs if the nominee was identified by a stockholder.
- If a stockholder, who beneficially owns more than five percent of the company's voting stock for at least one year, recommends a nominee, the proxy must identify the nominee, the stockholder that made the recommendation and whether the nominating committee recommended the candidate. This disclosure is only required if the nominee and the stockholder making the recommendation both consent in writing to be identified.

*Majority Voting for Elections of Directors*

There is a current focus to change the way in which directors are elected. Presently, most companies provide for plurality voting. Shareholders have been critical of this procedure because even if a nominee receives one affirmative vote, if there is no opposition candidate, the nominee will be elected regardless of whether there are a substantial number of votes withheld. If there is an opposition nominee, the candidate receiving the most votes will win, even if that candidate does not receive a majority of the votes cast.

Under pressure from shareholders and other parties interested in corporate governance matters, such as Institutional Shareholder Services, certain companies have changed their voting policies from plurality voting to majority voting. Majority voting requires that a nominee be elected only if he receives a majority of the votes cast at shareholder meetings. Pfizer Inc. was the first company to voluntarily adopt majority voting. On June 23, 2005, Pfizer announced that it had amended its corporate governance principles so that a director, who is nominated for re-election and receives a majority of withheld votes, must submit his resignation to the board. The board will then consider the resignation and make a recommendation. Pfizer clarified its policy in October by stating that any director who receives more "withheld" votes than "for" votes would be required to submit his resignation and that the majority voting policy would only apply to uncontested director elections.

*Communications Between Boards of Directors and Stockholders*

The SEC imposed new proxy statement disclosure requirements in 2003 as to the processes by which stockholders may communicate directly with directors. Under these new rules, a company must state in its proxy statement whether there is such a process in place. If not, the company must explain why the lack of a process is appropriate. The company must describe the process in the proxy statement or its web site (with the web site address included in the proxy statement, if applicable). If stockholders may not communicate directly with directors, the description should include the method for determining which communications will be forwarded to board members.

*Broker Voting of Shares Held in Street Name*

For most U.S. companies, the vast majority of their stock is held in "street name." This means that the registered owner of the stock on the records of the companies' transfer agents is not the real, beneficial owner of the stock but instead the broker with whom the beneficial owner maintains an account in which the stock is held. Thus, when a company solicits proxies for a stockholder vote, it requests the proxy of the broker because it is the record owner. Whether the broker can grant a proxy to vote the shares as requested or must seek the direction of the beneficial owner is governed by NYSE rules and depends upon the proposal for which the proxy is being requested.

Except for non-routine proposals, a broker is permitted to vote shares it holds in street name in favor of a proposal so long as it has transmitted the solicitation material to the beneficial owner, the beneficial owner has not informed the broker to oppose the proposal and the broker does not know of any contest with respect to the proposal. If these conditions are met for a proposal, then all shares held in street name are automatically voted in favor of it, and that vote will only be changed if the beneficial owner affirmatively directs the broker to do so. Proposals that are considered non-routine, and therefore require the direction of the beneficial owner, are those related to:

- approving a merger or consolidation;
- authorizing a mortgage;
- creating or increasing authorized indebtedness or preferred stock;
- altering the terms of existing stock or indebtedness;
- authorizing a remuneration plan the annual cost of which will amount to more than ten percent of average annual income before taxes for the preceding five years;
- changing certain quorum or voting requirements;
- acquiring assets for consideration of more than 20% of the company's current market capitalization;
- disposing of 20% or more of a company's assets or earning power;
- reducing earned surplus by 51% or to an amount less than three years' common stock dividends; and
- approving the establishment of or any material revision to an equity compensation plan unless certain exemptions apply, such as grants made in connection with mergers and acquisitions.

If brokers are allowed to vote in favor of a proposal, its passage is all but assured because the vast majority of shares will be voted and few beneficial owners will trouble themselves to reverse the vote. If a proposal is non-routine, however, passage becomes difficult. Generally, in order to obtain the votes necessary for passage, a company must retain the services of a proxy solicitor whose role is to encourage brokers to contact their clients to obtain their votes and to approach large stockholders directly to encourage them to vote. Sufficient time must be built into a timetable to allow the proxy solicitor to perform this function. Consideration must also be given to the threshold of approval needed. It is more difficult to obtain a super majority or a majority of all outstanding shares than a mere majority of shares present at the meeting.

# REPORTING AND OTHER OBLIGATIONS OF STOCKHOLDERS AND INSIDERS

The federal securities laws impose obligations on stockholders and executive officers and directors of companies, as well as companies. Under Sections 13 and 16 of the Exchange Act, stockholders must report their share ownership in public companies. These provisions are intended to keep the public informed as to insiders' trading in stock and to alert companies to any unusual trading activity in the market for its stock. These obligations are direct obligations of the stockholder, officer or director, and not of the company itself.

## Section 13 of the Exchange Act

All stockholders, and all groups of stockholders who act in concert, who come to "beneficially own" five percent or more of a class of the company's outstanding voting equity securities are required to file reports with the SEC under Section 13 of the Exchange Act. Beneficial ownership is defined broadly by the SEC to include the issued and outstanding securities a person has the sole or shared power to vote or dispose of and any securities a person has the right to acquire within 60 days through the exercise or conversion of derivatives or otherwise. Unless the stockholder qualifies for the less burdensome Schedule 13G, he will have to file a Schedule 13D within five days of the date on which he becomes a five-percent stockholder and will have to amend that Schedule promptly if any of the information contained in it changes materially. If the information that changes is the number of securities beneficially owned, any change of one percent or more of the amount of the outstanding securities is deemed material by SEC rule, and a smaller change may be material depending upon the facts and circumstances involved.

Certain stockholders are entitled to use a Schedule 13G, which requires less disclosure than a Schedule 13D and needs only to be amended after each year to reflect all changes that occurred in the year. In order to use Schedule 13G, a stockholder must beneficially own less than 20% of any class of the company's securities and must not have acquired the securities with the purpose, and the acquisition must not have had the effect of, changing or influencing the control of the company, and the acquisition must not have been in connection with any transaction having that purpose or effect. A stockholder may also use Schedule 13G if he was already a stockholder at the time the company first went public and he has bought no additional securities. Special entities such as broker dealers, registered investment companies and banks may also use Schedule 13G in lieu of Schedule 13D. The Section 13 reporting requirements apply to stockholders of both domestic and foreign reporting companies.

## Section 16 of the Exchange Act

In addition to having to file Schedules 13D or 13G, holders of 10 percent or more of the equity securities of a company are subject to Section 16 of the Exchange Act. Section 16 is broader than Section 13 in that it applies to all equity securities whether or not they are voting. Directors and executive officers of a company are also covered by Section 16 regardless of how many securities they beneficially own, and together with ten-percent stockholders are referred to as "insiders."

Section 16 of the Exchange Act is intended to prevent insider trading through the use of three principal mechanisms:

(i) Section 16(a) requires company insiders to report beneficial ownership upon becoming an insider and to report any change in such ownership;

(ii) Section 16(b) requires the disgorgement to the company of any deemed profits from a purchase and sale within a six-month period earned by an insider; and

(iii) Section 16(c) prohibits short-selling of the company's securities by an insider.

*Reports of Beneficial Ownership—Subsection 16(a)*

Each insider is required to file reports with the SEC relating to initial beneficial ownership and changes in beneficial ownership or changes in the nature of such beneficial ownership of the company's common stock or any other equity security issued by the company including related derivative securities such as stock options. The test for whether one must file a report under Section 16(a) as a 10% stockholder is the same for determining beneficial ownership under Section 13: whether one has the sole or shared right to vote or dispose of the securities. Only those shares in which one has a pecuniary interest, however, must be listed on the form, which can result in one having a filing obligation but having no shares to report. For example, a trustee of a voting trust that contains 10% of a company's equity shares would have the right to vote those shares and so would be required to file a Form 3, but because the trustee has no pecuniary interest in the shares the trustee's beneficial ownership on the Form 3 would be reported as zero. In contrast, the Schedule 13D the trustee would be required to file would report all the shares deposited in the trust (although a well-drafted Schedule 13D would make clear the limited nature of the trustee's rights in the shares).

Three types of reports are required to be filed pursuant to Section 16(a) of the Exchange Act:

- *Form 3: Initial Statement of Beneficial Ownership of Securities*. This form indicates a person's beneficial ownership in equity securities of the company (including derivative securities) and must be filed by individuals who have not previously filed such a statement with the SEC. The requirement to file a Form 3 arises when an individual becomes a director or is appointed an executive officer of the company for the first time or becomes a ten-percent equity holder, or when one is already a director, executive officer or ten-percent equity holder and the company goes public. Even if a director or executive officer has no direct, indirect or beneficial interest in the company's equity securities, a Form 3 must still be filed informing the SEC of the individual's new relationship with the company. Form 3 statements must be filed on the earlier of ten days after the occurrence of the event which necessitated the filing or the time the company goes public.

- *Form 4: Statement of Changes of Beneficial Ownership of Securities*. Once a Form 3 has been filed for an individual, and as long as that person remains a director, officer or ten-percent stockholder (and for up to six months after a person ceases to be a director or executive officer), a Form 4 must be filed whenever any of the following takes place: (i) a change in the number of equity securities (including derivative securities) beneficially owned or (ii) a change in the nature of beneficial ownership as previously reported to the SEC. Form 4 statements must be filed within two business days of the date on which the event or transaction occurred which necessitated the filing.
- *Form 5: Annual Statement of Beneficial Ownership of Securities*. Form 5 must be filed for any individual who has been an officer, director or ten-percent holder for any part of the company's fiscal year to disclose: (i) acquisitions during any six-month period aggregating less than $10,000; (ii) all transactions that should have been reported in the last year but were not; and (iii) all exempt transactions except as required to be reported on a Form 4. Previously, all transactions between a company and its officers, which were exempt from Section 16(b), were reportable after year-end on a Form 5. One of the most significant provisions of Sarbanes Oxley was to make these exempt transactions reportable on Form 4 within two days. Form 5 need not be filed if all transactions otherwise reportable have been previously reported on a Form 4. If required, Form 5 must be filed within 45 days after the end of the company's fiscal year.

As an incentive for the company to assist insiders in filing Section 16(a) reports in a timely manner, the SEC requires the company to disclose in its Form 10-K and proxy statement all persons who fail to file a required report in a timely manner. The company may rely on the statements within the four corners of a filing to determine whether it was made on a timely basis.

An event or transaction necessitating the filing of Form 4 should be reported by the insider to the company as soon as possible. The two-day requirement for Forms 4 was one of the most significant provisions of Sarbanes Oxley. Before that act, Forms 4 were required within ten days after the end of each month to reflect all transactions during the month. The two-day requirement brings an urgency to these filings that was not present before. All Sections 16(a) filings should be made electronically on Edgar and posted on the company's web site.

While Section 16(a) filings are the responsibility of the insiders and not the company, in practice most companies assist their officers and directors in making them. Companies should circulate a memorandum to each officer and director acquainting them with the short time for filing and soliciting a limited power of attorney to assist in preparing and filing Forms 4 on their behalf. The memorandum should require officers and directors to alert the company of a trade no later than the time at which it occurs, which alert may be in conjunction with requiring consent for a trade under trading windows. A sample of such a memorandum is attached as Exhibit I. Trading windows are discussed below.

*The Short-Swing Profit Rules—Subsection 16(b)*

To deter insiders from profiting on short-term trading transactions in the equity securities of a company on the basis of undisclosed information, Section 16(b) of the Exchange Act requires that they disgorge the "statutory profit" realized in any purchase and sale of equity securities (including derivative securities) of a company which takes place within any six-month period. Under Section 16(b), when the purchaser becomes irrevocably committed to the transaction and the parameters of the transaction become agreed upon, a purchase or sale is deemed to have occurred. The crucial point in the acquisition of the securities is not the technical "purchase" but rather when the trade becomes fixed.

The obligation to remit any profits to the company is automatic, and it is irrelevant whether the person trading had possession of material non-public information or even whether such information existed. Suit to recover such profits must be instituted by the company and, if the company fails to bring suit, the stockholders of the company may sue on its behalf. In fact, there exists a cottage industry of lawyers that specialize in scrutinizing Section 16(a) filings and bringing lawsuits on behalf of companies that ignore a request that they do so on their own. Section 16(b) requires that companies pay the fees of these lawyers under these circumstances, and they provide an effective private enforcement mechanism for the provision.

To compute statutory short-swing profits, the highest sale price and lowest purchase price during any six-month period are "matched," regardless of whether the sale and purchase involved the same equity securities, thereby maximizing the amount that must he returned to the company. The differences are then totaled to determine the "imputed profits" from the series of transactions. Moreover, losses sustained cannot he offset against the profits made. In this manner, an insider may be required to pay over "imputed profits" even though a series of transactions may have actually resulted in a loss.

Companies may rely on Rule 16b-3, which exempts certain transactions from Section 16(b) short-swing profit recovery. Many employee benefit plan transactions fall within this exemption. In addition, if transactions between officers or directors and the company are approved by the company's shareholders, its board of directors or a committee of two or more non-employee directors, such transactions are generally within this exemption.

In response to a 2002 court decision, the SEC amended Rule 16b-3 to clarify that companies may use the rule to exempt officer and director share transactions from Section 16(b) short-swing profit recovery, even if the transactions are not compensatory in nature. Thus, the SEC stated that "a transaction need not be pursuant to an employee benefit plan or any compensatory program to be exempt, nor need it specifically have a compensatory element."

*The Short Sale Prohibition—Subsection 16(c)*

Insiders are prohibited under Section 16(c) of the Exchange Act from making any "short sale" of the company's equity securities. A short sale occurs when the seller does not own the securities sold and must borrow certificates to deliver to settle the trade.

## TRADING IN STOCK

When they buy or sell the stock of their company, insiders must be careful not to do so while in possession of material non-public information. Most companies have established windows in which buying and selling is permitted to reduce the likelihood that this will occur and to diminish even the appearance that it has occurred. In addition to the existence of material non-public information, new rules imposed by Sarbanes Oxley affect when these trading windows open and close. All insiders must comply with restrictions on the resale of the stock they own, even if it is not restricted.

### Trading on Material Non-Public Information

Rule 10b-5 under the Exchange Act prohibits insiders of a company from engaging in transactions in the company's securities while in possession of material non-public information. "Insiders" for this purpose are generally considered to include those who file reports pursuant to Section 16(a) as well as persons (such as a non-officer employee) who, because of their relationship with the company, learn of material non-public information.

Not only are insiders forbidden from using material non-public information to their own advantage, but they also are prohibited by law from giving such information to an outsider for the improper purpose of exploiting the information for personal gain. A "tipper" is a person who divulges such information; a "tippee" is one who receives such information. Tipping is a violation of Rule 10b-5 of the Exchange Act if the insider has breached a duty that he or she owed to the company or its stockholders. Both the tipper and tippee are liable when a tippee trades on material non-public information.

In late 2000, the SEC adopted new Rule 10b5-1. It creates a set of affirmative defenses—a limited safe harbor, although the SEC does not use this phrase—for persons who regularly find themselves in possession of material non-public information but who nonetheless wish to buy or sell securities.

By meeting the requirements of Rule 10b5-1:

- companies will be able to eliminate restrictions on trading during periods when trading windows are closed; and
- large individual stockholders will be able to dispose of stock to create liquidity for diversification, estate planning, charitable giving or other similar purposes despite having access to material non-public information at the time of sale.

Companies and others may establish an affirmative defense under Rule 10b5-1 for trading in securities by:

- adopting a written plan, entering into a binding contract, or instructing another person orally or in writing to buy or sell a security provided they are not in possession of material non-public information at the time of such adoption, entry or instruction, and

- the plan, contract or instruction
  - specifies the amount, price (which may include a limit price) and date of purchases or sales, or
  - includes a formula or similar method for determining amount, price and date, or
  - gives to another party the exclusive right to determine whether, how and when to make purchases and sales, and the other party does so without being in possession of material non-public information at the time the purchases or sales are made.

Note that this defense is only available if the trade is in fact made pursuant to the pre-arranged terms of the plan, contract or instruction, and the terms are not altered at a time when the affected person becomes aware of material non-public information. In contrast to altering the terms of a Rule 10b5-1 plan in such a way that trading continues under it, one can always terminate further trading under a plan, even when in possession of material non-public information. This is because there can be no liability under Rule 10b5-1 unless there is a purchase or sale of a security. Thus, merely terminating a Rule 10b5-1 plan, which stops all purchases and sales of securities, is not a violation unless it is done so regularly that it amounts to a scheme to avoid the law. Note that Rule 10b5-1 provides flexibility to design plans for trading that use limit orders and formulas based on threshold or ceiling prices or rolling averages or percentages to determine price, amount and timing.

### Penalties for Securities Fraud

Sarbanes Oxley created a new criminal antifraud provision, making it a crime to engage in a scheme or artifice to defraud any person in connection with any security registered under the Exchange Act, or to obtain by false means any money or property in connection with the purchase or sale of any security of a public company. This provision broadens the basis for criminal prosecution of securities fraud and increases the potential penalties that may be imposed for it. Sarbanes Oxley also increased the criminal penalties for mail fraud, wire fraud, and certain existing anti-fraud provisions of the Exchange Act.

Sarbanes Oxley extended the statute of limitations for asserting a private claim of fraud, deceit or manipulation in contravention of the federal securities laws to the earlier of two years after discovery of the facts constituting the violation or five years after the violation. The rule had been one and three years, respectively.

Sarbanes Oxley also provided that, during the course of an investigation involving possible violations of the federal securities laws by a company with publicly traded securities, the SEC may obtain a temporary order to require the company to escrow any extraordinary payments to any employee or agent (whether compensation or otherwise) for 45 days. During that period, a court must order a hearing to review the merits of the imposed escrow. This period may be extended by the court for an additional 45 days upon a showing of good cause. If the company or other applicable individual is charged with violations of the federal securities laws prior to the