

SEC Update

GETTING READY FOR THE 2004 PROXY / 10K SEASON

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SEC Update

- Overview
- What recent developments mean for lawyers
- Primary releases driving new disclosure requirements in 10K/ proxy, elsewhere
 - Particular focus on most recent releases
 - 33-8340 on nominating committees
 - 33-8350 SEC guidance on MDA

SEC Update

- Miscellaneous topics
 - Internal control reporting sneaks in a year early
 - Staff comment letters online
 - Application to small business issuers, voluntary filers
 - Section 16
 - 10b-18 Amendments
 - Audit response letters
 - When the PCAOB audits you
 - Reg FD enforcement - Schering-Plough

SEC Update

Public, SEC question after recent corporate scandals: Where were the lawyers?

In 2004: Trying to implement 2000 pages of new SEC rules and releases

Remember what used to be known as the accounting profession – they resisted public demand to deal with fraud for 20 years

SEC Update

- Paradigm shift: more laws, regulations, regulatory and judicial decisions telling companies, boards, managements, lawyers, accountants what they must do in areas of ethics, disclosure, judgment previously left to broad principle and individual discretion
- “Best Practices” are breaking out all around
- Inherent conflict: An enforcement agency (SEC) trying to cause best practices



SEC Update

- Risk: Everything not prohibited is mandatory
- SEC: Don't treat this as a checklist exercise
- Risk: Failure to demonstrate compliance, best practices leads to claims, civil or criminal liability
- Risk: The “public,” as represented by Congress, FERC, SEC determine that not enough has been done to clean up corporate America
- Possible result: Sarbanes II, Sarbanes III, . Etc.
- Result: Increased focus on playing way inside the lines, not on the lines

SEC Update

- What does all this mean for you and me, personally?
- Rule 205 is now out there, is having an effect
- This season, accelerated filing will create “realtime” issues of reporting, responding to possible material violations, board discussion
- SEC still has reporting out, noisy withdrawal pending; wants to claim scalps - *in terroram*?
- Commissioners: Confidentiality has never been absolute, so not a big deal

SEC Update

- Lessons from Enron - Final Batson report on professionals, SJ's in class action litigation are in
- For general counsel:
 - Lead, follow or get out of the way. Enron GC was a pure manager, violations require scienter, hands on
 - Speak no evil - if you are not a “speaker,” it is very hard to create liability; review, don't originate disclosure
 - Never, never, never sell a single share of stock
 - On judgment calls, document consultation with outside counsel

SEC Update

- For outside counsel
 - Being close to your client is good, being too close to your client is bad
 - Object is to avoid being characterized as a principal actor in the client's affairs, avoiding protection of Central Bank
 - Check the forest and the trees
 - Be clear on whether you are providing securities advice that invokes Rule 205
 - Do not assist in excessive cleverness - i.e. sideletters, creation of inscrutable structures

SEC Update

- Disclosure Regarding Nominating Committee, Communications with Directors – Rel. 33-8340 (<http://www.sec.gov/rules/final/33-8340.htm>)
 - Proxy statements sent on or after 1/1/2004 must include specified disclosures
 - Focus on Nominating Committee processes, independence, charter, access by holders
 - Focus on holder communications means with board

SEC Update

- Management's Reports on Internal Control and Certification of Disclosure – Rel. 33-8238 (<http://www.sec.gov/rules/final/33-8238.htm>)
 - For reports due on or after August 14, 2003
 - Revised Section 302, 906 certifications
 - While full internal control disclosure, certification and attest by auditors is coming in 2005, the relevant certificate provisions may require discussion of changes and failures of internal controls in the 10K

SEC Update

- Strengthening the Commission's Requirements Regarding Auditor Independence – Rel. 33-8183 (<http://www.sec.gov/rules/final/33-8183.htm>)
 - In proxy statement for fiscal years ending after December 15, 2003
 - Revised breakdown of auditor's fees for current and prior year
 - Audit, audit-related, tax and all other
 - Description of audit committee pre-approval policy, percentage of non-audit approved by AC

SEC Update

- Disclosure of Off-Balance Sheet Arrangements and Contractual Obligations – Rel. 33-8182 (<http://www.sec.gov/rules/final/33-8182.htm>)
 - For fiscal years ending on or after June 15, 2003
 - Requires MDA discussion of off-balance sheet transactions, table of contractual obligations
 - Very difficult to combine plain English, new MDA requirements, need for focus on materiality, brevity in this area; start early

SEC Update

- Disclosure Regarding Audit Committee Financial Experts – Rel. 33-8177
(<http://www.sec.gov/rules/final/33-8177.htm>)
 - For fiscal years ending on or after June 15, 2003
 - Disclosure of "audit committee financial expert"
 - Post code of ethics on website, file as annual report exhibit or provide copies on written request
 - Charters and policies may take up more space than proxy in 2004

SEC Update

- Conditions for Use of Non-GAAP Financial Measures – Rel. 33-8176
(www.sec.gov/rules/final/33-8176.htm)
 - For fiscal years ending on or after March 28, 2003
 - Discussion and reconciliation of non-GAAP numbers reported, some prohibited
- Definition of “non-GAAP financial measure” per one SEC staff member:
 - “Throw out all the bad stuff”

SEC Update

- Interpretation: Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations – Rel. 33-8350 (<http://www.sec.gov/rules/interp/33-8350.htm>)
 - Think back to everything the staff has ever said about MDA
 - This time they mean it!
 - Be ready to integrate everything the issuer said last year - if you don't the staff will (they got AOL for Christmas)

SEC Update

- Summary by the Division of Corporation Finance of Significant Issues Addressed in the Review of the Periodic Reports of the Fortune 500 Companies
(<http://www.sec.gov/divisions/corpfin/fortune500rep.htm>)
 - Staff took a look at Fortune 500 2002 reporting, after Enron, Worldcom, etc.
 - Commented to 350 (most for future, i.e. 2003, action)
 - Release summarizes their issues, previews Rel. 33-8350 out in December 2003
 - SEC staff comments now available - Edgar Online

SEC Update

- Release 33-8340 Nominating Committee Process and Communications
 - Nominating Process: If no standing nominating committee, why?
 - Disclose charter; attach every 3 years or on web site
 - If listed, do members meet SRO independence standards
 - If not listed, do members meet company independence standards
 - Policy regarding holder nominations; if none, why?

SEC Update

- Preferred qualifications of nominees
- Process for identifying nominees, and who suggested this year's group
- 3rd party paid search?
- If a 5%+ holder nominated a candidate in past year, identify both (providing they consent) and the action taken by the committee
- Regulation SK, Sec. 401(j) added – disclose quarterly changes in procedures for holder recommendation of board nominees; implementing a policy = material change

SEC Update

- Holder Communications
 - Any process for direct communication with board; if not, why?
 - Description of process to communicate
 - If screened, less than all sent, who does it and why
 - Policy re board member attendance at annual meeting
 - Dropped – requirement to disclose action taken after holder communicates with board
 - How to manage communications
 - Someone has to read the stuff
 - Put up your spam filters

SEC Update

- Other proxy statement issues
- Proposed Rules - Rel. 34-48626, October 14, 2003 allowing “opt-in” holder nominations of directors when “proxy process of management may be ineffective”
 - Triggered by: (1) at least one company nominee gets 35% withhold vote (but not in a contest)
 - (2) a direct access proposal by 1% shareholder(s) gets 50% vote
 - (3) SEC considering – failure to implement a shareholder proposal getting 50% of the vote

SEC Update

- Result: Security holder "independent" nominee must be included in company proxy materials for next two meetings; qualifying nominators: 5%+holder, for at least two years, 13G filers; limited to 1 nominee if 8 directors or less, 2 if board numbers between 8 and 20 and 3 if board numbers above 20
- Wrinkle: Using procedure will not create a "group;" no "deputization" attribution of acts of nominee to nominators
- More than 10,000 comments, many by small holders

SEC Update

- Early "opt-in" proposals are coming – just introduce a shareholder resolution with self-actuating opt-in effects, stating that bylaws are amended to allow opt-in nominees if proposal gets majority vote
- SEC staff indicates they will allow these under Rule 14a-8
- AFSCME, NY State Common Fund, Calpers have submitted this proposal to Marsh & McLennan (parent of Putnam)

SEC Update

- Auditor Ratification – SOX gives auditor choice to audit committee, so should an issuer pull shareholder vote on auditor ratification?
- Maybe not: Sprint had 39% no vote on auditor ratification
 - institutions are worked up over questions about relationship with auditors at some issuers, especially where there have been accounting problems (i.e. Tyco)
 - pulling ratification back may be seen as taking power away from holders

SEC Update

- For Accelerated Filers – note that the date to file proxy materials to have them incorporated in the 10K has not changed – still 120 days from year-end
- Is incorporation of proxy materials by reference still the way to go? Volume of data, cross-referencing, online reading, result in some big shareholders preferring everything in a single document.
- Solution – consider 10KA amendment that pulls proxy data into 10K once it is finalized and mailed, and make that what your web site serves up

SEC Update

- Theme: When Law and Accounting Collide (or fail to connect, as the case may be)
 - This was at the heart of critical Enron issues
 - This is at the heart of many audit, disclosure busts, especially in increasingly complex structures
 - To really get the forest and the trees right, you have to integrate this knowledge
- A solution that worked: all hands due diligence
- Who owns MDA? Legal or Accounting?
- To get it right, share it

SEC Update

- Limits of the legal model
 - Easier to tell an executive "do it or you go to jail"
 - As opposed to "do it and the SEC may or may not notice or care, might require an amendment, and maybe an analyst or two somewhere will be happy"
 - Law is much more about what you must do and what you must not do than what you ought to do, especially in an area like drafting MDA
 - Competitive strategy this year - if you do it (disclose sensitive data to satisfy MDA requirements) SEC will make your competitors do it, too

SEC Update

- Key ideas from December MDA release:
 - Let investors see company through eyes of management
 - Provide a context for numerical data and footnotes
 - Provide information on quality and variability of earnings and cash flow to allow investors to gauge degree to which future results may or may not look like the past.

SEC Update

- To do: Make most important information most prominent
 - Start with an overview
 - Layer disclosure - big ideas first, detail later
 - Eliminate immaterial information
 - Identify and discuss key metrics
 - But watch for non-GAAP issues
 - Identify and discuss known trends, events, demands, commitments, uncertainties reasonably likely to impact condition or performance
 - Critical accounting policies

SEC Update

- Definition of “reasonably likely:
 - In hindsight, it is clear you knew or should have known this was going to be a problem
 - To avoid second guessing - go back to risk factor analysis, take into account ten most likely things that could go wrong
- MDA will be an interactive game over the next three years as SEC staff moves up learning curve, seeks to reconcile all information, listens to earnings calls, asks for management and board books. Be ready.

SEC Update

- Internal control analysis is sneaking into the tent a year early through Rel. 33-8238 internal control certification requirements.
 - "4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures . . .and have:
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

SEC Update

- 5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting."



SEC Update

- Even though the Section 5 certification specifies reports to the auditors and audit committee of instances of material problems or management fraud, the SEC staff has suggested that any of these that are material should be disclosed in the 10K
- SOX 404 implementation is just about guaranteed to have identified material weaknesses, caused material changes
- Note: PCAOB is bogged down by volume of comments on auditor attestation of internal control assessments by management. Adoption of standards may lag into second quarter of 2004

SEC Update

- Comment Letters Online
 - EdgarOnline has launched 25,000 FOIA requests to get SEC review comments, correspondence
 - Watch what you say
 - Watch what your competitors say
 - Prepare very specific Section 83 confidentiality requests – i.e individual words, numbers, not pages
 - Consider providing sensitive information "supplementally" per Rule 418 - SEC staff will return at end of communications, so FOIA request won't get it
 - SEC staff is grouchy and picky about Section 83 requests

SEC Update

- Voluntary Filers and Small Business Issuers
 - Voluntary filers – half in, half out
 - Per the SEC staff in SOX Q&A November 8, 2002, issuers that voluntarily choose to file '34 Act reports will not be deemed "issuers" for the purposes of SOX
 - Section 2(a)(7) of the . . . (1934) Act . . . defines an "issuer" as an "issuer . . . the securities of which are registered under Section 12 of that Act, or that is required to file reports under Section 15(d)...."

SEC Update

- **Voluntary Filers and Small Business Issuers**
- If a company's reporting obligations have been statutorily suspended under Section 15(d) because it had fewer than 300 security holders of record at the beginning of its fiscal year and has continued to file reports pursuant to its indenture, the Company is not considered an "issuer" under the Act. The definition of issuer applies
- However, a voluntary filer is subject to Rules 15d-14 and 15d-15 and the disclosure required by Item 307 of Regulations S-B and S-K because all companies filing or submitting reports under Section 13 or 15(d) must comply with those provisions.

SEC Update

- **Voluntary Filers and Small Business Issuers**
- All modifications to SEC rules and interpretations (ie changes to Regulation SK - independent financial experts (Section 407); codes of ethics (Section 406) and internal control reports (Section 404)) that derive from SOX, which apply to all reporting companies, will be equally applicable to mandatory and voluntary filers.
- And SEC staff may also argue that some of the statutory provisions that relate to disclosure should be complied with because, in a post-SOX world, it might be considered misleading or fraudulent in general terms not to do so.

SEC Update

- **Voluntary Filers and Small Business Issuers**
- Provisions of SOX that are directed more to governance than disclosure are, in the staff's view, not going to be applied to voluntary filers. These would include: provisions banning personal loans to directors and executive officers (Section 402), mandating fully independent audit committees (Section 301) and requiring disgorgement of profits following an accounting restatement (Section 304).
- While these and similar provisions may not be technically applicable to a voluntary filer, voluntary compliance should be considered as a "best practices" alternative
- Future events could propel a voluntary filer into mandatory filing status - be prepared. I.e. Consider auditor independence.

SEC Update

- Voluntary Filers and Small Business Issuers
 - Most of SOX changes apply to small business issuers. Exceptions:
 - Internal Control Report and Auditor Attestation - Effective date generally: August 14, 2003. SB issuers must comply with internal control report and auditor attestation for fiscal years ending on or after April 15, 2005. See: Rel. 33-8238 Management's Reports on Internal Control . . . in Exchange Act Periodic Reports. <http://www.sec.gov/rules/final/33-8238.htm>

SEC Update

- Voluntary Filers and Small Business Issuers
 - Standards Relating to Listed Company Audit Committees (only applies to exchange listed issuers). Effective date generally: April 25, 2003. SB issuers must comply by July 31, 2005. See Rel. 33-8220. <http://www.sec.gov/rules/final/33-8220.htm>
 - Disclosure in MD&A about off-balance sheet arrangements. Effective date generally: Year-end reports on or after June 15, 2003. SB issuers do not need to provide contractual obligations table. See Rel. 33-8182 <http://www.sec.gov/rules/final/33-8182.htm>

SEC Update

- Voluntary Filers and Small Business Issuers
 - Financial expert and code of ethics disclosure. Eff. date generally: May 6, 2003. SB issuers must provide code of ethics disclosure in 10-Ks for fiscal years ending on or after July 15, 2003; audit committee financial expert disclosure in 10-Ks for years ending on or after December 15, 2003. See Rel. 33-8177.
- Accelerated filing not applicable to SB issuers; if they trip triggers (i.e. float goes above \$75 million), will apply. See Rel. 33-8128.

<http://www.sec.gov/rules/final/33-8177.htm>

<http://www.sec.gov/rules/final/33-8128.htm>



SEC Update

- Section 16
- SEC gave 1 year of relief for one day late filings, June 30, 2004 – June 29, 2005
- All insiders need unique EDGAR code, can't crib on company number forever
- Year end Form 5 – Why Bother? Everything should be on Form 4's unless they missed one. But: for insiders with no stock activity, this may be first electronic filing.

SEC Update

SOX 303(a), Audit Responses

- A big question for this annual report cycle: Has SOX 303(a), prohibiting actions misleading to auditors, created a potential for criminal or civil liability for engaging in the normal process of editing draft disclosures of pending litigation and loss contingencies in counsel letters to auditors?

SEC Update

SOX 303(a), Audit Responses

- SOX 303(a): “It shall be unlawful . . .for any officer or director of an issuer, or any other person acting under the direction thereof, to take any action to fraudulently influence, coerce, manipulate, or mislead any independent public . . . accountant engaged in the performance of an audit of the financial statements of that issuer . . . for the purpose of rendering such financial statements materially misleading.”

SEC Update

SOX 303(a), Rule 13b2-2(b):

- “No officer or director of an issuer, or any other person acting under the direction thereof, shall directly or indirectly take any action to coerce, manipulate, mislead or fraudulently influence any . . . public accountant engaged in the performance of an audit or review of the financial statements of that issuer . . if that person knew or should have known that such action . . . could result in rendering the issuer’s financial statements materially misleading.”
- Note: SEC moved location of “fraudulently” between statute, rule, lowering the bar for their ability to bring civil actions under Rule 13b2-2(b).

SEC Update

Rule 13b2-2(b) Release:

- Are discussions between in-house, out-house counsel over audit response letters covered?
- “[W]e interpret Congress’ use of the term “direction” to encompass a broader category of behavior than “supervision.” [S]omeone may be “acting under the direction” of an officer or director even if they are not under the supervision or control of that officer or director.”
- “. . . Webster’s Dictionary (9th edition) . . . defines “direction” to include not only guidance or supervision of action or conduct but also explicit instruction.”

SEC Update

Rule 13b2-2(b) Release:

- “In appropriate circumstances, persons acting under the direction of officers and directors also may include . . . attorneys . . .”
- “We believe that third parties providing information or analyses to an auditor should exercise reasonable attention and care in those communications.”

SEC Update

SOX 303(a), Audit Responses

- Reread:
- American Bar Association Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (1976)
- Statement on Auditing Standards No. 12
- Your firm's standard response letter
- Your firm's policies
- "Exercise reasonable attention and care in those communications" in this and future years



SEC Update

SOX 303(a), Audit Responses

Does the following standard text imply “securities advice” for Rule 205 purposes?

“... whenever, in the course of performing legal services ... recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, we have formed a professional conclusion that the Company must disclose or consider disclosure [of that claim], we, as a matter of professional responsibility to the Company, will so advise the Company ...”

SEC Update

SOX 303(a), Audit Responses

- Consider adding, if appropriate: “This firm has not been engaged to provide advice to [client] with regard to federal or state securities laws, and nothing in this letter or in any other communications with [client] relating to these matters should be construed as offering such advice.”

SEC Update

SOX 303(a), Audit Responses

- Note: SEC has never opined upon or adopted current audit response letter practice.
- Note: Rule 205 does not speak to audit response letters at all to the extent that they do not constitute the offer of securities law advice.
- Query: If client copies audit letter text into 10K as description of litigation, does audit letter become securities advice? If counsel knows this, it might.

SEC Update

- When PCAOB comes knocking
 - If your auditor is audited by the PCAOB, you may be audited, too
 - PCAOB interviewers may cold-call your audit committee members
 - Provide Audit Committee members with materials that will allow easy reference to confirm what was done and when per rules

SEC Update

- Reg FD Enforcement – Schering-Plough Corp.
 - CEO nailed due to both verbal and non-verbal selective disclosure after he held private meetings with analysts, knowing company was below estimates
 - Conveyed negative news through "a combination of spoken language, tone, emphasis and demeanor" as reported by attendees at the meeting – he was down, pessimistic, even while saying the right things
 - Analysts downgraded, stock plunged
- Moral? Administer Prozac? Give acting lessons?
 - Disclose big news, then meet, not the other way around
 - Private analyst meetings are risky

SEC Update

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