

SEC Update

Overview of New Rules & Proposals

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Background

- **Last year was a relatively quiet year for SEC rulemaking**
 - ❖ **Having completed its rulemaking duties under the Sarbanes-Oxley Act of 2002, the SEC was able to turn to other items on its long-term agenda, including a proposal to reform the securities offering process**

Background

- **But it wasn't a quiet year for the SEC**
 - ❖ **The SEC got an earful on existing rules and proposals, *e.g.* shareholder access to company proxy statements and the new internal control report**

Outline

- **Staff Reviews Under Sarbox 408**
- **Website Posting of SEC Comment Letters**
- **Internal Control Report**
- **SEC Revised Form 8-K: Pitfalls**
- **Proposal Regarding Reform of the Securities Offering Process**
- **Tidbits . . .**

Outline

- **Staff Reviews Under Sarbox 408**

Staff Reviews Under Sarbox 408

- **Section 408 of the Sarbanes-Oxley Act of 2002 requires the Division of Corporation Finance to review each public company's SEC filings at least once every three years**

Staff Reviews Under Sarbox 408

- **The Division has taken the position that the “reviews” under Section 408 can be “legal” reviews, “accounting” reviews, or both, but will most often be accounting reviews**
- **The Division has commented that rather than review whole filings, it will more likely focus on reviewing specific issues, for example, disclosures regarding critical accounting policies**

Staff Reviews Under Sarbox 408

- **The Division of Corporation Finance has over 500 staff members, and, for the first time, accountants now outnumber attorneys**
- **The Division has announced that it is “on track” to meet this requirement: Your company’s review is coming soon if it has not happened already!**

Staff Reviews Under Sarbox 408

- **The Division has also announced that it will look at company websites when it is reviewing filings**
- **TIP: Regularly-scheduled reviews of your company's website (by both management and SEC counsel) should be part of your "Disclosure Controls and Procedures"**

Outline

- **Website Posting of SEC Comment Letters**

Website Posting of SEC Comment Letters

- **The SEC will begin publicly releasing on EDGAR its comment letters and your response letters relating to filings made after August 1, 2004 that are selected for review**
- **The comment and review letters will be published all at once, after the review is completed**

Website Posting of SEC Comment Letters

- **Exactly when and how this new approach will be implemented has not yet been decided**
- **Stay tuned to the SEC's website for details**

Outline

- **Internal Control Report**

Internal Control Report – Background and Status

- **Section 404 of the Sarbanes-Oxley Act of 2002 requires issuers to include in their Form 10-Ks:**
 - ❖ **Management's assessment, as of the end of the most recent FY, of the effectiveness of internal controls over financial reporting and**
 - ❖ **An auditor's attestation regarding management's report**

Internal Control Report – Background and Status

- **The Section 404 internal control report requirements have proven to be by far the most expensive and among the most controversial new compliance burdens imposed by the Sarbanes-Oxley Act of 2002**

Internal Control Report – Background and Status

- **What does it cost?**
 - ❖ **Cost estimates rose higher and higher as companies began the compliance process**
 - ❖ **As reported in the February 9, 2005 edition of the *Financial Times*, a survey conducted by the Corporate Executive Board found that, among large companies, there was an 80-130% increase in their audit fees**
 - **Not to mention additional costs – management time, outside consultants, new personnel and software**

Internal Control Report – Background and Status

■ The Rules:

- ❖ In June 2003 the SEC issued final rules implementing Section 404
- ❖ In June 2004 the SEC approved the PCAOB's Auditing Standard No. 2
- ❖ Also in June/July 2004 the SEC and the PCAOB issued separate FAQs on internal control reports

Internal Control Report – Background and Status

- **Until late fall 2004, compliance deadlines for calendar year companies:**
 - ❖ **Accelerated filers – Form 10-K for FY 2004 (due in 60 days)**
 - ❖ **Non-accelerated filers – Form 10-K for FY 2005**

Internal Control Report – Background and Status

- **In response to public outcry, the SEC extended the deadlines:**
 - ❖ **Nov. 2004 – 75 days to file 10-K (until March 16) instead of 60, for accelerated filers**
 - ❖ **Nov. 2004 – smaller accelerated filers given an additional 45 days from the 75-day deadline (until May 2) to comply with Section 404**
 - ❖ **March 2005 – non-accelerated filers given another year to comply (FY 2006 vs. FY 2005)**

Internal Control Report – Background and Status

- **Reported that approx. 300 companies filed Form 12b-25 for a 15-day extension past the (March 16) filing deadline, up from approx. 70 last year**
 - ❖ **Much of the delay is reported to be due to Section 404 compliance problems**
- **The Wall Street Journal reported on April 13th that more than 400 companies have acknowledged they have material weaknesses – roughly 4% of public companies**

Internal Control Report – Background and Status

- **Is relief coming for smaller public companies?**
 - ❖ **The SEC has established an Advisory Committee on Smaller Public Companies**
 - ❖ **COSO intends to publish guidance this summer to assist smaller companies in applying the COSO framework**

Internal Control Report – Background and Status

- **Is relief coming for everyone?**
 - ❖ **In response to complaints at the SEC's April 13, 2005 roundtable discussion, the PCAOB and SEC have indicated that they will look for ways to provide additional guidance and possibly ease compliance burdens**

Internal Control Report – Key Concepts

- **The SEC rules (Regulation S-K Item 308) require the management report to**
 - ❖ **State management’s responsibility for establishing and maintaining adequate internal controls over financial reporting**
 - ❖ **State whether or not they are effective as of the end of the most recent FY**
 - ❖ **Disclose any “material weaknesses” identified by management**
 - ❖ **Identify the framework used by management in its assessment**

Internal Control Report – Key Concepts

- **Management may not conclude that controls are effective if one or more material weaknesses have been identified**

Internal Control Report – Key Concepts

- **The PCAOB made a major decision that may or may not have been envisioned by Sarbanes-Oxley: the auditors must conduct a separate audit of the company’s internal control over financial reporting**
- **As a result, the auditor really gives 3 opinions:**
 - ❖ **The “regular” opinion on the financials**
 - ❖ **A “double-barreled” opinion covering both the auditor’s own opinion and the assessment of management’s report**

Internal Control Report – Key Concepts

- **A single material weakness in internal controls over financial reporting will preclude the auditor from rendering an unqualified opinion on them**

Internal Control Report – Key Concepts

- **The PCAOB says that the following (among many other things) is indicative of at least a significant deficiency and a strong indicator of a material weakness: oversight of the company's external financial reporting and internal control over financial reporting by the audit committee is ineffective**
 - ❖ **In other words, the auditor must assess the effectiveness of the audit committee**

Internal Control Report – Final Thoughts

- **And in case you have a material weakness, on March 31, 2005 the PCAOB proposed a new auditing standard that will allow for a company to voluntarily engage their auditor to provide assurance that the material weakness has been eliminated**
 - ❖ **Now, management can make this disclosure, but there is no mechanism for interim auditor assurance to be given**

Internal Control Report – Final Thoughts

- **Scott Bohannon, executive director at the Corporate Executive Board, said: “Some companies feel auditors have simply had to incur the extra cost and risk associated with Sarbanes-Oxley and there is no avoiding it. Others feel very strongly the auditors have taken advantage of Sarbanes-Oxley and significantly increased their profit margins.”**

Outline

- **SEC Revised Form 8-K – Pitfalls**



SEC Revised Form 8-K – Pitfalls

- **Comprehensive revisions of Form 8-K became effective on August 23, 2004**
 - ❖ **SEC November 2004 FAQs**
 - ❖ **Four Business Day Filing Requirement**

SEC Revised Form 8-K –Pitfalls

November 2004 FAQs

- **As the panel on Senior Executive and Board Compensation noted, in November 2004, the SEC released FAQs regarding revised Form 8-K**
- **The FAQs contain helpful (and, in some cases, surprising) information regarding the revised Form 8-K disclosure requirements**

SEC Revised Form 8-K –Pitfalls

November 2004 FAQs

- **You have already heard what the FAQ had to say regarding the disclosure of executive compensation and bonuses (under Item 1.01: Entry into a Material Definitive Agreement)**
- **Other topics of interest . . .**

SEC Revised Form 8-K –Pitfalls November 2004 FAQs

- **Under Item 2.04 (Triggering Events that Accelerate or Increase a Direct Financial Obligation), what happens if a company is “in default” under the terms of a loan or credit agreement (for example, for a covenant violation) but the counterparty has not provided a notice of default?**

SEC Revised Form 8-K –Pitfalls

November 2004 FAQs

- **It depends on how the agreement is written. In many cases, notice and an opportunity to cure are necessary before the financial obligations under the agreement are increased or accelerated. It is only upon the actual acceleration that a Form 8-K must be filed**

SEC Revised Form 8-K –Pitfalls

November 2004 FAQs

- **Under Item 5.02, what if a director or officer sends a letter to the company in September stating that he or she will retire or resign in December. When must a Form 8-K be filed?**
- **The Form 8-K must be filed in September within four business days of receipt of the notice and must specify the effective date of the resignation or retirement**

SEC Revised Form 8-K –Pitfalls

November 2004 FAQs

- **One more pitfall (not in the FAQs): If a company enters into a material revolving line of credit, a Form 8-K must be filed under Item 2.03 (Creation of a Direct Material Financial Obligation) (1) upon entering into the facility and (2) each time material draws are made under the facility**

SEC Revised Form 8-K – Pitfalls

Four Business Day Filing Requirement

- **Remember: There is now a four business day filing requirement**
- **If you are not careful, the four business day filing requirement can sneak up on you!**

SEC Revised Form 8-K – Pitfalls

Four Business Day Filing Requirement

- **Potential penalties include, among other things, losing for one year your eligibility to file “short-form” registration statements on Form S-3**

SEC Revised Form 8-K – Pitfalls

Four Business Day Filing Requirement

- **Generally, messing up the four-day filing requirement is “curable” in the sense that it will not disqualify the company from using Form S-3, as long as it is “cured” eventually (by the earlier of the filing of your next periodic report or the filing of your next registration statement)**

SEC Revised Form 8-K – Pitfalls

Four Business Day Filing Requirement

- **However, this “curable” status does not apply to some items - in other words, if it is messed up it can't be fixed**
- **Commonly-occurring items that are not-curable:**

SEC Revised Form 8-K – Pitfalls

Four Business Day Filing Requirement

1. ANY change in a director (other than election at a stockholders' meeting) or a “principal officer”

- *e.g.* resignation/removal/retirement/refusal to stand for reelection/hiring or appointing a new one) (Item 5.02)
- A “principal officer” is the CEO, president, CFO, principal operating officer, principal accounting officer or any person performing similar functions

SEC Revised Form 8-K – Pitfalls

Four Business Day Filing Requirement

2. **ANY amendment to the company's articles of incorporation or by-laws (Item 5.03)**

SEC Revised Form 8-K – Pitfalls

Four Business Day Filing Requirement

- **TIP: Make sure your employees are educated about the scope and timing of the new disclosure requirements**
 - ❖ **This should be part of your company's disclosure controls and procedures**
 - ❖ **For example: Entry into and termination of material definitive agreements. What qualifies as a “material definitive agreement” should be communicated to your employees**

Outline

- **Proposal Regarding Reform of Securities Offering Process**

Securities Offering Reform - Background

- **The federal scheme for regulating public offerings (the Securities Act of 1933) is over 70 years old and is showing its age**
 - ❖ **The scheme attempts to control information used in an offering, and information is harder and harder to control due to technological advances**

Securities Offering Reform - Background

- In 1998, the SEC proposed a comprehensive revision of the regulation of securities offerings
- It was referred to by securities law practitioners as the “Aircraft Carrier” due to its size
- It sank

Securities Offering Reform

- In October 2004 the SEC proposed incremental reforms to the securities offering process in a 400 page release
- The SEC has received about 130 comment letters and the staff is preparing a 100+ page summary that will be posted on the SEC website
- Nothing else likely to happen before late summer/fall 2005

Securities Offering Reform

- **Reforms are proposed in 3 main areas:**
 - ❖ **Communications re: registered offerings**
 - ❖ **Simplification of shelf registration**
 - ❖ **Modernization of final prospectus delivery**
- **New rules would also require additional disclosures in SEC reports**

Securities Offering Reform

- **What follows is a VERY brief summary of some of the key proposals**

Securities Offering Reform

- **The amount of flexibility depends on which of 4 new categories an issuer falls into:**
 - ❖ **“Well-known seasoned issuers” (WKSI): can register a primary offering on Form S-3 and has \$700 million or more market value of common equity held by non-affiliates**
 - ❖ **“Seasoned issuers”: can register a primary offering on Form S-3**
 - ❖ **“Unseasoned issuers”: cannot register a primary offering on Form S-3 but files reports with the SEC. Voluntary filers would fall into this category.**
 - ❖ **“Non-reporting issuers”: do not file reports with the SEC**

Securities Offering Reform – Liberalize Communications

- **The proposals would liberalize communications permitted around the time of a registered offering**

Securities Offering Reform – Liberalize Communications

- **WKSI**s could engage in oral communications at any time. They could also use a “free writing prospectus” at any time (= a writing beyond those currently permitted such as the statutory prospectus)

Securities Offering Reform – Liberalize Communications

- **Other issuers still could not make oral or written offers before the registration statement is filed**
- **After the registration statement is filed, other issuers could use free writing prospectuses but on a more limited basis than WKSIs**

Securities Offering Reform – Liberalize Communications

- **But . . . Issuers would generally have to file free writing prospectuses with the SEC**
- **Free writing prospectuses would have same liability standard as statutory prospectuses**

Securities Offering Reform – Shelf Registration

- **The proposals would update and in some cases liberalize the shelf registration process**
 - ❖ **WKSIs would get automatic effectiveness and “pay-as-you go” registration fees**
 - ❖ **Replace the requirement that issuers register only securities they intend to offer within 2 years with a requirement to update the shelf with a new one filed every 3 years**

Securities Offering Reform – Delivery of Final Prospectus

- **Proposals would (generally) eliminate the requirement of physical delivery to investors of a final prospectus that is filed with the SEC**

Securities Offering Reform – New Disclosures

- **Risk factor disclosure would be required in Form 10-Ks**
 - ❖ Many companies do this voluntarily now
- **Accelerated filers would be required to disclose in Form 10-Ks material unresolved SEC staff comments**
- **Required disclosure of “voluntary filer” status, if applicable**

Securities Offering Reform – Liability

- **The proposals change the application of some of the liability standards in the Securities Act of 1933 in a manner that could increase issuers' litigation exposure**

Outline

- Tidbits . . .

Tidbits . . .

- Shareholder access to company proxy statement. Last year, we described a new SEC rule proposed in October 2003 that would have given shareholders the right to use the company's proxy statement to solicit proxies for a shareholder board nominee in certain cases -- this proposal is reportedly now "beyond resuscitation"

Tidbits . . .

- **Executive compensation disclosure.** The SEC is reportedly working on a comprehensive revision of the executive compensation disclosure rules – last revised in 1992

Tidbits . . .

- Stock option expensing. Six month reprieve from stock option expensing, plus some guidance issued by the SEC (covered in earlier panel)

Tidbits . . .

- **Reg. FD – Flowserve. Recent Regulation FD enforcement action against Flowserve reminding everyone of the perils of confirming earnings guidance (covered in earlier panel)**

Tidbits . . .

- **NYSE corporate governance rules. In November 2004, the NYSE adopted some refinements to its corporate governance rules**

For More Information

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