

# The End of the Sarbanes-Oxley Storm and What Lies Ahead

## *Overview of Recent SEC and Stock Market Rules*

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# Background

- In 2003 and early 2004, the SEC completed its Congressional mandate to adopt new corporate governance rules under the Sarbanes-Oxley Act of 2002
- The SEC also introduced additional reforms that are meant to increase information available to investors and strengthen stockholder participation in the election of directors

# Background

- **In November 2003, the SEC (finally) approved the final version of the NYSE and Nasdaq corporate governance listing standards, which had been originally proposed concurrently with the Sarbanes-Oxley Act in 2002**
- **Most of the new corporate governance listing requirements must be implemented by the 2004 annual meeting of stockholders**

# Outline

- **Revised Form 8-K**
- **Internal Control Reports and Attestation**
- **Proposal re: Stockholder Access to Company Proxy Materials**
- **New Proxy Statement Disclosures, Effective January 1, 2004**
- **Issuer Repurchases of Equity Securities**
- **MD&A**
- **Trading Market Corporate Governance Rules**
- **And Don't Forget . . .**

*Note: Compliance dates in this presentation assume a calendar fiscal year end and an accelerated filer*

# Outline

- Revised Form 8-K

# Revised Form 8-K

- **Complete overhaul of Form 8-K**
- **How did the form change?**
  - ❖ **Eight new items**
  - ❖ **Two items moved from Forms 10-K and 10-Q**
  - ❖ **Two current items expanded**
  - ❖ **Items are now organized by topic**

# Revised Form 8-K

- **Also new accelerated filing deadline**
  - ❖ **Four business days after a triggering event**
  - ❖ **Does not apply to Regulation FD or voluntary disclosures or certain exhibits**
- **Effective date: August 23, 2004**

# Revised Form 8-K

## Eight New Items

### 1. Creation of a material direct financial obligation or obligation under an off-balance sheet arrangement

#### ❖ “Direct financial obligation” means

- Long term debt, capital lease and operating lease obligations, as defined in the MD&A rules for the table of contractual obligations
- Short term debt obligations arising other than in the ordinary course of business (as defined in Form 8-K)

# Revised Form 8-K

## Eight New Items (Continued)

### 1. (Continued)

- ❖ “Off-balance sheet arrangement” has same definition as under the MD&A rules
- ❖ No Form 8-K disclosure required for securities sold under a registration statement

# Revised Form 8-K

## Eight New Items (Continued)

2. Events that accelerate or increase a direct financial obligation or an obligation under an off-balance sheet arrangement, if the consequences are material to the company

# Revised Form 8-K

## Eight New Items (Continued)

### 3. Entry into a material definitive agreement or a material amendment thereto

- ❖ This item is similar to Item 601(b)(10) of Regulation S-K with respect to the types of agreements that are material to a company
- ❖ Companies are encouraged, but not required, to file the agreement or amendment as an exhibit (but must file with next Form 10-Q or 10-K)
- ❖ Does not require disclosure of entry into a non-binding agreement, such as a letter of intent

# Revised Form 8-K

## Eight New Items (Continued)

### 4. Termination of a material definitive agreement

- ❖ Disclosure is only required if the agreement is terminated other than by expiration on a stated termination date or as a result of all parties completing their obligations

# Revised Form 8-K

## Eight New Items (Continued)

### 5. Costs associated with exit or disposal activities

- ❖ Requires disclosure when a company will incur material charges under GAAP because it commits to an exit or disposal plan (or otherwise disposes of a long-lived asset) or terminates employees under a plan of termination described in paragraph 8 of SFAS No. 146

# Revised Form 8-K

## Eight New Items (Continued)

### 5. (Continued)

- ❖ **Disclosure must include estimates of amounts**
  - **If this cannot be done by the filing deadline, the company must later amend its Form 8-K when the information is available**

# Revised Form 8-K

## Eight New Items (Continued)

### 6. Material impairments

- ❖ Requires disclosure when a company concludes that a material charge for an impairment to an asset (including securities or goodwill) is required under GAAP
- ❖ Disclosure of estimated amounts is required, similar to new “exit cost” disclosure requirement
- ❖ Disclosure is not required if the conclusion is made in connection with the preparation, review or audit of financials required for the next periodic report, if disclosed in that report

# Revised Form 8-K

## Eight New Items (Continued)

### 7. Non-reliance on previously-issued financial statements or a related audit report or interim review

- ❖ Requires disclosure when a company concludes that previously issued financial statements no longer should be relied upon because of an error (as addressed in APB Opinion No. 20)
- ❖ Requires disclosure if the independent auditor sends notice that disclosure should be made to prevent future reliance on a previously issued audit report or interim review

# Revised Form 8-K

## Eight New Items (Continued)

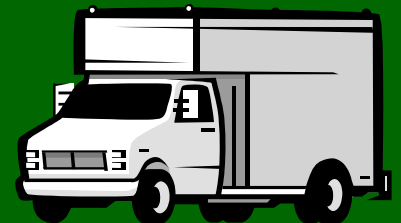
8. Notice of delisting or failure to satisfy a continued listing standard; transfer of listing

# Revised Form 8-K

## Two Moved Items

### 1. Unregistered sales of equity securities

- ❖ For example, private placements
- ❖ Disclosure currently required under Item 2(c) of Form 10-Q and Item 5(a) of Form 10-K
- ❖ If  $< 1\%$  of outstanding stock, can wait to report until next 10-Q or 10-K
- ❖ Includes definitive agreements to sell

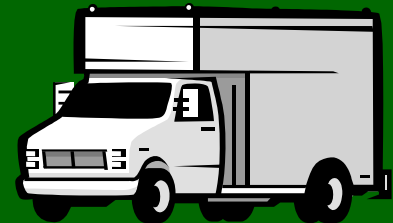


# Revised Form 8-K

## Two Moved Items (Continued)

### 2. Material modifications to rights of security holders

- ❖ Disclosure currently required under items 2(a) and (b) of Form 10-Q



# Revised Form 8-K

## Two Expanded Items

### 1. Changes in Directors and Officers

- ❖ **A director retires, resigns, refuses to stand for re-election or is removed for cause**
  - **Disclosure currently required only if the director asks that a letter of disagreement be disclosed**
  - **New rule requires disclosure every time**
  - **If due to a disagreement with the company known to an executive officer, this must be disclosed**
  - **Any related written correspondence from the director must be filed as an exhibit**

# Revised Form 8-K

## Two Expanded Items (Continued)

### 1. (Continued)

- ❖ **A principal officer retires, resigns or is terminated**
  - **Covers CEO, President, CFO, CAO, COO or any person performing a similar function**
  - **Reasons do not have to be disclosed**

# Revised Form 8-K

## Two Expanded Items (Continued)

### 1. (Continued)

- ❖ Appointment of new director, except at a stockholders' meeting
- ❖ Appointment of new principal officer

**In both cases, the company must disclose certain information about the new director or principal officer**

# Revised Form 8-K

## Two Expanded Items (Continued)

2. Amendments to articles of incorporation or bylaws; Change in fiscal year
  - ❖ Current Item 8 only requires disclosure of a change in fiscal year

# Revised Form 8-K



## One of the Penalties for Late Filing

- **Loss of eligibility for use of Form S-2 or Form S-3 for 12 months**
  - ❖ **Does not apply to any of the new disclosure items except**
    - **Non-reliance on prior financial statements, when notice comes from the accountant**
    - **Notice of delisting or failure to satisfy a continued listing standard; transfer of listing**

# Outline

- **Internal Control Report and Attestation**

# Internal Control Report and Attestation

- **Rules will require, annually in Form 10-K:**
  - ❖ **A management report on internal controls over financial reporting**
    - SEC final rules adopted June 2003
  - ❖ **The independent auditor's attestation report regarding management's evaluation**
    - PCAOB standard announced March 2004
- **Next presentation will address in more detail**

# Internal Control Report and Attestation

## New Compliance Dates

- **Management internal control and auditor attestation reports**
  - ❖ **Accelerated filers – Must first appear in Form 10-K for the first fiscal year ending on or after November 15, 2004 (previously, June 15, 2004)**
  - ❖ **Others – Must appear in Form 10-K for the first fiscal year ending on or after July 15, 2005 (previously, April 15, 2005)**

# Outline

- **Proposal re: Stockholder Access to Company Proxy Materials**

# Proposal re: Stockholder Access to Company Proxy Materials

- If adopted, these highly controversial rules would require companies to include in their proxy materials director nominees submitted by long-term, significant stockholders upon the occurrence of certain triggering events
- Currently, a stockholder dissatisfied with the board must
  - ❖ Try to convince the nominating committee to recommend desired candidates
  - ❖ Finance own proxy solicitation in support of desired candidates
  - ❖ Sell

# Proposal re: Stockholder Access to Company Proxy Materials

- **Triggering events:**

- ❖ **At least one company director nominee received “withhold” votes from > 35% of the votes cast at an uncontested stockholders’ meeting after January 1, 2004**

**-or-**

- ❖ **A Rule 14a-8 stockholder proposal that the company be subject to the stockholder proxy access procedures was submitted for a vote at a meeting after January 1, 2004 by > 1%-for-one-year stockholder(s) and received > 50% of the votes cast**

# Proposal re: Stockholder Access to Company Proxy Materials

- **What would happen upon the occurrence of one or both of the triggering events?**
  - ❖ **Any stockholder or group who has held > 5% of the company's stock for at least two years would become eligible to submit director nominee(s) for the next two annual meetings**
  - ❖ **Stockholder(s) must be eligible to file and have filed a Schedule 13G indicating no change of control intent**

# Proposal re: Stockholder Access to Company Proxy Materials

- **How many nominees could be submitted?**
  - ❖ **1 (if the board has 8 or fewer members)**
  - ❖ **2 (if the board has between 9 and 19 members)**
  - ❖ **3 (if the board has 20 or more members)**
- **If the number of nominees exceeds the number the company is required to include in the proxy materials, the largest stockholder “wins”**

# Proposal re: Stockholder Access to Company Proxy Materials

- **Eligible nominees**

- ❖ **Must be independent from the nominating stockholder(s) under a new definition**
- ❖ **Must be independent from the company under the applicable trading market definition**

# Proposal re: Stockholder Access to Company Proxy Materials

- Heated debate since rules proposed in October 2003
  - ❖ Make companies more responsive to stockholders

vs.

- ❖ Introduce disruptive special interests and discourage qualified candidates
- Proposed triggers would cover this year's proxy season; has led to unprecedented "withhold the vote" campaigns (e.g. Disney, CalPERS)
- Comment period extended to March 31

# Outline

- **New Proxy Statement Disclosures, Effective January 1, 2004**

# New Proxy Statement Disclosures, Effective January 1, 2004

1. Enhanced proxy statement disclosures regarding board nominating committees and new disclosures regarding the director nomination process

# New Proxy Statement Disclosures, Effective January 1, 2004

## 2. Stockholder Communications with Directors

- ❖ Must disclose whether the board provides a process by which stockholders can send communications to the company's directors (and if not, why not)
- ❖ If it has such a process, the company must describe the the process

# New Proxy Statement Disclosures, Effective January 1, 2004

## 3. Director Attendance at Stockholder Meetings

- ❖ Disclose whether the company has a policy regarding director attendance at stockholder annual meetings
- ❖ Disclose the number of directors who attended last year's annual meeting

# Outline

- Issuer Repurchases of Equity Securities

# Issuer Repurchases of Equity Securities

- **New rules require Form 10-K and 10-Q disclosure of all open market and private repurchases of registered equity securities by issuers**
  - ❖ **Most companies previously provided minimal disclosure in the footnotes to their financial statements**
- **Effective date: Forms 10-K and 10-Q filed for periods ending on or after March 15, 2004**

# Issuer Repurchases of Equity Securities

- **The following information about stock repurchases must be disclosed in Forms 10-Q and 10-K in a tabular format (broken down by month):**
  - ❖ **Total number of shares repurchased**
  - ❖ **Average price per share**
  - ❖ **Number of shares repurchased under publicly-announced plans or programs**
  - ❖ **Maximum number or approximate dollar value of shares the company may repurchase under the programs in the future**

# Issuer Repurchases of Equity Securities

- **Related new rules also made a number of technical amendments to Rule 10b-18 under the '34 Act**
  - ❖ **Rule 10b-18 provides issuers repurchasing their own common stock with a safe harbor from federal securities law liability for manipulative trading activity if they satisfy certain manner of purchase, timing, price and volume conditions**
  - ❖ **Effective date: December 17, 2003**

# Outline

- MD&A

# MD&A

## Recent SEC Releases on MD&A

- **December 2001**
  - ❖ Encouraged disclosure of critical accounting policies
  - ❖ Fortune 500 review comments
- **January 2002**
  - ❖ Interpretive guidance (focus on Enron issues)
- **May 2002**
  - ❖ Proposed rules re: critical accounting policies (still under consideration)

# MD&A

## Recent SEC Releases on MD&A (Continued)

- **January 2003**
  - ❖ **New rules require disclosure of off-balance sheet arrangements in designated section and table of contractual obligations**
- **December 2003**
  - ❖ **More interpretive guidance**

# MD&A

## December 2003 Guidance (Continued)

- **Hard to summarize – read the release and see what speaks to you**
- **Encourages better organization and presentation (suggests overview, tables, headings, eliminate repetition, focus on material items)**
- **Focuses on**
  - ❖ **Liquidity and capital resources**
  - ❖ **Critical accounting policies**

# Outline

- **Trading Market Corporate Governance Rules**



# Trading Market Corporate Governance Rules

- **The SEC (finally) approved the proposed Nasdaq and NYSE corporate governance rules in November 2003, which should now be familiar**
- **Many of the new rules must be complied with by the first annual stockholder's meeting after January 15, 2004, but no later than October 31, 2004, including**
  - ❖ **Majority of independent directors**
  - ❖ **Independent director/committee recommendation of executive officer compensation and director nominees**
  - ❖ **New audit committee requirements**

# Trading Market Corporate Governance Rules

- **NYSE also requires**
  - ❖ **Internal audit function**
  - ❖ **Corporate governance guidelines**
  - ❖ **Website posting of code of ethics, governance guidelines, committee charters**

# Outline

- **And Don't Forget . . .**

# And Don't Forget . . .

- **Public disclosure of waivers of code of ethics for directors and executive officers (on Form 8-K)**
- **Proxy Statement disclosure:**
  - ❖ **Audit committee financial experts**
  - ❖ **Audit committee pre-approval policy**
  - ❖ **Enhanced disclosure of fees paid to auditor**

# And Don't Forget . . .

- **Accelerated filing deadlines**
  - ❖ **Forms 10-K and 10-Q**
- **Tightened NYSE and Nasdaq rules requiring stockholder approval of equity compensation plans and material revisions**
  - ❖ **Rule also prohibits discretionary proxy voting by brokers**

# And Don't Forget . . .

- **Regulation FD: In September 2003, the SEC imposed civil penalties on Schering-Plough of \$1 million and on its former CEO of \$50,000**
  - ❖ **Largest penalty to date for a Regulation FD violation and the first penalty imposed on an individual**

**Thank You!**

# How to Use this Presentation

- **This presentation gives an overview of various laws, regulations and rules. Most of the rules described have been summarized to provide a general idea of how they may apply. You should not rely on this overview as legal advice for a particular situation, but should consult legal counsel before making any specific decision.**

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