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# NEW SEC REPORTING REQUIREMENTS FOR COMPANIES AUDITED BY ARTHUR ANDERSEN

*By Allison Bell*

On March 18, 2002, the SEC issued a release containing new disclosure requirements and guidance for Exchange Act filers audited by Arthur Andersen. The release addresses the presentation of financial statements of companies that continue to engage Arthur Andersen and modifies the reporting requirements and deadlines for filers that have previously engaged Arthur Andersen but are unable or choose not to have Arthur Andersen issue an audit report for their most recently completed fiscal year.

With respect to companies that continue to engage Arthur Andersen, the SEC stated that it has received assurances from the accounting firm that it will continue to audit financial statements in accordance with GAAS and applicable professional and firm auditing standards, including quality control standards. A company to which Arthur Andersen issues a signed audit report after March 14, 2002, must file a letter as an exhibit to its filing stating that it has received certain representations from Arthur Andersen concerning audit quality controls. The SEC stated that as long as Arthur Andersen continues to be in a position to provide these assurances, it will continue to accept financial statements audited by Arthur Andersen.

The SEC also stated that companies that are unable or choose not to have Arthur Andersen issue a signed audit report must adhere to existing filing deadlines, but those filings may include unaudited financial statements if audited statements cannot be produced at the time of filing. A company electing this alternative generally will be required to amend its filing within 60 days to include audited financial statements. The company must provide on the cover page of its filing a prominent statement that the filing includes unaudited financial statements because the company was unable or elected not to obtain a signed audit report from Arthur Andersen. The company must also include this statement immediately before the financial statements in its filing, and indicate when and how the company intends to provide the audited financial statements, as well as the fact that no auditor has opined that the unaudited financial statements fairly present the financial position of the company.

The SEC also stated that electing to include unaudited financial statements in a filing will not jeopardize a company's ability to use certain short-form registration statements in the future.

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# NASD AND NEW YORK STOCK EXCHANGE PROPOSE NEW RULES GOVERNING ACTIONS OF RESEARCH ANALYSTS

*By W. Benjamin Lackey*

On February 7, 2002, the NASD released proposed rules designed to deal with the conflicts that can arise "when analysts work for firms that have other business relationships with the company being analyzed, like investment banking services." On the same day, the New York Stock Exchange approved proposed amendments to its rules governing member reporting requirements that are similar in scope and effect to those proposed by the NASD. The NASD and the New York Stock Exchange worked in conjunction with each other and the SEC to develop the proposed rules.

Among other things, the proposed NASD and New York Stock Exchange rules would:

- prohibit tying an analyst's compensation to specific investment banking transactions;
- prohibit the supervision or control of a research analyst by a firm's investment banking department;
- prohibit the submission of a research report to a company prior to its publication, except in limited circumstances (which include (1) the verification of the factual accuracy of sections *other than* the research summary, the research rating and the price target and (2) the disclosure of a change in rating to a company not earlier than after the close of trading on the day prior to the announcement of the change);
- require quiet periods before and after initial public offerings and secondary offerings during which the managers of the offering could not issue research reports regarding the subject company;
- prohibit firms from offering or threatening to withhold favorable research to induce companies to purchase services;
- restrict, during certain periods, the ability of analysts to purchase securities issued by companies they cover or that are in industries they cover; and

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- require significant additional disclosure of conflicts of interest, including disclosure of securities held by analysts and their firms that have been issued by recommended companies.

## SEC TO PROPOSE CHANGES IN PERIODIC DISCLOSURE REQUIREMENTS

*By Dionne M. Rousseau and W. Benjamin Lackey*

In February 2002, the SEC announced that it plans to propose changes to the periodic disclosure rules applicable to companies subject to the reporting requirements of the Securities Exchange Act of 1934, which may include:

- shortening the filing period for 10-Ks from 90 to 60 days and for 10-Qs from 45 to 30 days;

- expanding the universe of events requiring Form 8-K disclosure and shortening the time frames during which events must be reported;

- requiring companies to make their Exchange Act reports available on their web sites at the same time they are filed with the SEC; and

- requiring disclosure in MD&A about "critical accounting policies" (those policies that are "most important to the portrayal of a company's financial condition and results, and require management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain").

In its release, the SEC also stated that it supported legislative action to shorten the period for reporting trades by company insiders. Pending legislative action, the SEC expects to require that significant trades by insiders be reported by companies on a current basis, and is also exploring ways in which these reports could be filed electronically.

The SEC has not established a timetable for releasing the proposals for public comment, but has stated that it intends to move quickly to adopt the new rules.

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# SEC SUGGESTS IMPROVEMENTS IN MD&A DISCLOSURE

*By Dionne M. Rousseau and W. Benjamin Lackey*

In January 2002, in response to a petition from the "Big 5" accounting firms requesting specific interpretive guidance with respect to the rules governing MD&A, the SEC issued suggestions for improved MD&A disclosure with respect to the following matters:

- liquidity and capital resources (including off-balance sheet arrangements);
- trading activities involving non-exchange traded contracts accounted for at fair value; and
- transactions with related or non-independent parties.

The SEC cautioned that its statement did not constitute a change in existing law, and was designed to assist companies in meeting their current disclosure obligations. Among other things, the release

- gives examples of items management should consider when drafting disclosure about trends and uncertainties in liquidity and capital resources, including provisions in debt agreements that could trigger acceleration, factors that could affect credit ratings, the potential effect of guarantees, and circumstances that could impair the company's ability to continue to engage in transactions that have been or are integral to the company's operations;
- advises that where off-balance sheet arrangements are material sources of liquidity and financing, specific disclosure is required, and suggests that management consider, among other items, the economic substance of the arrangement, the key terms and conditions of any commitments by the company, the past and present relationships with the company and its affiliates, and the potential risk to which the company may be exposed as a result of the arrangement;
- suggests a tabular disclosure format covering (1) contractual obliga-

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tions and other commercial commitments and (2) trading activities involving commodity contracts accounted for at fair value but for which a lack of market price quotations necessitates the use of fair value estimation techniques; and

- states that material related party transactions should be discussed in MD&A to the extent necessary for an understanding of current and prospective financial position, and advises companies to consider whether relationships with non-independent parties who do not fit the definition of related parties (such as former senior management) are material and need to be disclosed.

## SEC RECOMMENDS DISCLOSURE OF CRITICAL ACCOUNTING POLICIES

*By Dionne M. Rousseau*

In December 2001, the SEC issued a statement regarding the selection and disclosure by public companies of critical accounting policies and practices. Among other things, the SEC encouraged public companies to include in their MD&A full explanations, in plain English, of their critical accounting policies: "To enhance investor understanding of the financial statements, companies are encouraged to explain in MD&A the effects of the critical accounting policies applied, the judgments made in their application, and the likelihood of materially different reported results if different assumptions or conditions were to prevail." The SEC defines "critical accounting policies" as those that "are both most important to the portrayal of the company's financial conditions and results, and . . . require management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain." The SEC also encouraged proactive discussions among the audit committee, senior management and the auditor about these policies.

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# SEC CAUTIONS COMPANIES REGARDING USE OF PRO FORMA DATA AND TAKES FIRST-EVER ACTION ADDRESSING PRO FORMA ABUSES

*By Amos J. Oelking, III*

In December 2001, the SEC provided cautionary advice to companies regarding the disclosure of earnings and other financial information compiled in accordance with principles other than GAAP. In its release, the SEC acknowledged that such information, commonly referred to as "pro forma" information, can be useful to investors, for example, by allowing a company to emphasize the results of its core operations.

However, the SEC expressed concern that pro forma information can also be misleading to investors if it distorts a company's GAAP results. Moreover, in the SEC's view, it can be difficult for investors to compare pro forma information with a company's financial information for other periods and the financial information of other companies.

Accordingly, the SEC has advised companies to:

- be particularly cognizant of their obligation not to mislead investors when presenting pro forma information;
- disclose the basis and assumptions upon which pro forma information was prepared;
- not omit material information from a pro forma presentation unless a clear explanation of the nature and size of the omission is provided; and
- provide a "plain English" explanation of any deviations from GAAP, including the amount of such deviations.

Within a month of issuing this caution, the SEC instituted its first-ever enforcement action addressing the abuse of pro forma earnings figures. The enforcement action, brought against Trump Hotels and Casino Resorts Inc., targeted the pro forma earnings figures contained in Trump Hotels' third-quarter 1999 earnings release.

While Trump Hotels properly disclosed the exclusion of a one-time

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charge to its earnings, it failed to disclose that the pro forma earnings figures *included* an unusual one-time gain that resulted from the termination of a lease. On the day the earnings release was issued, Trump Hotels' stock rose 7.8 percent; however, when news of the impact of the one-time gain was published three days later, the stock's price fell approximately 6 percent.

According to the SEC, the earnings release gave investors the false and misleading impression that Trump Hotels had exceeded analysts' earnings expectations through operational improvements, when in fact Trump Hotels' net income for the quarter was due entirely to the one-time gain. The *Trump Hotels* case, stated the director of the SEC's enforcement division, "starkly illustrates how pro forma numbers can be used deceptively and the mischief that can cause."

## SEC ADOPTS NEW EQUITY PLAN DISCLOSURE REQUIREMENTS

*By Richard B. Montgomery*

In light of growing concerns about the impact of the increased use of equity compensation during the last decade on public companies and their security holders, the Securities and Exchange Commission adopted new equity compensation plan disclosure requirements. The new disclosure rules, which are located in Item 201(d) of Regulation S-K, require companies to include a new table in their annual reports on Form 10-K or 10-KSB (and proxy statements in years that they are submitting a compensation plan for security holder action) that requires information about two general categories of equity compensation plans:

- plans that have been approved by security holders; and
- plans that have not been approved by security holders.

With respect to each category, companies must disclose (1) the number of securities to be issued upon the exercise of outstanding options, warrants and rights; (2) the weighted-average exercise price of those outstanding options, warrants and rights; and (3) the number of securities remaining available for future grant under the equity compensation plans. Specific disclosure is also required of securities that may be issued other than upon the exercise of options.

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Companies must disclose information with respect to any equity compensation plan (including individual compensation arrangements) in effect as of the end of the company's last completed fiscal year that provides for the award of its securities or the grant of options, warrants or rights to purchase its securities to its employees or employees of its parent, subsidiary or affiliated companies, or to any other person, such as its directors, consultants, advisors, vendors, customers, suppliers or lenders. Disclosure is not required for qualified plans such as 401(k) plans, but Section 423 employee stock purchase plans are required to be included in the table.

If action is to be taken by security holders with respect to amending an existing plan, companies should not include in the table the number of additional securities that are the subject of the plan amendment. Instead, the table should only include information about the securities previously authorized for issuance under the plan. Additionally, companies must briefly describe in narrative form, the material features of, and file as an exhibit to the Form 10-K or 10-KSB, each plan that was adopted without the approval of security holders.

Prior to the adoption of these new disclosure requirements, companies were not required to publicly disclose information regarding all of their equity compensation plans. Investors were therefore unable to determine the total size of a company's equity compensation program and the amount of potential dilution. The SEC adopted the new disclosure requirements so that investors would be furnished with "a more understandable presentation" of a company's equity compensation program.

Companies must comply with the new disclosure requirements for their annual reports on Forms 10-K and 10-KSB to be filed for fiscal years ending on or after March 15, 2002 and for proxy statements for meetings on or after June 15, 2002. Companies may, however, voluntarily comply with the new disclosure requirements before these dates.

## RECENT DEVELOPMENTS IN THE HSR ACT PREMERGER NOTICE FILING AND WAITING PERIOD REQUIREMENTS

*By Celeste E. Rasmussen*

Recently, the Department of Justice and the Federal Trade Commission have taken two noteworthy actions in connection with administering the Hart-Scott-Rodino Antitrust Improvement Act of 1976. The HSR Act provides a

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mechanism for the FTC to review potential mergers and other types of business combinations in order to ensure that the transactions, when consummated, will not violate United States antitrust laws.

1. The first development involves a recent "gun jumping" complaint filed by the DOJ against two software companies for conduct between the date they agreed to merge and the transaction closing date (*U.S. v. Computer Associates International, Inc.* D.D.C., No. 1:01 CV 02062, 9/28/01). In the *Computer Associates* complaint, the DOJ charged that the merger parties "consummated" their merger transaction prior to receiving HSR clearance because their merger agreement imposed extraordinary "conduct of business" restrictions on the target company that prohibited the target company from undertaking certain competitive activities during the HSR waiting period. For example, the target company could not, without the acquiring company's approval, offer software discounts greater than 20% off of list prices or vary the terms of customer contracts from an agreed "standard contract." In addition, during the HSR waiting period, the acquiring company made day-to-day management decisions for the target and reviewed sensitive information about the target company's customers. The complaint makes it clear that the DOJ intends to strictly enforce the HSR waiting period and will critically review any agreements between an acquiring and a target company that make it appear that the companies are attempting to coordinate their business practices before the HSR review process is complete.

2. The second development involves the levy of a record $4 million civil penalty on the Hearst Corp. to settle charges that it failed to include all of the documents required by Item 4(c) of the HSR Notification and Report Form in connection with its acquisition of Medi-Span (*U.S. v. Hearst Trust*, D.D.C., No. 1:01CV02119, 10/11/01). During the post-consummation investigation, which occurred three years after the merger, the FTC discovered that Hearst had withheld certain documents responsive to Item 4(c), which requires the submission of all studies, surveys or reports prepared by or for company officers or directors in connection with their business evaluation of the potential combination. The complaint filed against Hearst is a clear indication that the DOJ will continue to aggressively ensure that companies comply with the HSR premerger filing requirements. As Daniel P. Ducore, Assistant Director in the Compliance Division of the Bureau of Competition explained in an October 11, 2001 FTC press release: "This case high-

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lights the importance of companies creating sufficient safeguards to assure that complete and accurate notifications are filed. This is not the Commission's first 4(c) case, but it appears that some companies are still not taking their obligation to do an effective and careful search for required documents seriously."

*Please remember that these legal principles may change and vary widely in their application to specific factual circumstances. You should consult with counsel about your individual circumstances. For further information regarding these issues you may contact the head of our Corporate and Securities practice group:*

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