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SEC ADOPTS LISTED COMPANY AUDIT COMMITTEE STANDARDS

By Richard P. Wolfe and Izabela M. Chabinska

On April 9, 2003, the SEC issued its final rules implementing Section 10A(m)(1) of the Securities Exchange Act of 1934, as added by Section 301 of the Sarbanes-Oxley Act of 2002. The final rules direct national securities exchanges and national securities associations to prohibit the listing of any security of a company that is not in compliance with the audit committee standards established by Congress that relate to:

- audit committee member independence;
- audit committee responsibility to select and oversee the company's independent auditor;
- procedures for handling complaints relating to the company's accounting practices;
- authority of the audit committee to engage independent advisors; and
- funding for the independent auditor and outside advisors engaged by the audit committee.

Listed companies must be in compliance with the new audit committee standards by the earlier of (1) their first annual shareholders meeting after January 15, 2004, or (2) October 31, 2004. Listed foreign private issuers and small business issuers must be in compliance by July 31, 2005. *(Click here to link to the full text of the SEC's final rules release.)*

Audit Committee Member Independence

The SEC's final rules elaborate on the statutory independence criteria. Specifically, audit committee members must be barred from accepting any consulting, advisory or compensatory fee from the issuer, other than in the member's capacity as a board or committee member.

- This prohibition applies to both direct and indirect payments.
- Indirect payments include those made to spouses, minor children or stepchildren, or children or stepchildren sharing a home with the audit committee member.

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- Indirect payments also include payments for services to law firms, accounting firms, consulting firms, investment banks or financial advisory firms of which an audit committee member is a partner, member or officer.

- The prohibition against indirect payments does not apply to members who are limited partners or non-managing members of such entities, or those in similar positions who do not have an active role in providing services to the entity.

- The prohibition also does not apply to non-advisory financial services such as lending, check clearing, customer account maintenance, stock brokerage services or custodial and cash management services.

- The prohibition only applies to current relationships and not to relationships prior to the member's appointment to the audit committee. However, the SEC expects national securities exchanges and associations to require a "look back" period in their own listing standards.

- Receipt of <u>any</u> consulting, advisory or compensatory fee is prohibited and there is no de minimis exception to this requirement.

Also, audit committee members must not be affiliated persons of the issuer or any subsidiary thereof, other than in their capacity as a committee or board member.

- "Affiliate" is defined as "a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified."

- "Control" is defined as "the possession, direct or indirect, of 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."

- Determination of whether one is an "affiliated person" is based on facts and circumstances. The rules provide a safe harbor whereby a person who is not an executive officer or shareholder beneficially owning more than 10% of any class of voting equity securities of a person will be deemed <u>not</u> to control that person.

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- The final rules clarify that only executive officers of an affiliate, directors who are also employees of an affiliate, and general partners or managing members of an affiliate will be deemed to be affiliates. Thus, non-control, non-policy making positions such as limited partners are not covered.

In the final rules, the SEC created an exception for new, non-investment company IPO issuers that requires the audit committee of such issuers to have at least one independent member at the initial listing, a majority independent committee within 90 days, and a fully independent committee within one year.

The SEC also created an exemption for overlapping board relationships under which a member of the audit committee may sit on the board of directors of the issuer and any affiliate, provided the member meets the independence criteria for each entity.

Oversight of Auditors

With respect to auditor oversight, the final rules require that audit committees be directly responsible for the appointment, compensation, retention and oversight of the independent auditor, including resolution of disagreements between management and the independent auditor regarding financial reporting matters.

- Oversight responsibilities include the authority to retain and terminate the independent auditor.

- Additionally, the audit committee must have the ultimate authority to approve all audit engagement fees and terms.

- The final rules clarify that none of these oversight requirements conflict with, and do not affect the application of any requirement under, the issuer's governing law, charter documents or other home country requirements requiring shareholders to elect, approve or ratify the selection of the issuer's independent auditor.

Complaint Receipt Procedures

The final rules also require that each audit committee establish procedures for:

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- the receipt, retention and treatment of complaints regarding accounting, internal accounting controls or auditing matters; and
- the confidential, anonymous submission by employees of concerns regarding questionable accounting or audit matters.

The SEC made clear that it is not mandating specific procedures that must be established by audit committees. Rather, the final rules provide audit committees with the flexibility to develop and implement complaint procedures appropriate for their companies' particular circumstances.

Authority to Engage Advisors

The SEC's final rules require that audit committees be given the authority to engage outside advisors, including counsel, as necessary to carry out their duties.

Funding

The final rules also require listed companies to provide appropriate funding, as determined by the audit committee, to compensate:

- any registered public accounting firm engaged to prepare or issue an audit report or to perform other audit or review services for the company; and
- any advisors employed by the audit committee.

Additionally, listed companies must provide appropriate funding for the ordinary administrative expenses of their audit committees.

Other Provisions

- The final rules permit securities exchanges and associations to adopt supplemental listing standards governing audit committees.
- The final rules apply to issuers of any listed security regardless of its type, including debt securities and derivative securities.
- While the rules do not make a distinction between domestic and foreign issuers, the SEC's final rules include limited exemptions applicable to foreign jurisdictions where corporate governance arrangements significantly differ from U.S. practices.

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- The final rules do not make a distinction based on the issuer's size and, thus, apply to small business issuers.

- To ensure compliance with the SEC's final rules, securities exchanges and associations must require listed issuers to notify them promptly after an executive officer of the company becomes aware of any material noncompliance with the SEC's final rules.

- Securities exchanges and associations are also required to establish procedures providing issuers an opportunity to cure defects prior to delisting their securities.

- Where issuers rely on an exemption from the SEC's final rules, they must disclose that fact in, or incorporate it by reference into, their Forms 10-K.

- The final rules also require that the names of audit committee members be disclosed in, or incorporated by reference into, the issuer's Forms 10-K. Listed companies that do not have a separately designated audit committee are required to disclose that its entire board of directors is acting as the audit committee.

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SEC PROPOSES AMENDMENTS TO CEO AND CFO CERTIFICATION RULES

By R. Joseph Parkey, Jr. and Celeste E. Rasmussen

On March 21, 2003, the SEC proposed amendments that would require issuers to file the CEO and CFO certifications required by Sections 302 and 906 of the Sarbanes-Oxley Act of 2002 as exhibits to their periodic reports. Specifically, issuers would be required to file the Section 302 and Section 906 certifications as Exhibits 31 and 32, respectively, to the periodic reports to which they relate.

According to the proposing release, the purpose of the proposed amendments is to enable investors and the SEC to locate and review the certifications more easily. Currently, the Section 302 certification must appear immediately after the signature page of the corresponding periodic report. Issuers have developed a number of ways for addressing the Section 906 certification requirement, including electronically filing the certifications as correspondence, which renders many issuers' Section 906 certifications impossible to locate on EDGAR.

If the amendments are adopted as proposed, the Section 302 certifications would continue to be considered "filed" with the SEC. The Section 906 certifications would continue to be considered "furnished," and thus would not be subject to liability under Section 18 of the Securities Exchange Act of 1934 and would not automatically be incorporated by reference into any other SEC filing.

In its proposing release, the SEC encourages issuers, until the final rules are adopted, to file Section 906 certifications as exhibits to the periodic reports to which they relate. According to the release, an issuer using this approach should designate the Section 906 certification as an "Additional Exhibit" under Item 99 of Regulation S-K or S-B or, in the case of a foreign private issuer, satisfy the exhibit requirements of the appropriate report form. Furthermore, the issuer should insert the following legend after the text of each Section 906 certification: "A signed original of this written statement required by Section 906 has been provided to [name of issuer] and will be retained by [name of issuer] and furnished to the Securities and Exchange Commission staff upon request."

The proposing release does not indicate when these amendments would take effect. In light of the 45-day comment period, the amendments would not likely become effective prior to May 9, 2003. *(Click here to link to the full text of the SEC's proposing release.)*

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SEC INSTITUTES REGULATION FAIR DISCLOSURE ACTIONS

By Richard P. Wolfe and George A. Mueller, III

On November 25, 2002, the SEC brought its first enforcement proceedings under Regulation Fair Disclosure ("Reg FD"). Three of the administrative proceedings, which involved the release of nonpublic company information to stock analysts, were settled by the issuance of cease-and-desist orders; one of these settlements also involved a civil penalty. The fourth resulted in the issuance of a Report of Investigation under Section 21 of the Exchange Act concerning the release of nonpublic company information to two portfolio managers.

A consistent finding in each of these four enforcement proceedings is that material, nonpublic information was intentionally disclosed by top officers of the cited companies. Additionally, in each case the cited company failed to make the simultaneous disclosure required by Reg FD, and the SEC documented a measurable and significant change in price and trading volume of the companies' stocks as a direct result of the disclosures.

To date, the SEC has commenced and settled Reg FD charges involving only these four companies: Raytheon Company, Siebel Systems, Inc., Secure Computing Corporation and Motorola, Inc.

- **Raytheon Company** (Release No. 34-46897)

Raytheon Company and its chief financial officer, Franklyn A. Caine, submitted offers of settlement in response to the SEC's institution of cease-and-desist proceedings against Raytheon and Caine. The SEC instituted this action in response to alleged Reg FD violations involving the selective disclosure of earnings guidance to sell-side analysts. The disclosures addressed Raytheon's first quarter, six month and annual earnings per share ("EPS") estimates for 2001.

On February 7, 2001, Raytheon conducted a publicly simulcast investor conference during which it reiterated earlier annual earnings guidance that annual EPS would be between $1.55 and $1.70, but provided no quarterly guidance. Soon after the conference, Caine directed his staff to contact each sell-side analyst whose Raytheon quarterly estimates are included in Thomson Corporation's First Call Service ("the Street") to

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obtain their quarterly earnings estimates models. Caine then phoned each analyst and told them their quarterly revenue and earnings estimates exceeded Raytheon's internal estimates, and that Raytheon expected two-thirds of its earnings in the second half of the year. Soon after these conversations, the analysts revised their earnings estimates, causing their collective estimates to fall to one cent below Raytheon's internal first quarter EPS estimate.

The following are key elements in the SEC's findings warranting the imposition of a cease-and-desist order:

- At the time Raytheon called the analysts, Raytheon's internal first quarter 2001 EPS estimate was lower than the Street's consensus.
- Raytheon provided no public guidance regarding quarterly EPS distribution for 2001 prior to contacting the analysts.
- Raytheon collected analysts' models and initiated one-on-one conversations with analysts who cover Raytheon.
- Raytheon selectively disclosed guidance concerning its quarterly and semiannual earnings estimates generally, and first quarter earnings estimates in particular.
- One of the analysts notified his firm's customers, who sold 2 million shares of Raytheon stock, after which the price of Raytheon's class A and class B common stock fell approximately 3% and 6%, respectively.
- Raytheon's selective disclosures enabled Raytheon to beat the Street's consensus 2001 first quarter EPS estimate by one cent.
- Raytheon's disclosures to analysts were material and nonpublic and Raytheon failed to make the necessary simultaneous public disclosure.

Based on these findings, the SEC concluded that Raytheon violated Section 13(a) of the Exchange Act and Reg FD, and that Caine was a cause of these violations. The SEC's release noted that the offending behavior was prototypical of the disclosures Reg FD is intended to prevent. Accordingly, the SEC issued a cease-and-desist order to Raytheon and Caine. Commissioner Campos dissented from the SEC's failure to assess a

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penalty against Raytheon and Caine. *(Click here to link to the full text of the SEC's release regarding the Raytheon administrative proceeding.)*

- **Siebel Systems, Inc.** (Release No. 34-46896)

The SEC issued a cease-and-desist order against Siebel Systems, Inc. in response to alleged Reg FD violations involving the disclosure of material, nonpublic information to persons attending an invitation-only technology conference in California hosted by Goldman Sachs & Co.

Specifically, Siebel's CEO disclosed that Siebel was "pretty optimistic" because its business was returning to normal in response to questions from the Goldman analyst who organized the conference. These statements were inconsistent with the CEO's previous statements made just three weeks earlier, in which he characterized the information technology market as "tough," and indicated that Siebel expected business to continue to be "quite tough through the remainder of the year."

The SEC found that Siebel's statements constituted an intentional disclosure of material, nonpublic information because Siebel's investor relations staff knew that the conference would not be simulcast to the public. As the public did not have equal access to, and was unable to benefit from, this information, the disclosure constituted a violation of the Exchange Act and Reg FD.

The chronology of events leading to the SEC's imposition of a cease-and-desist order follow:

- Goldman learned on November 2, 2001 that Siebel was likely to set "a positive tone" at the technology conference.

- Following last minute preparations for the conference, the Goldman analyst prepared a report for inclusion in Goldman's "U.S. Morning Preview," an electronic mail message that was internally circulated just prior to the opening bell and well before Siebel's participation in the technology conference. The report quotes the Goldman analyst as stating "[a]fter speaking with management, we think there is a good chance [Siebel's CEO] sets a positive tone at our software conference . . . . It seems as if business activity has increased and . . . this data point will likely be taken positively this morning."

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- Siebel disclosed at the technology conference on November 5, 2001 to persons covered by Reg FD that Siebel was optimistic because “we’re seeing a return to normal behavior in IT buying patterns.”

- Within hours of hearing the disclosures, attendees at the conference purchased Siebel stock or communicated the disclosures to others who also purchased Siebel stock. On the day of the conference, Siebel’s stock price closed approximately 20% higher than its prior day closing price and traded at a volume more than twice its average daily trading volume.

- Siebel did not issue a press release or file an 8-K with the SEC regarding its CEO’s remarks at the conference.

In consideration of these facts, the SEC found that Siebel’s CEO was aware his disclosures were based on material, nonpublic information and that Siebel’s investor relations director knew the conference would not be simulcast to the public. The company agreed, without admission or denial of the SEC’s findings, to the entry of a cease-and-desist order. Siebel was also required to pay a $250,000 civil penalty assessed by the SEC under Section 21C of the Exchange Act. *(Click here to link to the full text of the SEC’s release regarding the Siebel administrative proceeding.)*

- **Secure Computing Corporation** (Release No. 34-46895)

The SEC instituted cease-and-desist proceedings in response to Secure Computing Corporation’s release of inside information to two institutional portfolio managers. On March 6, 2002, Secure CEO John McNulty told a portfolio manager and brokerage firm salesperson in a conference call, with Secure’s investor relations director on the line, that Secure had entered into a sales and manufacturing agreement. McNulty directed the managers to Secure website postings containing information peculiar to the terms of the agreement. Specifically, these postings included software downloads for the buyer’s sales force and other product-related postings that were made pursuant to the contract’s terms. Though these postings implied that a deal was “in the works,” no public announcements or press releases had been made in conjunction with the postings.

Moments after learning this information, the salesperson e-mailed the Secure web page to the brokerage firm’s sales force. About an hour later, McNulty retrieved a phone message sent by Secure’s investor relations

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director indicating that the information McNulty disclosed was nonpublic, and that it should not be discussed. McNulty subsequently phoned the brokerage firm's managing partner and requested that the information be kept confidential, but it was too late.

On March 6, 2002, Secure's stock closed approximately 8% higher than the previous day's closing price and traded at more than double the previous day's trading volume. On March 7, 2002, Secure realized that a remedial press release was required, but nevertheless discussed the nonpublic information with another brokerage firm. On March 7, 2002, Secure's stock closed approximately 7% higher than the previous day's closing price and traded at 130% of the previous day's trading volume. After the close of the market on March 7, 2002, Secure issued a press release announcing the agreement. In the days following this release, Secure's stock price and trading volume continued to rise. In total, between March 5, 2002 and March 11, 2002, Secure's stock price rose approximately 35% at a trading volume significantly higher than normal.

While the press release was intended as a remedial measure, the SEC found that ". . .investors who sold Secure stock prior to the Company's press release were denied information that may have affected their investment decisions." Similar to the previously discussed actions, the SEC's actions were prompted by intentional disclosures of material, nonpublic information without simultaneous public disclosure.

The SEC concluded that Secure violated, and McNulty was a cause of Secure's violation of, Section 13(a) of the Exchange Act and Reg FD, and issued cease-and-desist orders against Secure and McNulty. The defendants neither admitted nor denied the allegations in agreeing to the entry of the orders. Commissioner Campos dissented from the decision not to impose a civil penalty. *(Click here to link to the full text of the SEC's release regarding the Secure administrative proceeding.)*

- **Motorola, Inc.** (Release No. 34-46898)

The SEC issued a Section 21(a) report on its investigation of Motorola, Inc. in deciding not to bring a formal enforcement action against the electronics company. The SEC citied erroneous legal advice related to disclosures that was "sought and given in good faith" as a mitigating factor.

In a February 23, 2001 press release and public conference call, Motorola stated that sales and orders were showing "significant weakness," and that it was likely that earnings would fall short of quarterly estimates.

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The SEC alleged that between March 6, 2001 and March 12, 2001, Motorola's investor relations director provided additional first quarter sales and order information to analysts indicating first quarter sales and orders were down by at least 25%.

Motorola's alleged violations arose from the investor relations director's efforts to clarify the use of the term "significant" as used on February 23, 2001 by stating to analysts that "significant" actually meant a "25 percent or more" decline. The SEC said that the investor relations director had seen the analysts' models and research notes, and concluded that the analysts did not understand "just how disappointing the results were for the quarter." The SEC's report stated that "Motorola affirmatively decided not to issue a new press release or otherwise make a simultaneous public disclosure of the additional information." The SEC also noted that during the same period as the investor relations director's telephone calls, trading volume in Motorola stock rose significantly, and the price of Motorola stock fell more than 15%.

The SEC found that before calling the analysts, the investor relations director asked the advice of the in-house lawyer responsible for SEC reporting and disclosure issues. Motorola counsel specifically advised the investor relations director that it was permissible to make the quantitative clarification of the qualitative terms used in the February 23rd announcements. Counsel allegedly gave this advice based on the conclusion "that providing a quantitative definition for the term 'significant' was not material," and that the company's particular definition of "significant" was a matter of public record for Reg FD purposes.

Counsel stated that he based this decision on three factors: (i) Motorola had purportedly used the term "significant" to convey a rate of change of 25% or more for a long time and the usage was generally "out there;" (ii) Motorola representatives had previously stated that the term "significant" generally meant a rate of change of 25% or more in response to analyst questions on earlier conference calls; and (iii) Motorola had periodically defined the term in so-called "Order Detail" documents as having a range of 25% or more. In the SEC's view, however, these factors did not provide an adequate basis for concluding that Motorola's definition of "significant" was public.

The SEC concluded that counsel's factual assumptions and reasoning were "demonstrably incorrect." The private quantification of the term

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"significant" was deemed material, and the failure to disclose it constituted a violation of the Exchange Act and Reg FD. However, the SEC found that counsel's advice "although erroneous, was sought and given in good faith," and ultimately issued a Report of Investigation, foregoing the issuance of a cease-and-desist order. *(Click here to link to the full text of the SEC's release regarding the Motorola report of investigation.)*

* * * *

The SEC has indicated that it does not wish to engage in hair splitting in enforcing Reg FD and is inclined to bring enforcement actions only in cases of "clear violations." Currently the SEC staff is said to be "actively probing" a number of Reg FD matters. In mid-March 2003, Stephen Cutler, head of the SEC's Division of Enforcement, told attendees at a Georgetown University Legal Center conference that "we've got a number of active investigations in the pipeline" related to Reg FD.

On March 12, 2003, the SEC announced that it intends to bring a civil action against Schering-Plough Corporation and CEO Richard Jay Kogan for allegedly providing a "profit warning" to certain analysts and institutional investors last fall. The allegations arose out of the SEC's investigation into a series of decreases in Schering-Plough's stock price and meetings between investors and CEO Kogan, which were followed by a Schering-Plough press announcement in late September 2002 that profits would be lower than expected. Schering-Plough's shares fell nearly 20% in the week after Kogan allegedly met with the analysts and investors. At this time, the SEC is awaiting Schering-Plough's response to the allegations before commencing a civil action.

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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