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SEC PROPOSES ADDITIONAL MD&A DISCLOSURE RULES

By Curtis R. Hearn and Andrew D. Pilant

On November 4, 2002, the SEC released proposed new rules to implement changes mandated by Section 401(a) of the Sarbanes-Oxley Act of 2002, relating to three specific topics to be discussed in the Management's Discussion and Analysis (MD&A) section of a company's disclosure documents, namely:

- off-balance sheet arrangements;
- contractual obligations; and
- contingent liabilities and commitments.

The statutory safe harbors that protect forward-looking statements against private legal actions alleging a material misstatement or omission would apply to these proposed rules.

Off-Balance Sheet Arrangements

The proposed rules would require each public company to present a comprehensive explanation of a company's off-balance sheet arrangements under a separately-captioned section of its MD&A. This presentation will be required in each quarterly and annual report. The SEC has defined an "off-balance sheet arrangement" as being any transaction, agreement or other contractual arrangement pursuant to which a reporting company has, or in the future may have, with respect to any unconsolidated entity:

- any obligation under a direct or indirect guarantee;
- a retained or contingent interest in assets transferred to the unconsolidated entity;
- risk with respect to derivatives, to the extent that their fair value is not fully reflected as a liability or asset in the financial statements; or
- any obligation or liability, including a contingent obligation or liability, to the extent that it is not fully reflected on the face of the financial statements (but excluding contingent liabilities arising out of liti-

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gation, arbitration or regulatory actions).

According to the SEC, disclosure should focus on the risk associated with the off-balance sheet transaction and not the structure (except to the extent helpful to the investor's understanding). Disclosure is appropriate when management concludes that the off-balance sheet arrangement is material to the company or may become so in the future.

The proposed rules would also require the disclosure of facts and circumstances that would provide investors with a clear understanding of the company's financial arrangements. Specifically, a company would have to disclose:

- the nature and business purposes of the off-balance sheet arrangements;
- information regarding the assets and liabilities (including contingent obligations and liabilities) of the entity through which off-balance sheet activities are conducted;
- revenues, expenses and cash flows arising from the arrangements;
- information regarding the interests retained, securities issued or indebtedness incurred by the company;
- any other obligation or liability of the company arising from the arrangements that may become material and the triggering events that could cause them to arise;
- management's analysis of the material effects of the off-balance sheet arrangements on the company's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures and capital resources; and
- the effects that a termination or material reduction in the benefits of the off-balance sheet arrangements would have on the company.

Disclosure of an off-balance sheet arrangement is required at the time of execution of the definitive agreement providing for the transaction, or, in the absence of an agreement, upon the settlement of the transaction. In addition, no disclosure is required if the likelihood of either the occurrence of an event implicating the off-balance sheet arrangement, or the materiality of its effect, is remote. The SEC interprets "remote" to

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mean "outside the realm of reasonable possibility."

Contractual Obligations

The proposed rules would require tabular disclosure of the amounts of contractual obligations, aggregated by type of contractual obligation (which should be tailored to the company's business), for at least the periods specified in the sample table below:

Contractual Obligations [Examples are below]	Payments due by period				
	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Long-Term Debt					
Capital Lease Obligations					
Operating Leases					
Unconditional Purchase Obligations					
Other Long-Term Obligations					
Total Contractual Obligations					

Contingent Liabilities and Commitments

In addition to the tabular disclosure of contractual obligations, a company would have to disclose, either in tabular format or in text, the expected amount, range of amounts or maximum amount of contingent liabilities or commitments, such as guarantees, that are expected to expire in less than one year, from one to three years, from three to five years, and more than five years.

Comments on the proposed rules should be delivered to the SEC no later than December 9, 2002. *(Click here to link to the full text of the SEC's proposed rules.)*

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SEC PROPOSES RULES REGARDING USE OF NON-GAAP FINANCIAL MEASURES

By Curtis R. Hearn and Meredith Guthrie Maxwell

On November 5, 2002, the SEC released proposed rules under Section 401(b) of the Sarbanes-Oxley Act of 2002 to regulate the disclosure and release of financial information prepared or derived on a basis other than GAAP. The SEC's proposed rules include:

- a new disclosure regulation, Regulation G, which would require public companies that disclose or release material information that includes a non-GAAP financial measure to also present the most comparable GAAP financial measure and a reconciliation of the two measures;

- a proposed amendment to Regulation S-K requiring additional disclosures in SEC filings regarding non-GAAP financial measures; and

- a requirement that public companies file a Form 8-K for any earnings or other press release that discloses material non-public financial information about completed annual or quarterly fiscal periods.

Because the term "pro forma financial information" is used in other contexts, the SEC has adopted the term "non-GAAP financial measures," which it defines as a numerical measure of a registrant's historical or future financial performance, financial position or cash flows that:

- excludes amounts, whether directly or through adjustments, that are included in the comparable GAAP measure presented in the company's financial statements; or

- includes amounts, whether directly or through adjustments, that are excluded from the comparable GAAP measure presented in the company's financial statements.

Non-GAAP financial measures would <u>not</u> include financial information that does not provide numerical measures different from the comparable GAAP measure.

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Proposed Regulation G

Proposed Regulation G would apply to all registrants that publicly disclose or release material information that includes a non-GAAP financial measure. The registrant would be required to provide the following information as part of the release:

- a presentation of the most comparable financial measure calculated and presented in accordance with GAAP; and

- a quantitative reconciliation of the GAAP and non-GAAP financial measures by schedule or other clearly understandable method.

If a registrant only releases a non-GAAP financial measure orally, telephonically, in a webcast or broadcast, or by similar means, the proposed rule would permit the registrant to provide the required accompanying information by posting it on the registrant's website, so long as during the presentation, the registrant discloses the location and availability of the required accompanying information.

Proposed Regulation G would also require that any non-GAAP financial measure, taken together with the required accompanying information, not misstate a material fact or omit to state a material fact necessary to make the presentation of the non-GAAP financial measure not misleading, in light of the circumstances under which it is presented. If any registrant fails to comply with Regulation G, the registrant could be subject to an SEC enforcement action alleging a violation of Regulation G, and possibly a violation of Rule 10b-5.

Proposed Amendments to Regulation S-K.

In addition to proposing new Regulation G, the SEC has also proposed amendments to Item 10 of Regulation S-K to require registrants using non-GAAP financial measures in filings with the SEC to provide:

- a presentation, *with equal or greater* prominence, of the most directly comparable financial measure calculated and presented in accordance with GAAP;

- a quantitative reconciliation (by schedule or other clearly understandable method) of the non-GAAP financial measure with the most directly comparable GAAP financial measure;

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- disclosure of the purposes underlying the non-GAAP financial measure presented; and
- disclosure of the reasons why management believes that such non-GAAP financial measure provides useful information to investors.

The proposed amendments would prohibit a registrant from:

- presenting a non-GAAP financial measure more prominently than the comparable GAAP financial measure;
- excluding from non-GAAP liquidity measures charges or liabilities that required, or will potentially require, a cash settlement;
- adjusting a non-GAAP performance measure to eliminate or smooth items identified as non-recurring, infrequent or unusual, when the nature of the charge or gain is such that it is reasonably likely to recur;
- presenting non-GAAP financial measures on the face of the registrant's GAAP financial statements;
- presenting non-GAAP financial measures on the face of any pro forma financial information required to be disclosed by Article 11 of Regulation S-X;
- using titles or descriptions of non-GAAP financial measures that are the same as, or confusingly similar to, titles or descriptions used for GAAP financial measures; and
- presenting a non-GAAP per-share measure.

The proposed requirements in Regulation S-K for information relating to non-GAAP financial measures are obviously more extensive and stringent than those set forth in proposed Regulation G.

Proposed New Disclosure Item of Form 8-K

The SEC has also proposed to amend Form 8-K to add new Item 1.04, "Disclosure of Results of Operations and Financial Condition," which would require registrants to file a Form 8-K within two business days of any public announcement or release, such as an earnings release disclosing mate-

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rial non-public information regarding a registrant's results of operations or financial condition for a *completed* annual or quarterly fiscal period.

If the non-public material information is disclosed orally, telephonically, in a webcast or broadcast, or by similar means, Item 1.04 would not require the registrant to file a Form 8-K if:

- the disclosure initially occurs within 48 hours of a written release or announcement filed on Form 8-K pursuant to Item 1.04;
- the presentation is accessible to the public by dial-in conference call, webcast or similar technology;
- the financial and statistical information contained in the presentation is provided on the registrant's website, together with any information that would be required under proposed Regulation G; and
- the presentation was announced by a widely disseminated press release that included instructions as to when and how to access the presentation and the location on the registrant's website where the information would be available.

Currently, earnings announcements and releases are subject to Regulation FD. A Form 8-K pursuant to Item 1.04 would satisfy the registrant's obligation under Regulation FD *only if* the Form 8-K were filed within the time frame required by Regulation FD.

Comments on the proposed rules should be delivered to the SEC no later than December 13, 2002. *(Click here to link to the full text of the SEC's proposed rules.)*

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SEC PROPOSES REGULATION BLACKOUT TRADING RESTRICTION

By Richard B. Montgomery IV and Margaret F. Murphy

On November 6, 2002, the SEC released proposed Regulation Blackout Trading Restriction ("Regulation BTR") to clarify the scope and application of Section 306(a) of the Sarbanes-Oxley Act of 2002 (the "Act"). Section 306(a) prohibits directors and executive officers from trading or otherwise acquiring or transferring equity securities of the issuer acquired in connection with service or employment when a substantial number of the issuer's employees are unable to engage in transactions through their individual plan accounts.

Persons Subject to Trading Prohibition

Under proposed Regulation BTR, the terms "director" and "executive officer" would be broadly defined to include a person who functions as a director or executive officer, whether or not such individual holds the title, as under Section 16 of the Securities Exchange Act of 1934.

Transactions Subject to Trading Prohibition

The trading prohibitions of proposed Regulation BTR would apply to any equity security of the issuer, including derivative securities, such as options, that are acquired in connection with service or employment under the following circumstances:

- at a time when he or she was a director or executive officer of the issuer, under a compensatory plan, contract, authorization or arrangement, including, but not limited to, plans relating to options, pension, retirement or deferred compensation or bonus, incentive or profit-sharing (whether or not set forth in any formal plan document), including a compensatory plan, contract, authorization or arrangement with a parent, subsidiary or affiliate of the issuer;

- at a time when he or she was a director or executive officer of the issuer, as a result of any transaction or business relationship required to be disclosed in the issuer's proxy statement to the extent that he or she has a pecuniary interest in the equity securities;

- as "director's qualifying shares" or other securities that he or she must hold to meet an issuer's minimum ownership

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requirements for directors or executive officers; or

- prior to becoming, or while, a director or executive officer of the issuer if the equity security was acquired as an inducement to service or employment with the issuer or a parent, subsidiary or affiliate of the issuer or as a result of a merger, consolidation or other acquisition transaction involving the issuer.

To simplify identification, eliminate tracing the source of equity securities involved in a disposition transaction and prevent possible evasion of the Act, proposed Regulation BTR would establish an irrebuttable presumption that, with certain limitations, any equity securities sold or otherwise transferred during a blackout period were acquired in connection with service or employment as a director or executive officer to the extent that the director or executive officer holds such securities, without regard to the actual source of the securities disposed. Since most directors and executive officers hold options or other equity securities of the issuer they serve, the trading prohibition would affect almost any transfer not otherwise exempt.

Except equity securities acquired as an inducement to service or employment with the issuer or as a result of a merger, consolidation or other acquisition transaction involving the issuer, equity securities acquired by an individual before he or she became a director or executive officer of an issuer would not be subject to Section 306(a) of the Act or proposed Regulation BTR. Consequently, any equity securities acquired under a plan, contract, authorization or arrangement while the individual was an employee, but not a director or executive officer, of the issuer would be excluded from the statutory trading prohibition. On the other hand, equity securities acquired in connection with service or employment as a director or executive officer before the issuer became a public company or the effective date of the Act would be subject to Section 306(a) of the Act and proposed Regulation BTR.

Exempt Transactions

The following transactions would be exempt from the prohibitions of proposed Regulation BTR:

- acquisitions of equity securities under dividend or interest reinvestment plans;

- purchases or sales of equity securities pursuant to a pre-established contract, instruction or written plan that satisfies the af-

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firmative defense conditions of Exchange Act Rule 10b5-1(c);

- purchases or sales of equity securities pursuant to certain "tax-conditioned" plans, such as 401(k) plans, Section 423 employee stock purchase plans and ESOPs, other than discretionary transactions through those plans; and

- increases or decreases in the number of equity securities held as a result of a stock split, stock dividend or similar rights.

Blackout Period

Blackout periods typically occur as a result of administrative changes to a benefit plan. The most common reasons for imposing a blackout period include:

- changes in investment alternatives;

- changes in the frequency of portfolio valuations;

- changes in plan record-keepers or other service providers;

- changes in plan trustees; and

- corporate mergers, acquisitions and spin-offs that affect the pension coverage of groups of participants.

Under Section 306(a) of the Act, a "blackout period" is a period of more than three consecutive business days during which the ability of not fewer than 50% of the participants or beneficiaries under all individual account plans maintained by the issuer to purchase, sell or otherwise acquire or transfer an interest in any equity security of such issuer held in such an individual account plan is temporarily suspended by the issuer or by a fiduciary of the plan. Proposed Regulation BTR would clarify the scope, and address the application, of this definition.

Under the Act, the term "individual account plan" is defined to include a variety of pension plans, such as Section 401(k) plans, profit-sharing and savings plans, stock bonus plans, and money purchase pension plans, and certain non-qualified deferral compensation arrangements. A one-participant retirement plan is excluded from the definition of individual account plan.

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Proposed Regulation BTR would clarify that, for purposes of making this calculation, the individual account plans "maintained by the issuer" would include only individual account plans in which participants or beneficiaries held or could hold equity securities of the issuer, whether or not the account plan actually contained equity securities of the issuer at the time of the calculation. This would include individual account plans that:

- permit participants or beneficiaries to invest their plan contributions in the equity securities of the issuer;
- include an "open brokerage window" that permits participants or beneficiaries to invest in the equity securities of any publicly-traded company, including the issuer;
- match employee contributions with equity securities of the issuer; or
- reallocate forfeitures that included equity securities of the issuer to the remaining plan participants.

For purposes of Section 306(a) of the Act, once an issuer identified the relevant individual account plans for purposes of the 50% test, it would apply the test by comparing the number of participants or beneficiaries located in the United States and its territories and possessions under all individual account plans maintained by the issuer that will be subject to a temporary suspension of trading in such equity securities, to the overall number of participants or beneficiaries located in the United States and its territories and possessions under all individual account plans maintained by the issuer. If this percentage is at least 50%, the statutory trading prohibition would apply to the directors and executive officers of such issuer.

Section 306(a) of the Act expressly excludes the following transactions from the definition of blackout period:

- a regularly scheduled period in which the participants and beneficiaries may not purchase, sell or otherwise acquire or transfer an interest in any equity security of an issuer, if such period is incorporated into the individual account plan and timely disclosed to employees before they become participants under the individual account plan or as a subsequent amendment to the plan; and
- any suspension described in the general definition of "blackout period" that is imposed solely in connection with persons becoming participants or beneficiaries, or ceasing to be participants

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or beneficiaries, in an individual account plan by reason of a corporate merger, acquisition, divestiture or similar transaction involving the plan or plan sponsor.

Proposed Regulation BTR would clarify the application of these exceptions as follows:

- The requirement that the blackout period be incorporated in the individual account plan could be satisfied by including a description of the regularly scheduled blackout period, and the plan transactions to be affected by, the blackout period and its frequency and duration, in the documents or instruments under which the plan operates.

- The disclosure of the blackout period to an employee would be timely if the employee was provided notice of the blackout period prior to, when, or within 30 calendar days after, he or she formally enrolled in the plan, or, in the case of a subsequent amendment to the plan, within 30 calendar days after the adoption of the amendment. The notice could be in any graphic form that is reasonably accessible to the intended recipient, including via e-mail.

- In the case of a blackout imposed to consolidate plans following a major acquisition, divestiture or similar transaction, the blackout period would not trigger the statutory trading prohibition if its principal purpose is to enable individuals to become participants or beneficiaries in the plan, or to terminate participation in the plan, even though the blackout also is used to effect other administrative actions that are incidental to the admission or withdrawal of plan participants or beneficiaries. In addition, the proposed rule would provide that the exception would be available only as to participants or beneficiaries of the acquired or divested entity.

Remedies

A violation of the statutory trading prohibition of Section 306(a) of the Act is subject to a possible SEC enforcement action or a required disgorgement of profits, with a strict standard of liability similar to that under Section 16(b) of the Exchange Act. No suit may be brought more than two years after the date on which the recoverable profits were realized. The SEC is soliciting comment on the various approaches described in the proposed rules to calculate recoverable profits.

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Notice

Under proposed Regulation BTR, whenever a director or executive officer of an issuer is subject to the statutory trading prohibition, the issuer must provide notice of the blackout period to the director or executive officer, as well as to the SEC on Form 8-K.

As proposed, the notice would be required to include the following information:

- the reason or reasons for the blackout period;
- a description of the plan transactions to be suspended during, or to be affected by, the blackout period;
- the description of the class of equity securities subject to the blackout period;
- the actual or expected beginning and ending dates of the blackout period; and
- the name, address and telephone number of the person to respond to inquiries about the blackout period.

Proposed Regulation BTR would require that, with certain limited exceptions, notice to directors and executive officers be provided at least 15 calendar days in advance of commencement of the blackout period.

The notice requirement would apply to blackout periods commencing on or after January 26, 2003, the effective date of Section 306 of the Act. For blackout periods occurring between January 26, 2003 and February 10, 2003 (the date 15 days after the effectiveness of the statute), issuers should furnish notice as soon as reasonably possible.

Comments on proposed Regulation BTR should be delivered to the SEC no later than December 16, 2002. *(Click here to link to the full text of the SEC's proposed rules.)*

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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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