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Corporate Securities

A bulletin designed to keep corporate executive and investment banking professionals informed on major developments in the securities industry

If you have questions regarding material in this issue of *Corporate Securities* or suggestions for a specific topic you would like addressed in a future issue, please contact Steven J. Gray (312/609-7528), Jennifer R. Evans (312/609-7686), or any other Vedder Price attorney with whom you have worked.

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REFORMS PROPOSED FOR CORPORATE AUDIT COMMITTEES

The New York Stock Exchange (NYSE), National Association of Securities Dealers, Inc. (NASD), and a "blue ribbon" panel of industry leaders have recommended strengthening corporate audit committees to improve the quality of corporate financial reporting.

The proposed reforms are in direct response to prevailing concerns at the SEC about earnings management and the use of manipulative accounting practices to smooth earnings or meet financial analyst forecasts. These practices have included:

- overstating one-time restructuring charges to provide a cushion for meeting future earnings estimates

- misuse of acquisition accounting, such as improper write-offs of acquired in-process research and development, which results in higher future earnings

- setting up "cookie jar reserves," by accruing excessive charges for loan losses, warranty costs or sales returns, in order to smooth future earnings
- premature revenue recognition
- improper deferral of expenses to inflate current earnings
- misapplying the concept of "materiality" to avoid unwanted accounting treatment

The proposed reforms are embodied in ten recommendations aimed at ensuring the independence of the audit committee, making the audit committee more effective, and firmly establishing the accountability of the audit committee, outside auditors, and management. The ten recommendations are:

1. ***Defining "independence" for audit committee members***

   A definition of "independence" should be adopted by the NYSE and NASD for persons serving on the audit committees of listed companies with market capitalizations above $200 million. A member would be independent if he or she had no relationship that would interfere with the exercise of his or her independence from management and the corporation.

   Examples of relationships that would disqualify a director from being independent include:

   - the director is employed by the company for the current year or was employed by the company during any of the past five years
   - the director accepts compensation from the company other than for board service or under a tax-qualified retirement plan
   - the director is part of the immediate family of an individual who is an executive officer of the company or was an executive within the past five years
   - the director is a partner in, or a controlling

stockholder or executive officer of, another corporation to which the company made, or from which the company received, significant payments over any of the last five years

- the director is an executive officer of another corporation for which any of the company's executives serve on that corporation's compensation committee

A director failing the independence test could serve on the audit committee only if the full board determines that such service is in the best interests of the company and is fully disclosed in the company's proxy statement.

Companies with a market capitalization of $200 million or below would remain subject to the existing definition of independence under NYSE and NASD rules. (To be independent under current NYSE and NASD rules, a director must not be an officer or employee of the company or have a relationship that would interfere with independent judgment. Affiliates of the company are also disqualified under current NYSE rules.)

2. ***All audit committee members should be independent***

All larger listed companies (with market capitalizations above $200 million) should have audit committees comprised solely of independent directors.

Current NYSE and NASD rules on independence and audit committee membership would remain in place for smaller market cap companies. (NYSE rules now require that the audit committee be comprised solely of independent directors. Former officers of a company can qualify, but a majority of audit committee members must be directors who were not former officers. NASD rules require that the audit committee be comprised of a majority of independent directors.)

3. ***Audit committees should be comprised of at least three directors, all of whom are financially literate***

The minimum number of directors on the audit committee should be three for larger cap companies, and each member should be financially literate. At least one member must have accounting or financial management expertise.

Current NYSE and NASD rules in place would remain unchanged for smaller market cap companies. (The NYSE and NASD presently require a minimum of two members on the audit committee.)

4. ***Audit committee charters***

Each listed company should be required to adopt a formal written charter specifying responsibilities, structure, procedures, and membership requirements for the audit committee. The charter would be approved by the entire board and subject to annual review.

5. ***Proxy statement disclosures***

SEC rules should require that the audit committee of each reporting company disclose in the proxy statement the existence of the audit committee charter and whether the committee met its responsibilities under the charter for the prior year. The charter would be disclosed every third year in the annual report to shareholders or the proxy statement.

6. ***Outside auditor accountability***

NYSE and NASD listing rules should require that the audit committee charter state that the outside auditor is ultimately accountable to the board and the audit committee and that the audit committee has the ultimate authority to select, evaluate, and replace the outside auditor.

7. ***Audit committee accountability***

Listing rules should also require that the audit committee charter state that the audit committee is responsible for identifying and monitoring all relationships between the outside auditor and the company. The charter would charge the audit committee with ensuring the independence of the outside auditor.

8. ***Auditor's statement on quality of financial reporting***

Generally Accepted Auditing Standards should require that the outside auditor discuss with the audit committee the quality of financial reporting. Assessment of quality would address clarity of financial disclosures, use of aggressive or conservative accounting principles, and management estimates used in preparing financial disclosures.

9. ***Audit committee letter to shareholders***

The SEC should require all reporting companies to provide an audit committee letter to shareholders in the Form 10-K Annual Report. The letter would disclose whether:

- management has reviewed the audited statements with the audit committee
- the outside auditor has discussed with the audit committee the quality of the accounting principles and significant judgments applied by management
- the audit committee members have discussed among themselves the information provided to them by management and the outside auditors
- the audit committee believes that the company's financial statements are presented in accordance with GAAP

10. ***Outside auditor's review of interim reports***

The SEC should require the outside auditor to conduct an SAS 71 Interim Financial Review prior to the filing of a Form 10-Q. SAS 71 should also be amended to require, prior to the filing of a Form 10-Q and before a quarterly earnings release, that the outside auditor discuss significant accounting issues with the audit committee and management.

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The recommendations give the audit committee direct responsibility for active and independent oversight of the financial reporting function. Implementation of the recommendations, as noted, will require administrative action at the NYSE, NASD, and the SEC.

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SEC WEIGHING ADOPTION OF INTERNATIONAL DISCLOSURE STANDARDS FOR FOREIGN ISSUERS

In order to ease the burden on cross-border offerings by foreign private issuers, the SEC is proposing regulations that would adopt international disclosure standards for registered offerings by foreign issuers in the United States.

In September 1998, the International Organization of Securities Commissions (IOSCO) endorsed disclosure standards for cross-border offerings and listings by multinational issuers. As a member of IOSCO, the SEC is poised to revise existing disclosure standards for foreign issuers under the federal securities laws by adopting the international standards in their entirety.

The SEC's interest in conforming to international standards is driven by a number of concerns:

- increasing globalization of securities markets requires collective international efforts to promote and maintain high quality disclosure standards
- increased volatility in securities markets around the world heightens the need for increased transparency in public company information
- broad acceptance of IOSCO standards may serve to raise the level of disclosure in

emerging markets

The SEC has stated that IOSCO standards are of comparable quality to existing SEC disclosure requirements for foreign issuers. The SEC also believes that adopting IOSCO standards will bring foreign issuer disclosure in line with the best practices of international securities markets.

The SEC is proposing that the international disclosure guidelines be incorporated into Form 20-F. There would be no effect on current SEC procedures and practices for review and comment on filings, liability standards, or listing requirements.

The SEC is also proposing to clarify the definition of "foreign private issuer" under Rule 405 of the Securities Act of 1933 (1933 Act). The definition currently requires an analysis of whether more than 50% of an issuer's outstanding voting securities are held of record by residents of the United States. The SEC is proposing to require that issuers look through the record ownership of brokers, dealers, banks, and nominees to determine the residency of their customers. Shares held in an ADR program will be presumed to be held solely by United States residents. Issuers must also take into account beneficial ownership reports filed publicly or otherwise provided to the issuer.

Comments on the proposed rules concerning international disclosure standards for foreign issuers and the changes to the definition of "foreign private issuer" must be received at the SEC by April 12, 1999.

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SEC ADOPTS CHANGES AFFECTING EMPLOYEE BENEFIT PLANS

The SEC has adopted final rules amending the abbreviated registration form for securities issued under employee benefit plans (Form S-8) and the registration exemption for securities issued under employee benefit plans by nonreporting companies (Rule 701). The SEC has also clarified its views on disclosure of transferred options in proxy and registration statements.

Form S-8 Amendments

Form S-8 is available for reporting companies to register securities issued under employee benefit plans for compensatory purposes. Employees, consultants, and advisors are eligible to receive securities under Form S-8. The Form S-8 changes address intra-family transfers of employee options and certain offering practices the SEC has found inconsistent with the underlying purpose of the form.

Intra-Family Transfers of Employee Options

The amendments to Form S-8 expand the form to cover exercises of employee options by immediate family members of an employee if the options are transferred by gift or a domestic relations order. Transferred options will not be covered if the transfers are for value. Qualifying option transfers can occur directly or indirectly through other family members.

The definition of family member is expanded to include nieces and nephews, any person sharing the employee's household (other than a tenant or employee), and entities in which family members (or the employee) own more than 50% of the beneficial interest. A foundation will qualify if family members have management control over the foundation's assets. Form S-8 will not, however, be available to cover transfers to 501(c)(3) charities.

Family member transferees will now be treated like employees for all purposes under the form. Form S-8 will be available for reload options issued directly to family member transferees. Resale prospectuses can also be used by affiliate-family members to sell securities registered on Form S-8 and by family member transferees of restricted securities acquired upon exercise of options that were transferred before a Form S-8 was filed. Registration of transferred options will be allowed at any time prior to exercise.

An employee transferee will not be required to provide a prospectus to the family member transferee when the transfer is by gift or under a domestic relations order.

Existing issuer prospectus delivery requirements, however, will apply to family member transferees. Updated prospectus materials will be required for family member transferees as for employees. An issuer must provide the basic prospectus to option transferees, but can do so at the time of updates rather than at the time the option is transferred. The issuer is also obligated to deliver to transferees all shareholder communications and reports. Material tax disclosure in prospectus materials for plans that permit options to be transferred should address material estate and gift tax consequences to an employee/optionee of an option transfer.

Proxy and Registration Statement Disclosure of Transferred Options

The Form S-8 amendments do not alter the SEC's view that the transfer of an option does not negate the option's status as compensation that should be reported in the company's proxy or registration statements (as required under Regulation S-K).

The summary compensation table and the option/SAR grants table must include all options/SARs that may have been transferred during the year. The SEC has reiterated its view that transferability should be disclosed in a footnote to the options/SAR grants table. The SEC has agreed not to require footnote disclosure of subsequent transfers (including information as to dates and names of transferees).

The aggregated option/SAR exercises and fiscal year-end option/SAR value tables remain unaffected by the amendments. The SEC continues to take the view that issuers should report options and SARs held or exercised by transferees.

Abusive S-8 Offering Practices

Some issuers and stock promoters have utilized Form S-8 to distribute securities to the public at large, a practice the SEC views as at odds with the form's purpose. Stock promoters acting as consultants or employees receive stock registered under Form S-8 and quickly resell the stock in the public markets. Proceeds are then funneled back to the issuer or used to pay issuer expenses that are unrelated to any service provided by the consultants or employees. Form S-8 has also been used to deliver registered securities to compensate persons for promoting an issuer's securities.

To curb these practices, the SEC has adopted revisions which provide that Form S-8 will be available to consultants and advisors only if they are natural persons and provide bona fide services that are not related to capital-raising transactions or do not promote or maintain the market for an issuer's stock. Persons now excluded from receiving securities under Form S-8 include:

- brokers, dealers, and finders
- investor relations or shareholder communications professionals
- persons who effect mergers to take private companies public (through public shell companies)
- publishers of Internet newsletters that tout the issuer's securities
- accountants that audit the issuer's financial statements
- attorneys representing the issuer in an offering

The SEC is also considering further amendments to Form S-8 to further curtail abusive practices. For example, companies going public through shell mergers would be precluded from using Form S-8 until a Form 10-K or Form 10-KSB has been filed which includes audited financial statements reflecting the merger. The SEC is also proposing to tighten requirements that Exchange Act reports must be filed on a timely basis in order to use the form. Comments on these proposals are due at the SEC by May 7, 1999.

About Vedder Price

Vedder, Price, Kaufman & Kammholz is a national, full-service law firm with approximately 180 attorneys in Chicago, New York City and Livingston, New Jersey.

The Corporate Securities Group

The firm's corporate finance and securities attorneys regularly represent underwriters and issuers, both foreign and domestic, in a wide variety of matters, including:

- debt and equity offerings, including initial public offerings, structured debt financings, aircraft securitizations, dual-class equity structures and sophisticated preferred stock instruments;
- capital formation, for initial capitalization, financing ongoing operations and acquisitions;
- corporate disclosure, periodic reporting, proxy solicitations, and insider trading and beneficial

ownership compliance matters;
- private placement of securities including Rule 144A and Regulation S transactions;
- tender offers, mergers and acquisitions and recapitalizations and restructurings;
- international offerings of securities and compliance by foreign issuers with the U.S. securities laws; and
- litigation, administrative and arbitration proceedings involving various securities fraud claims, disclosure issues and regulatory enforcement matters.

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Exempt Offerings Under Rule 701

Rule 701 under the 1933 Act provides an exemption from the registration requirements for offers and sales to employees, consultants or advisors under compensatory benefit plans, or written compensation agreements. The exemption is available only to nonreporting companies.

The SEC has amended Rule 701 to provide greater flexibility under the rule. The SEC has removed the $5 million aggregate offering ceiling. The SEC has also raised the annual amount that can be *sold* under the rule to the greater of $1 million (up from $500,000) or 15% of total assets or outstanding securities. There is no longer any limit based upon the amount of *offers*.

For purposes of the annual limit, calculations will be made as of the transaction date for restricted stock and compensatory stock purchases. Deferred compensation will be measured on the date of an irrevocable election, and options will be valued at the date of grant without regard to whether the options are exercisable or vested.

The SEC has also amended Rule 701 to clarify that the value of services exchanged for securities under the rule is measured by reference to the value of the securities and not by an employee's salary or consultant's invoice.

Under amended Rule 701, no offering disclosure is mandated for sales up to $5 million in a 12-month period (other than a copy of the benefit plan or contract which still must be provided). For offerings over $5 million, the issuer must provide:

- a copy of the benefit plan or contract
- a copy of the summary plan description, if subject to ERISA, or summary of the plan's material terms
- risk factors associated with an investment in the securities
- financial statements meeting the requirements

of Form 1-A under Regulation A

The disclosure requirements apply equally to foreign private issuers and domestic issuers. If foreign private issuers do not prepare financial statements in accordance with U.S. GAAP, the financial statements must be reconciled to U.S. GAAP.

The SEC is also adopting for Rule 701 the revised definition of "consultants and advisors" under amended Form S-8 to ensure the rule is not the subject of the abusive practices that have been associated with Form S-8 offerings.

Other changes simplifying Rule 701 include the following:

- Rule 701 will apply to sales to employees of a parent's wholly owned subsidiaries

- transferable options and family members will be treated the same as under amended Form S-8

- a subsidiary may aggregate its assets with its parent's assets when making the 15% of total assets calculation, provided the parent unconditionally guarantees the subsidiary's obligations

- sales to former employees will be allowed so long as the securities were offered during employment

Transition Rules

The Form S-8 amendments become effective for new Form S-8 filings on April 7, 1999, and for existing Form S-8 registration statements on May 10, 1999. The family member transfer rules apply immediately for all Form S-8 filings. The proxy and registration statement disclosure amendments will apply to all filings on April 7, 1999. The amendments to Rule 701 also become effective on April 7, 1999.

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MICRO-CAP OFFERINGS THE SUBJECT OF SEC RULE CHANGES

The SEC has announced rule changes effective April 7, 1999 that are directed at eradicating abusive and manipulative practices in the over-the-counter micro-cap stock arena.

The SEC has targeted "pump and dump" broker-dealer practices involving low-priced stocks of thinly capitalized companies for which there is little or no public information or analyst coverage. In the typical scheme, broker-dealers use cold-calling techniques to sell these securities at increasing prices to naive investors and then let the secondary market for the stocks collapse.

Issuers and broker-dealers engaging in these schemes have relied upon the registration exemption found in Rule 504 of Regulation D under the 1933 Act in offering and reselling micro-cap stocks. Rule 504 currently permits primary sales of securities by means of general solicitation and advertising so long as the offering amount over any 12-month period does not exceed $1 million. Securities sold under Rule 504 are not "restricted" securities and are freely tradeable.

Amended Rule 504 provides that securities issued under the exemption cannot be sold by means of general solicitation or advertising unless the following conditions are met:

- the offering is registered under state law requiring public filing and delivery of a disclosure document before sale, or
- the securities are issued under a state law exemption that permits general solicitation and advertising so long as sales are made only to "accredited investors" as defined in Regulation D

In addition, securities issued under Rule 504 will now be "restricted" securities and subject to resale restrictions unless issued under the state law provisions described above.

The SEC believes the Rule 504 amendments will help deter micro-cap fraud without preventing smaller companies from raising seed capital.

Additional SEC micro-cap initiatives are discussed above under the Form S-8 amendments.

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