VEDDER PRICE

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), Dan L. Goldwasser (212/407-7710), or any other Vedder Price attorney with whom you have worked.

In This Issue:

January 2000

INITIATIVES TO BAN SELECTIVE DISCLOSURE AND CLARIFY INSIDER TRADING

The SEC recently proposed several new rules designed to strengthen and clarify the law relating to selective disclosure and insider trading. If adopted, these rules could radically change the way companies and insiders communicate with the public and outsiders.

Crackdown on Selective Disclosure

The SEC has grown increasingly concerned with the informal exchange of information between companies and analysts, institutional investors, portfolio managers and other selected investors. According to the SEC, this practice of "selective disclosure" poses a serious threat to investor confidence in the fairness and integrity of the securities markets. As a result, the SEC is proposing a new Regulation FD (Fair Disclosure) to deal with the problem. This proposed regulation would require that:

- intentional disclosure of material information must

be made through public disclosure, not selective disclosure; and

- nonintentional selective disclosure of material information must be rectified with prompt public disclosure.

Companies can satisfy their public disclosure requirement by filing information with the SEC on Form 8-K, issuing a press release through a widely circulated news or wire service or by disseminating the information through any other method reasonably designed to provide broad public access (e.g., an announcement at a press conference to which the public is granted access). However, posting information on a website would not be deemed sufficient.

For purposes of Regulation FD, selective disclosure is "intentional" when the individual making the disclosure either knew prior to making the disclosure, or was reckless in not knowing, that he or she would be communicating information that was material and nonpublic. In the case of intentional disclosure, companies are required to simultaneously provide that information to the public. Inadvertent slips of the tongue or mistaken (but not reckless) beliefs that the information was already made public will not constitute an intentional communication. Such "nonintentional" disclosures must be promptly disclosed to the public, which means as soon as reasonably practicable (but no later than 24 hours) after a senior official knows of the nonintentional disclosure. "Senior official" is defined under Regulation FD as any executive officer, director, investor relations or public relations officer, or any employee responsible for performing equivalent functions.

As proposed, Regulation FD would not apply to internal disclosures, disclosures made by persons acting outside the scope of their corporate authority or any disclosure made to persons who have agreed not to use the information and to keep it confidential prior to public disclosure. Furthermore, since Regulation FD would not be an antifraud rule, private parties could not sue a company for its failure to comply with its requirements. Noncompliance could give rise to liability, however, under an SEC enforcement action.

If adopted, Regulation FD will require corporate officials to be more cautious in their communications with

outsiders. As the SEC has pointed out, companies can limit potential exposure by implementing the following practices:

- designate only a limited number of persons who are authorized to "speak" on behalf of the company;
- keep a record of the substance of private communications with outsiders such as analysts;
- decline to answer questions that raise issues of materiality until the company has had an opportunity to consult with legal counsel; or
- enter into agreements with analysts to keep information confidential until the company has had the opportunity to review the content of the conversation and reach a conclusion as to its materiality.

The regulation would not apply to companies undertaking an IPO until after effectiveness of the registration statement. However, the regulation would apply to reporting companies that are in registration. Disclosures made during road show presentations by public companies would be affected.

Clarification of Insider Trading Prohibitions

The SEC is also proposing new rules designed to clarify two unsettled issues in insider trading law.

Use/Possession Issue: Under current law, courts have split on the issue of whether insider trading liability requires trading while in "knowing possession" of material nonpublic information, or proof that the trader "used" the information in trading. To clarify this issue, the SEC has proposed a rule that would impose insider liability on a person when he or she trades while "aware" of material nonpublic information. The rule also provides for specific defenses against liability for certain trades that occur as a result of a pre-existing plan, contract, or instruction that was made in good faith and before the person became aware of material nonpublic information. The defenses, however, will not be available if, after becoming aware of material nonpublic information, a person alters the previous contract, plan, or instruction or enters into or alters a corresponding or hedging transaction with respect

to the planned trade.

Misappropriation based on family or personal relationships: The misappropriation theory of insider trading imposes liability on a person for fraud when such person has misappropriated material nonpublic information for purposes of trading in securities, in breach of a duty of loyalty or confidence. The misappropriation theory is most commonly applied in connection with established business relationships. It is not clear, however, under what circumstances certain non-business relationships, such as family or personal relationships, may provide a duty of trust or confidence required under the misappropriation theory. The rule proposed by the SEC seeks to clarify this situation. Under the proposed rule, a duty of trust or confidence will exist:

- when a person agrees to keep information confidential;
- when the persons involved in the communication have a history, pattern, or practice of sharing confidences that results in a reasonable expectation of confidentiality; or
- when the person who receives the information is the spouse, child, or sibling of the person who communicated the information, unless it can be shown, under the facts and circumstances of that particular relationship, that no reasonable expectation of confidentiality existed.

Both of these proposed rules are aimed at clarifying specific insider trading issues. Neither rule is intended to modify or address any other aspect of insider trading law previously established by case law under Rule 10b-5.

Return to Top of Document

MATERIALITY THRESHOLDS IN FINANCIAL DISCLOSURE

In August 1999 the SEC released Staff Accounting Bulletin ("SAB") No. 99 regarding the use of certain quantitative benchmarks or thresholds to assess materiality

in preparing corporate financial statements. In SAB 99, the SEC cautions reporting companies that misstatements in financial statements are not immaterial simply because they fall beneath a numerical threshold.

Numerical Thresholds as a Rule of Thumb

Materiality concerns the significance of an item to the users of a company's financial statements. The omission or misstatement of an item in a financial report is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item.

The SEC has stated that corporate management and auditors must consider both quantitative and qualitative factors in assessing an item's materiality. Exclusive reliance on numeric thresholds (i.e., if an item falls below a 5% threshold it is not material) is not sufficient.

While the SEC has no objection to the use of quantitative "rules of thumb," such thresholds should be used only as an initial step in assessing materiality. Despite the fact that a misstatement may quantitatively fall below a certain numeric threshold, the SEC believes there are other considerations that may render such misstatements material. These include, among others, whether the misstatement:

- masks a change in earnings or other trends;
- hides a failure to meet analysts' consensus expectations for the company's performance;
- changes a loss into income or vice versa;
- concerns a segment of the company's business that has been identified as playing a significant role in its operations or profitability; or
- has the effect of increasing management's compensation.

The SEC also requires that a company consider historical, demonstrated volatility in the price of its stock in response to certain types of disclosures in determining whether

investors would regard a misstatement as material. If management or the company's auditors expect, based on a pattern of market performance, that a known misstatement may result in a significant positive or negative market reaction, that reaction should be considered in determining whether a misstatement is material.

Managing Earnings

Companies should particularly take care in determining the nature and scope of any intentional misstatements reported in its financial statements that reflect an attempt on the part of management to "manage" the company's earnings. The SEC warns that companies and their auditors should not assume that small intentional misstatements in financial statements pursuant to actions to "manage" earnings are immaterial. While the intent of management does not render a misstatement material, it may provide significant evidence of materiality. This evidence may be particularly compelling where management has intentionally misstated items in the financial statements to "manage" reported earnings, since the SEC believes that investors generally would regard as significant a management practice to over- or understate earnings.

Aggregating and Netting Misstatements

The SEC acknowledges that the materiality of a misstatement may turn on where it appears in the financial statements as well as its impact on the financial statements as a whole. Where multiple misstatements occur, companies and their auditors should consider each misstatement separately and in the aggregate. If the misstatement of an individual amount causes the financial statements as a whole to be materially misstated, that effect cannot be eliminated by other misstatements whose effect may be to diminish the impact of the misstatement on other financial statement items. Companies should also consider the effect of misstatements from prior periods on current financial statements.

Practical Considerations

SAB 99 is a reminder to public companies and their auditors that even the smallest misstatement in a company's financial statements may be material, depending on the surrounding facts and circumstances. It

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.

Vedder, Price, Kaufman & Kammholz
A Partnership including Vedder, Price, Kaufman & Kammholz, P.C.

Chicago
222 North LaSalle Street
Chicago, Illinois 60601
312/609-7500
Facsimile: 312/609-5005

New York
805 Third Avenue
New York, New York 10022
212/407-7700
Facsimile: 212/407-7799

New Jersey
354 Eisenhower Parkway
Plaza II
Livingston, New Jersey 07039
973/597-1100
Facsimile: 973/597-9607

is not appropriate for management or the company's auditors to rely exclusively on a numeric, quantitative benchmark or threshold in assessing which items in the financial statements are material.

The SEC reminds public companies in SAB 99 of their obligation to comply with the books and records requirements of Section 13(b)(2)-(7) of the Exchange Act, including their obligation to consider whether a misstatement in their financial statements results in a violation of the company's obligation to keep books and records that are accurate "in reasonable detail." Auditors are also reminded of their responsibility and obligation to take certain actions upon the discovery of an "illegal act" with respect to a company's financial statements, including making sure the company's audit committee is adequately informed about the illegal act.

Although SAB 99 is not intended to change the current law or guidance in the accounting or auditing literature, it is a clear indication of the SEC's position and continuing focus on misstatements in financial statement reporting and particularly the use of earnings management. Management is well advised to carefully consider SAB 99 when working with its auditors in the preparation of its financial statements for upcoming periodic reports.

Return to Top of Document

NEW RULES FOR AUDIT COMMITTEES

The SEC adopted new rules in December 1999 for public company audit committees. The new rules are based upon the recommendations of the Blue Ribbon Committee formed to suggest ways of increasing the effectiveness of audit committees. The new rules are designed to improve disclosure relating to the functioning of audit committees and enhance the reliability and credibility of financial statements. The new rules will require the following:

interim financial statements must be reviewed by an independent auditor;

proxy statements must contain a report from the audit committee that, among other things, discloses whether the

audit committee reviewed and discussed the audited financial statements with management and recommended to the board of directors that the financial statements be included in the annual report on Form 10-K or 10-KSB;

proxy statements must indicate whether the audit committee has a written charter and include a copy of the charter in the proxy statement every three years; and

NYSE, AMEX and NASDAQ companies must disclose whether audit committee members are "independent" as defined in the applicable listing standards. Companies not listed may choose which definition of "independent" to apply to their audit committee members.

There is a transition period to allow companies time to comply with the new rules. Interim financial statement reviews will be required beginning with the fiscal quarter ended March 31, 2000. Compliance with the other requirements of the rules will not begin until the 2001 proxy season.

In addition to adopting the above rules, the SEC approved amendments to the listing standards for each of the NYSE, the AMEX and the NASDAQ. These new rules:

- require audit committees to consist of at least three independent directors who are financially literate;
- require that at least one audit committee member have accounting or financial management expertise;
- require companies to adopt written charters for their audit committees;
- give the audit committee the right to hire and terminate the auditors; and
- apply a more rigorous definition of "independence" for audit committee members.

The SEC has stated that these rules are not intended to subject audit committee members to increased liability. In fact, the SEC believes that by more clearly defining the procedural requirements for, and disclosure of, the operation of audit committees, liability claims alleging breach of fiduciary duties under state law may actually be reduced. As a result, the SEC did not provide any

protection to audit committees from private litigation in connection with performing these additional obligations. The SEC did, however, provide a safe harbor for the audit committee report. Under this safe harbor, the report will not be considered "soliciting material" or "filed" for purposes of the proxy rules of Section 18 of the Exchange Act.

Return to Top of Document

- Return to: Corporate Securities
- Return to the Vedder Price: Publications Page.
- Return to: Top of Page.

Home | Legal Services | Attorneys | **Publications** | Recruiting | Seminars | Speakers | Links | Contact Us | Search
Top of Page