The Public Company Handbook:

A Corporate Governance and Disclosure Guide for Directors and Executives

Third Edition

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with

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Perkins Coie LLP

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Dedication

We dedicate this to our families. Margaret Breen, Hackett, Jamie, and Owen Landefeld, Cori Gordon Moore, Susanne Wagner-Fischer, and Maximilian and Sebastian Fischer gave us patient support throughout the drafting and editing process.

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Chapter 1

You're a Public Company? What Does It Mean?

The Public Company Handbook serves as a practical guide for directors and executives of public companies.

A *public company* is a corporation, limited liability company or partnership subject to the regulations and disclosure requirements of the Securities Exchange Act of 1934 (1934 Act). Usually, this applies to corporations that have completed an initial public offering (IPO) registered with the Securities and Exchange Commission (SEC) under the Securities Act of 1933 (1933 Act).

1934 Act Registration

The 1934 Act requires companies with a widely traded class of equity securities to register those securities with the SEC. 1934 Act registration is a one-time registration of an entire class of securities. By contrast, 1933 Act registration, an IPO for example, registers a certain number of securities for a particular public distribution. Two events trigger 1934 Act registration: listing on an exchange or meeting certain size thresholds.

Listing on an Exchange

To list any securities for trading on a national securities exchange, a company must register the securities with the SEC under Section 12(b) of the 1934 Act. The company will also have to file a listing application with the exchange.

Meeting Size Thresholds

Alternatively, a company may trigger 1934 Act registration requirements simply by reaching a certain size. An issuer with a class of equity securities owned by 500 or more persons and total assets in excess of $10 million must register the securities under Section 12(g) of the 1934 Act. An issuer must register within 120 days after the last day of the fiscal year in which it meets both the shareholder and total asset size thresholds.

Trap for the Unwary:
Stock Options Are a Class of Equity Securities

The 1934 Act defines *equity security* to include employee stock options. Does your company, before its IPO, have fewer than 500 shareholders but 500 or more option holders and more than $10 million in assets? If so, the options, as a class of equity security, could trigger a requirement that your company register under Section 12(g) even though the common stock and the options themselves are not publicly traded. To avoid the burden of 1934 Act reporting, your company could either buy back or cancel enough options to fall below the threshold – or seek relief from the SEC.

The SEC will usually grant a temporary exemption from Section 12(g) registration requirements if:

- The options are issued only to eligible employees under a valid SEC employee plan exemption (Rule 701);
- The options are issued only without consideration, with fair market value exercise prices, and for the purpose of incentivizing employees;
- The options are not transferable except on death or disability of the option holder;
- The stock received on exercise of the options is not transferable (prior to registration under the 1934 Act) except back to the company or in the event of death or disability;

Trap for the Unwary: Stock Options Are a Class of Equity Securities (Cont'd)

- All unvested options expire upon termination of employment; and
- Option holders receive essentially the same information they would have received had the company registered under the 1934 Act (information equivalent to the information included in the 1934 Act Form 10 registration statement that we discuss later in this Chapter).

Concurrent Registration Under the 1933 and 1934 Acts

Typically, a company will register its securities under the 1934 Act simultaneously with its IPO. This allows the Company to list the securities offered in the IPO on a stock exchange or Nasdaq.

Form 8-A makes 1934 Act registration relatively simple for a company concurrently registering an IPO. Form 8-A is a shortened registration statement that requires disclosure of general characteristics of the company and its securities, including dividend rights, voting rights and any anti-takeover provisions in the company's certificate or articles of incorporation and bylaws.

Practical Tip: The Inadvertent Public Company

Some companies become 1934 Act registrants simply because of a gradually broadening of the shareholder base as the company's shares are sold and resold in private transactions. Your company may trigger 1934 Act registration other than for the traditional reason of completing an IPO, if, for example, it inadvertently crosses the 500 equity holders threshold. Without an IPO, your company would file a registration statement under the 1934 Act on Form 10. Form 10 requires financial statements and other more extensive disclosure than does Form 8-A.

1934 Act Periodic Reporting Requirements

A company with securities registered under Section 12(b) (exchange listing) or 12(g) (companies reaching a certain size) of the 1934 Act must file periodic reports with the SEC to keep information contained in its 1934 Act registration statement current. As we describe in Chapter 2, a public company files annual, quarterly and current reports with the SEC.

Additional 1934 Act Regulation

In addition to periodic reporting, 1934 Act registrants and their directors, executive officers and significant shareholders are subject to the following requirements:

- The proxy rules;
- The tender offer rules;
- Section 16 reporting obligations and short-swing profit restrictions;
- Beneficial ownership reporting on Schedules 13D and 13G; and
- The listing standards of Nasdaq, NYSE or other exhanges or listing services.

Trap for the Unwary: 1933 Act Registration Alone Triggers 1934 Act Periodic Reporting Under Section 15(d)

A company that has issued equity or debt securities to the public in an offering registered under the 1933 Act must file quarterly, annual and current reports with the SEC under Section 15(d) of the 1934 Act. This reporting requirement applies even though the company does not list the securities on an exchange or market and the company has not crossed the size thresholds triggering 1934 Act registration. Section 15(d) companies, subject to periodic reporting only by reason of Section 15(d), are free from a host of other 1934 Act requirements, including regulation of proxy solicitations and tender offers, beneficial ownership reporting and short-swing profit restrictions.

In Chapter 14, we discuss the process by which a Section 15(d) registrant can cause its periodic reporting obligations to be automatically suspended.

Chapter 2

The Basics: Public Company Periodic Reporting Obligations

A company subject to the 1934 Act files annual, quarterly and current reports with the SEC. These reports regularly update and supplement the information that the company has made available to the public in previous 1933 and 1934 Act filings. Companies file the reports within a specified number of days after the end of each reporting period, or after certain material events.

Practical Tip: How to Keep Pace With Periodic Reporting in a Post-Enron World? Maintain a Periodic Reporting Disclosure Checklist

Enron and other corporate failures focused public attention on the integrity and quality of disclosures in companies' annual, quarterly and current reports. Congress mandated reforms to periodic reporting and corporate governance through the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley), and the SEC, NYSE and Nasdaq raced to keep pace. These initiatives have thrust the most basic of public company obligations – periodic reporting – into the forefront of directors' and officers' attentions, and challenge even the most organized companies to keep track of what must now be disclosed in reports filed with the SEC. In **Appendix 1** we provide companies with a model Periodic Reporting Disclosure Checklist of key Sarbanes-Oxley, SEC, NYSE and Nasdaq periodic reporting and proxy statement disclosure requirements, and in **Appendix 2** a model 1934 Act Annual Reporting Calendar. We discuss these in greater detail in this and later Chapters, and urge you to use them to create comparable checklists for your company.

CEO and CFO Certifications and Disclosure Practices

Since Sarbanes-Oxley, public company CEOs and CFOs have certified each annual report on Form 10-K and quarterly report on Form 10-Q. To ensure that a disclosure system is in place to backstop these certifications, each company must also maintain *disclosure controls and procedures* and *internal control over financial reporting.*

Certifications by CEO and CFO

A company's CEO and CFO are each required to provide two separate certifications in each Form 10-Q and 10-K, a "Section 302" and a "Section 906" certification. In a Section 302 certification, the CEO and CFO make statements in two areas:

1. *Accuracy of Report.* The officer has reviewed the report, and to the officer's knowledge,
   - the report does not contain any material misstatements or omissions; and
   - the financial statements, and other financial information included in the report, fairly present in all material respects the company's financial condition, results of operations and cash flows.
2. *Controls and Procedures.* The CEO or CFO is responsible for establishing and maintaining disclosure controls and procedures and internal control over financial reporting, and has:
   - Designed the disclosure controls and procedures to ensure that all material information is made known to the CEO and CFO;
   - Designed the internal control over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements in conformity with GAAP;
   - Evaluated the effectiveness of the disclosure controls and procedures as of the end of the period covered by the Form 10-Q or 10-K;
   - Described in the Form 10-Q or 10-K the effectiveness of the disclosure controls and procedures based on the evaluation;

- Indicated in the Form 10-Q or 10-K whether there were any changes in the internal control over financial reporting during the most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, the internal control over financial reporting; and
- Disclosed to the company's auditors and Audit Committee any significant deficiencies or material weaknesses in the design or operation of internal control over financial reporting or any fraud that involves employees who have a significant role in internal control over financial reporting.

In a second, shorter Section 906 certification, the CEO and CFO make two basic statements that overlap with their Section 302 certifications:

- The periodic report containing financial statements fully complies with the requirements of the 1934 Act; and
- Information contained in the report fairly presents, in all material respects, the company's financial condition and results of operations.

Unlike the Section 302 certification, the Section 906 certification may take the form of a single statement signed by both the CEO and CFO, and may be "furnished" rather than "filed" with the related report. (We discuss the difference between "furnishing" and "filing" later in this Chapter.) Section 302 and Section 906 certifications are for Forms 10-K and 10-Q, and need not accompany reports on Form 8-K or Form 11-K.

The company submits both Section 302 certifications and Section 906 certification as exhibits to the related periodic report.

Disclosure Controls and Procedures

To back up the certifications, companies maintain a system of disclosure controls and procedures designed to ensure that the company records, processes, summarizes and discloses on a timely basis information required to be disclosed in 1934 Act filings. Companies also need to evaluate on a quarterly basis the effectiveness of their disclosure controls and procedures. The newly coined phrase

"disclosure controls and procedures" is broad in scope and extends beyond financial matters to cover all controls and procedures relating to required disclosure.

Internal Control Assessment

The most costly and controversial aspect of Sarbanes-Oxley is the internal control requirement of Section 404. Section 404 and related rules require each public company to include in its Form 10-K a management report on the effectiveness of the company's internal control over financial reporting. The company's independent auditor is then required, in a separate audit-like analysis, to attest to, and report on, management's assessment. Non-accelerated filers (generally companies with market capitalizations of less than $75 million) need to comply with Section 404 only for fiscal years ending on or after July 15, 2007.

Internal control over financial reporting includes policies and procedures that:

- *Track Transactions in Assets* – relate to the maintenance of records that in reasonable detail accurately and fairly reflect the acquisitions and dispositions of assets.
- *Control Receipts and Expenditures* – provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP, and that receipts and expenditures are being made only in accordance with authorizations of management and directors.
- *Protect Assets* – provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of assets that could have a material effect on the financial statements.

Management needs to base its internal control evaluation on some "recognized control framework" in order to have a widely accepted standard of comparison. The SEC identified the Treadway Commission's "Committee of Sponsoring Organizations" report – "Internal Control – Integrated Framework" – as the evaluation framework of choice. Although the SEC does not mandate any particular framework, U.S. companies quickly came to adopt COSO as the standard, indeed as the only realistic standard readily available for domestic issuers.

Breaking News:
COSO Provides Guidance
For Smaller Public Companies

In the adopting rules under Section 404, the SEC and others expressed concern that existing internal control frameworks, including the COSO framework, are not appropriately tailored to a small business control environment and that, as a result, the costs and burdens of internal control assessments may fall disproportionately on smaller businesses. Due to these concerns, SEC staff encouraged COSO to develop guidance on the use of their framework to address the needs of smaller businesses. In late 2005 an Advisory Task Force of the COSO Board published for comment new guidance on the use of its framework to address the needs of smaller businesses in fulfilling the requirements of Section 404. Specifically, COSO noted that smaller companies' management tends to have a hands-on approach, wider spans of control and the ability to provide ongoing monitoring through direct relationships with key personnel, customers, vendors and capital providers that can create opportunities for controls to be effective while being less formal. Ask your counsel or independent auditor about the status of COSO's guidance for smaller public companies.

Methods of conducting evaluations of internal control will vary from issuer to issuer. Although the SEC does not specify the method or procedures to be used, it has made these observations that encourage documentation – one of the expensive side effects of internal controls:

- *Develop – and Test – Procedures.* Management must base its assessment on procedures to evaluate the design of internal control over financial reporting. And management then should "actively" test its operating effectiveness, going beyond simple inquiry.
- *Results of Tests.* Management must base its assessment on evidence including documentation of the internal control design and on the process and results of testing.
- *Keep Records.* Companies should develop, and maintain in company records, documentation and other evidence that support management's assessment.
- *Outside Auditors Can Help Within Limits.* Management must be actively involved in the process and cannot delegate its responsibility to assess internal control to the auditor. But the SEC recognizes the need for coordination between management and auditors. For example, the auditors may provide advice and make recommendations for improvements to internal controls, so long as management, and not the auditor, makes the accounting decisions. And someone other than the auditor (management or a third party provider) needs to design the control procedures, because for an auditor to do so would place it in the position of auditing its own work and violate auditor independence rules.

Practical Tip: One Size Fits All? Good for Socks, Bad for SOX – Tailor Your 404 Assessment Process to Your Company's Unique Risks and Issues

Addressing a growing chorus of criticism that Section 404 compliance is too expensive and burdensome, the SEC and the Public Company Accounting Oversight Board (PCAOB) issued suggestions and guidance on compliance in 2005. A principal theme of the SEC's and PCAOB's guidance is that "one size does not fit all" when it comes to designing an internal control assessment process. The SEC and PCAOB highlighted these key concepts:

- U*se a Top-Down, Risk-Based Approach.* By "top-down," the SEC means an approach where management and accountants focus their greatest efforts on processes and classes of transactions that are most likely to have a material impact on the company's financial statements, starting with company-level controls and then to significant accounts and significant processes and, finally, to individual control levels. Similarly, by "risk-based" approach, the SEC and PCAOB suggest a common-sense, big picture review, in which management and accountants give less attention to areas of the company's controls where there is a low risk that a material weakness could exist and more attention to areas where there is a high risk that a material weakness could exist. An example of not using a risk-based approach is too much dependence on standardized checklists that may not address a company's unique risks and control issues.
- *Streamline Testing Through Ongoing Monitoring.* Not all testing needs to be done during the year end close period. Management may be able to complete the testing of a substantial number of controls through regular supervisory activities, monitoring adherence to company policies and taking other actions on an ongoing basis throughout the fiscal year.

Practical Tip: One Size Fits All? Good for Socks, Bad for SOX — Tailor Your 404 Assessment Process to Your Company's Unique Risks and Issues (Cont'd)

- *Use an Integrated Audit.* Many companies have already begun to use an "integrated" audit that combines an audit of internal control over financial reporting (the Section 404 audit) with the audit of the financial statements. The PCAOB and SEC encourage the use of integrated audits, which they view as more cost-effective. They also believe an integrated audit leads to better financial reporting, as the auditor's evaluation of internal controls will help the auditor better plan and conduct the financial statement audit.
- *It Can Be OK for Auditors to Use the Work of Others.* Auditors are permitted to rely on the work of others, for example internal company personnel, especially in areas where there is a low risk that a material weakness could exist. Auditors should perform more of their direct work in high-risk areas and use the work of others in areas of less risk.
- *No Need to Test IT Controls Unrelated to Financial Reporting.* For purposes of the Section 404 assessment, companies do not need to test general IT controls that pertain to the efficiency or effectiveness of the company's operations but do not pertain to financial reporting.

If a company identifies a material weakness, it must disclose the existence of the material weakness in the Form 10-K, and management is not permitted to conclude that the company's internal control over financial reporting was effective for that period. The SEC encourages companies to provide additional disclosure to allow investors to assess the potential impact of the material weakness. Experience has shown that analysts and investors are, with sufficient information, able to quickly assess the impact, in many cases with no negative impact on stock price or company reputation. The SEC's suggested three topics are useful as a checklist for disclosure:

- The nature of the material weakness;
- Its impact on financial reporting and the control environment; and
- Management's plans for remediating the weakness.

Practical Tip:
Form a Disclosure Practices Committee

Most widely traded public companies have followed an SEC recommendation to establish a non-Board "Disclosure Practices Committee." This Committee of officers and employees develops and oversees the procedures that support the CEO's and CFO's Sarbanes-Oxley certifications. The Committee's mandate is simple:

- Identify and analyze information for inclusion in 1934 Act reports; and
- Develop, implement and evaluate disclosure controls and procedures and internal control over financial reporting.

Who serves on the Committee? Two to ten officers or employees from the key functional areas in the company best able to gather and analyze material financial and other information. The SEC suggests:

- Controller or principal accounting officer;
- General counsel or lawyer responsible for disclosure;
- Risk management officer;
- Investor relations officer; and
- Internal audit manager.

Have your Disclosure Practices Committee meet at least three times during each quarter to fulfill its three categories of duties:

1. **Information Gathering.** Put into place and oversee the internal procedures for gathering information for possible disclosure in the company's 1934 Act reports. For example, interview personnel who have authority over significant business functions or subsidiaries.

Practical Tip:
Form a Disclosure Practices Committee (Cont'd)

2. **Review and Communication.** Analyze the materiality of information collected and determine your company's disclosure obligations.

3. **Evaluation and Improvement.** Evaluate your company's disclosure controls and procedures and internal control over financial reporting. Identify weaknesses and recommend improvements.

The Committee or its chair will report its conclusions to the CEO, CFO and, possibly, the Audit Committee.

Form 10-K and 10-Q Filing Deadlines

Form 10-K and 10-Q filing deadlines depend on which of these categories of filers the company fits into:

- *Accelerated filer.* Companies that:
  - have a public equity float of at least $75 million but less than $700 million;
  - have been subject to the 1934 Act's reporting requirements for at least 12 calendar months;
  - previously have filed at least one annual report on Form 10-K; and
  - are not eligible to file their quarterly and annual reports on Forms 10-QSB and 10-KSB.
- *Large accelerated filers.* Companies that have a minimum public equity float of $700 million and otherwise meet the definition of accelerated filers.
- *Non-accelerated filers.* Companies that do not meet the definition of accelerated filers or large accelerated filers.

The table below summarizes the Form 10-K and 10-Q filing deadlines for each category of filer:

Category of Filer	**Deadlines for Reports Beginning with the Annual Report for Fiscal Years Ending on or after December 15, 2005**	
	Form 10-K Deadline	**Form 10-Q Deadline**
Large Accelerated Filer ($700+ MM)	75 days after year end (60 days after year end for fiscal years ending on or after December 15, 2006)	40 days after quarter end
Accelerated Filer (between $75 MM and $700 MM)	75 days after year end	40 days after quarter end
Non-accelerated Filer (less than $75 MM)	90 days after year end	45 days after quarter end

Practical Tip:
How to Prepare for Accelerated Filings?
Create a 1934 Act Reporting Calendar

Preparing your company's 1934 Act reports will require extensive input by your Disclosure Practices Committee and finance, marketing, engineering and legal departments, as well as review by external auditors and lawyers. Allow adequate time to complete each step of your disclosure controls and procedures and internal control over financial reporting, and for review by your CEO, CFO and the company's other officers and directors. To ensure that your working group remains on schedule, and to allow adequate review time, create a 1934 Act reporting calendar and circulate it to the members of the working group well in advance of each reporting cycle. **Appendix 2** provides a sample 1934 Act Reporting Calendar, including suggested Disclosure Practices Committee meeting dates.

Integrated Disclosure Under Regulation S-K and Regulation S-X

Regulation S-K, the SEC's disclosure guidance "cookbook," sets forth detailed disclosure requirements governing the content of 1934 Act periodic reports. Regulation S-K is a centralized source of disclosure requirements for periodic reports, proxy solicitations, registration statements and other filings pursuant to the 1933 and 1934 Acts. Regulation S-X is the financial information counterpart to Regulation S-K. Regulation S-X provides the centralized source of requirements for the form and content of financial information required to be included in filings under the 1933 and 1934 Acts.

Annual Report on Form 10-K

A public company must file an annual report on Form 10-K following the end of each fiscal year. The first Form 10-K is due 90 days after the end of the first fiscal year in which the issuer becomes subject to the periodic reporting requirements of the 1934 Act. (We summarize the filing deadlines for future years earlier in this Chapter.)

Information Included in Form 10-K

Form 10-K is the most comprehensive periodic report filed with the SEC. It includes much of the same information that is required in a registration statement filed for an IPO under the 1933 Act. Required information includes:

- A description of the company's properties and business, including developments during the fiscal year.
- MD&A – management's discussion and analysis of financial condition and results of operations, including a table of the company's contractual obligations and a discussion of material off-balance sheet arrangements.
- Qualitative and quantitative disclosure about market risks.
- A description of material legal proceedings.
- "Selected" and full year end audited financial information, including the independent auditor's opinion, in compliance with Regulation S-X.
- Management's conclusions regarding the effectiveness of the company's disclosure controls and procedures as of the end of the fourth quarter.
- Management's report on internal control over financial reporting and the related independent auditor's attestation.

These items are also required, but companies that file a proxy statement within 120 days after the end of the fiscal year may meet these requirements by including these items in the proxy statement:

- Information regarding directors, executive officers and more than 5% beneficial owners, including compensation, transactions with related parties and security ownership.
- Identification of the company's Audit Committee financial expert or experts. If a company does not have at least one financial expert on its Audit Committee, the company must explain why.
- Whether or not (and if not, why not) the company has adopted a code of ethics for its principal executive officer,

principal financial officer and principal accounting officer or controller.

- Textual and tabular information regarding equity compensation plans.
- Disclosure of the fees billed by the company's independent public accounting firm for audit, audit-related, tax and other fees, and of the Audit Committee's pre-approval policy for audit and non-audit services.

The company's principal executive officer, principal financial officer and principal accounting officer, and at least a majority of the members of the company's Board of Directors must sign the Form 10-K.

MD&A

The heart and soul of Form 10-K is MD&A, management's discussion and analysis of the company's financial condition and results of operations. MD&A, governed by Item 303 of Regulation S-K, requires a discussion of liquidity, capital resources, results of operations and other information necessary to an understanding of the company's financial condition, changes in financial condition and results of operations.

In December 2003, the SEC issued detailed interpretive guidance regarding disclosure in MD&A, whose key concepts continue to be extremely helpful guideposts for the drafter of MD&A. The SEC developed its themes from recent experiences, including enforcement actions, its review of annual reports and a detailed review of the MD&A disclosure of Fortune 500 companies. The SEC emphasized these key concepts in its 2003 interpretive release:

Through Your Eyes: The Purpose of MD&A

- The purpose of MD&A is to enable readers "to see the company through the eyes of management" and to provide readers with the information they need to readily understand the company's financial condition and performance.

Overall Presentation

- Include an executive-level overview to provide a context for the presentation of MD&A. Encourage top-level participation in the drafting process.
- Give the greatest prominence to the most important information.
- Omit duplicative information, like information already included in financial statement footnotes.

Focus and Content

- What are the key performance metrics that management uses to run the business? Identify and discuss them.
- Focus on material information and eliminate the immaterial.
- Disclose known trends and uncertainties and their impact on the company's prospects. (This is *required* MD&A disclosure – not just a best practice – and a healthy MD&A will provide a thoughtful CEO's-eye view of trends.)
- Explain management's view of the significance of the information presented.

Substantive Guidance

- *Liquidity and Capital Resources.* Focus analysis on sources and uses of cash. This is particularly useful for companies using the indirect method in preparing cash flow statements. Consider enhanced disclosure regarding debt instruments, guarantees and related covenants.
- *Critical Accounting Estimates.* Consider enhanced discussion and analysis for accounting estimates and assumptions that are subjective and require judgments for highly uncertain matters. What are these estimates and assumptions and how are they susceptible to change, and how could a change have a material impact on financial condition or operating performance?

Practical Tip: Pick Up the Pen! Ask Your CEO & CFO to Draft an MD&A Overview

The SEC restates a constant theme in its 2003 interpretive release: management should provide "early top-level involvement" in "identifying the key disclosure themes and items" to include in a company's MD&A. These key themes should first appear in the "executive-level" overview. Although the content of an introduction or overview will depend on the circumstances of each particular company, the SEC suggests that a good overview will discuss:

- Economic or industry wide factors relevant to the company.
- How the company generates revenue, cash flow and net income.
- The company's lines of business, locations of operations and principal products and services in a way that does not duplicate the Business section of the Form 10-K.
- Material opportunities, challenges and risks, such as those presented by known material trends and uncertainties, on which the company's executives are most focused for both the short and long term, as well as the actions they are taking to address these opportunities, challenges and risks.

Ask your CEO or CFO to sketch out a one-page narrative or outline addressing these factors in his or her own words, or to discuss them with the principal MD&A drafter, to provide a "through the eyes of management" starting point for the MD&A overview.

In the SEC's recent focus on the quality of MD&A disclosure, it has re-emphasized the need to *identify* and *analyze* material trends, demands, commitments, events and uncertainties that could impact a company's liquidity, financial condition or operating results. This

disclosure, the SEC believes, is critical to understanding a company's reported financial information and the extent to which reported information is indicative of future results or financial condition.

SEC regulations require that MD&A focus on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or future financial condition. A disclosure duty exists where a trend, demand, commitment, event or uncertainty is both:

- Presently known to management, and
- Reasonably likely to have a material effect on a company's liquidity, financial condition or results of operations.

The "reasonably likely" threshold is higher than "possible" but lower than "more likely than not." The SEC indicates that it expects disclosure of an identified trend, future event or uncertainty unless management concludes that either:

- It is not reasonably likely the trend, event or uncertainty will occur or come to fruition; or
- The trend or uncertainty is not reasonably likely to have a material effect on the company's liquidity, capital resources or results of operations.

Trap for the Unwary:
Caterpillar's Tango With MD&A

The year 1989 was a profitable one for the Brazilian subsidiary of Caterpillar Inc. It accounted for 23% of the earnings of the Peoria, Illinois maker of heavy machinery engines. A number of non-operating gains caused by hyperinflation and currency exchange rates contributed to the strong year.

Trap for the Unwary: Caterpillar's Tango With MD&A (Cont'd)

In its 1989 Form 10-K, as in years past, Caterpillar presented its financial results on a consolidated basis, melding the Brazilian subsidiary with the rest of the company. Its MD&A did not discuss the extent to which Caterpillar's 1989 earnings were derived from the subsidiary. Moreover, neither the Form 10-K nor Caterpillar's Form 10-Q for the first quarter of 1990 discussed what seemed to be known risks faced by the Brazilian subsidiary arising from possible economic reforms in Brazil that could have had a material adverse effect on the subsidiary's financial performance and the overall financial performance of Caterpillar.

When, in June 1990, Caterpillar announced that new economic policies in Brazil would hurt the company's overall earnings, its stock price plummeted by 16%.

The SEC charged Caterpillar with disclosure violations in a proceeding that centered on the MD&A section of the company's Form 10-K and first quarter Form 10-Q. In the SEC's release, which it still refers to today for MD&A guidance, the SEC described Caterpillar's MD&A disclosure as deficient in that:

- Caterpillar's Form 10-K should have discussed the impact of the Brazilian subsidiary on Caterpillar's overall results of operations; and
- Both the Form 10-K and the Form 10-Q should have discussed future uncertainties regarding the subsidiary's operations, the possible risk of Caterpillar having materially lower earnings as a result of that risk and, if practicable, quantified the impact of the risk.

Caterpillar's experience reminds us that an MD&A that provides a view of the company "through the eyes of management" will:

- Transparently describe the contributions of subsidiaries, divisions or sectors;

Trap for the Unwary: Caterpillar's Tango With MD&A (Cont'd)

- Disclose the risks, trends or uncertainties that may affect future financial performance, identifying them as they develop; and
- Quantify, where possible, the potential consequences of these risks.

Breaking News: Attention Kmart Investors: SEC's MD&A Focus Continues

In 2005, the SEC made the critical point that the text of a quarterly MD&A needs to accurately reflect management's views of the reasons behind balance sheet shifts. The SEC charged Kmart's former CEO and CFO for misleading investors about Kmart's financial condition in the months preceding a 2001 bankruptcy. According to the SEC's complaint, the former executives were responsible for materially false and misleading textual disclosure – not false financial data – in the MD&A section of a Kmart Form 10-Q.

The Form 10-Q disclosed a huge inventory build-up – but according to the SEC, failed to explain the "why" of the build-up and its impact on the company's liquidity. For example, while the SEC noted that a Kmart officer had made a reckless and unilateral purchase of $850 million of excess inventory, the MD&A disclosure made the increase appear to be innocuous, as ordinary course "seasonal inventory fluctuations and actions taken to improve our overall in-stock position."

The lesson? Today, as it was in the Caterpillar case, "through the eyes of management" means the senior executives' view of the company needs to make the at times difficult translation to an accurate "word picture" in each quarter's MD&A.

Incorporation by Reference

Most companies' Form 10-Ks incorporate portions of the "glossy" annual report to shareholders and the proxy statement by reference, without repeating the incorporated information. For example, companies generally incorporate by reference from the proxy statement all compensation information and related party transactions regarding directors and officers, known as Part III information. (We describe this information under "Annual Report on Form 10-K" above.) This is permitted even though the proxy statement is filed later than the Form 10-K. Incorporation by reference requires that:

- All the incorporated information be included in a definitive proxy statement that involves the election of directors;
- The company file its definitive proxy statement within 120 days after the end of the fiscal year covered by the Form 10-K; and
- The Form 10-K specifically identify the incorporated material by page, paragraph, caption or otherwise.

Form 10-K may also incorporate by reference to the "glossy" annual report to shareholders. If so, the company must file the annual report with the SEC as an exhibit to the Form 10-K. (We discuss both the glossy annual report and the proxy statement in greater detail in Chapter 6.)

Risk Factors and the Safe Harbor

As part of the SEC's 2005 securities offering reforms, most companies are required, beginning December 1, 2005, to include disclosure of risk factors in their Form 10-Ks. (We discuss the SEC's 2005 securities offering reforms in Chapter 12.) This risk factor disclosure of circumstances, trends or issues that may affect the company's business, prospects, future operating results and financial condition is similar to the disclosures made in an IPO prospectus and in many 1933 Act registration statements. Although the SEC discourages companies from unnecessarily repeating the risk factors in the Form 10-Qs, companies filing Form 10-Qs will need to

update their risk factors on a quarterly basis to reflect any material changes. This risk factor disclosure requirement does not extend to small business issuers that file Form 10-KSB and Form 10-QSB.

Even if not mandated to include risk factors, many issuers include risk factors in 1934 Act reports in order to take advantage of the safe harbor provided by Section 21E of the 1934 Act. Section 21E provides a public company with a safe harbor defense in securities litigation challenging a forward-looking statement made by the company. To fall within the safe harbor, the forward-looking statement must be identified as a forward-looking statement and be accompanied by meaningful cautionary language that, in the case of written statements, identifies important factors that could cause actual results to differ materially from those projected in the forward-looking statement. (We discuss and provide practical tips for using these safe harbors in Chapter 3.)

Periodic reports usually include forward-looking statements, particularly in the MD&A where the SEC encourages disclosure of forward-looking information. Risk factors accompanying these forward-looking statements will provide the meaningful cautionary language that identifies important factors that could cause actual results to differ from projected results. In addition, the company can protect oral forward-looking statements under the safe harbor provisions of Section 21E of the 1934 Act by referring to the most recent Form 10-K and Form 10-Q risk factors.

Form 10-K Exhibits

Some of the most valuable sources of information about a public company are the exhibits to its Form 10-K. Item 601 of Regulation S-K identifies the documents to be filed as exhibits. (Companies generally incorporate by reference documents that they have previously filed as exhibits.)

The most significant category of documents that must be filed as exhibits to Form 10-K is material contracts. All material contracts made outside the ordinary course of business must be filed as exhibits. If a contract was made in the ordinary course of business, it does not have to be filed unless it is material and falls within one of the following categories:

- A contract with a director, officer or shareholder named in the report;
- A contract on which the company is substantially dependent;
- Any contract involving the acquisition or sale of property, plant or equipment for a purchase price exceeding 15% of the company's fixed assets;
- Any material lease; or
- A management contract or compensatory plan for a director or executive officer that is not generally available to all employees.

Quarterly Reports on Form 10-Q

Public companies file a quarterly report on Form 10-Q after the end of each of their first three fiscal quarters. (We summarize the filing deadlines earlier in this Chapter.)

Information Included in Form 10-Q

Form 10-Q generally includes:

- Unaudited interim financial statements in compliance with Regulation S-X;
- MD&A;
- Qualitative and quantitative disclosure about market risks;
- Management's conclusions regarding the effectiveness of the company's disclosure controls and procedures as of the end of the quarter; and
- Any changes in the company's internal control over financial reporting during the quarter that have materially affected, or are reasonably likely to materially affect, the company's internal control over financial reporting.

MD&A in the Form 10-Q will include, among other disclosures, a textual update to the Form 10-K table of contractual obligations and a discussion of material off-balance sheet arrangements. In addition, a company will disclose specific events that occurred during the quarterly period, including:

- Material legal proceedings and material developments during the quarter in previously reported legal proceedings; and
- The results of matters submitted to a vote of the company's shareholders.

Signatures and Certifications

A duly authorized officer signs Form 10-Q on behalf of the company, as does either its principal financial or chief accounting officer. Unlike Form 10-K, Form 10-Q does not require CEO or Board signatures.

Although the CEO does not necessarily sign the Form 10-Q, the CEO and CFO each make the Section 302 certification and the Section 906 certification for each Form 10-Q.

Practical Tip:
Filing Your First 10-Q

Companies that go public during a quarter must file a Form 10-Q that covers the entire quarter in which the 1933 Act registration statement becomes effective. The first Form 10-Q after the company's IPO will include information regarding the status of the offering. If the issuer held a special shareholders' meeting immediately prior to the IPO, the results of that meeting will also appear in the first Form 10-Q. Until all IPO proceeds have been applied, each post-IPO 10-Q will describe the use of the IPO proceeds.

Form 10-Q Exhibits

Item 601 of Regulation S-K identifies the documents that must be filed as exhibits to Form 10-Q. Companies may and generally do incorporate previously filed exhibits by reference. Although most companies list only those exhibits that are actually filed with Form 10-Q, rather than all the exhibits that are incorporated by reference, Item 601 by its text requires that all exhibits that have been incorporated by reference be listed in the exhibit index to Form 10-Q.

Missed Form 8-K Filings

Form 10-Q must identify any information required to be disclosed in a Form 8-K during the quarter but not reported.

Current Reports on Form 8-K

Form 8-K is a current report filed between quarterly and annual reports to provide the public with information on recent material events. Form 8-K disclosure is mandatory if specified events occur. In addition, many companies make optional filings on Form 8-K to ensure maximum public disclosure of material developments. A duly authorized officer of the company signs Form 8-K.

In response to the "real time issuer disclosure" mandate of Sarbanes-Oxley, the SEC adopted changes to Form 8-K in 2004 that radically expanded the types of events required to be reported on Form 8-K and accelerated the filing deadline to four days for most reportable events.

Mandatory Filing

Appendix 3 contains a complete list and description of the items a company is required to report on Form 8-K. These items include:

- Entry into or termination of, or material amendment to, material agreements, including compensation agreements;
- Significant acquisitions or dispositions;
- Specified financial information, including earnings releases, creation of direct financial obligations or off-balance sheet arrangements and events that accelerate or increase those obligations or arrangements, costs associated with exit and disposal activities and material impairments;
- Information regarding the company securities and trading markets, including delisting notices or failure to satisfy listing standards, sales of unregistered securities and material modifications to rights of security holders;

- Matters relating to accountants and financial statements, including changes in the independent auditor and restatements of financial statements;
- Bankruptcy or receivership; and
- Information regarding corporate governance and management, including changes in control of the company, departures or appointments of directors and executive officers, amendments to the company's charter documents, amendments or waivers to the company's code of ethics and suspension of trading under employee benefit plans.

Trap for the Unwary: Have You Identified All Your Material Definitive Agreements?

Your company must report the entry into, or termination or material amendment of, a material definitive agreement on Form 8-K. The SEC defines a material definitive agreement as an agreement that provides for obligations that are material to and enforceable against the company, or rights that are material to the company and enforceable by the company against one or more other parties to the agreement. Companies assess materiality in light of both quantitative and qualitative factors. Some are finding material definitive agreements in unexpected places:

- *Some "Nonbinding" Agreements May Trigger a Form 8-K Report.* Although a nonbinding letter of intent that contains binding confidentiality or no-shop provisions would not be deemed to contain material binding terms (stated in a footnote to the SEC adopting release), the determination of whether a nonbinding letter of intent contains binding material terms requires careful review of the facts and circumstances of each particular case. Before signing even a nonbinding instrument, discuss with your counsel whether the instrument contains binding terms that, individually or together, could be deemed material.

Trap for the Unwary: Have You Identified All Your Material Definitive Agreements? (Cont'd)

- *Agreements Can Become Material Over Time.* An agreement that is not material when made can later become material over time as the business relationship between the parties evolves – for example, through sales growth to a specific customer. If the parties do not amend the agreement in connection with the changed relationship, the SEC has indicated that a Form 8-K would not be required, although the agreement would need to be filed with the company's next periodic report. However, if the parties amend the agreement, the company must report the amended agreement on Form 8-K.
- *Compensation-Related Actions Can Require a Form 8-K Filing.* Bonuses for executive officers named in the company's proxy statement and changes in compensation for those executive officers and for directors could be deemed an amendment to a material compensation arrangement that requires Form 8-K filing, even if no formal written employment contract exists. Best practices in this area are evolving, so seek the advice of your counsel early regarding the obligation to file Form 8-Ks that address compensation-related actions.

Work with your counsel and Disclosure Practices Committee to ensure that all material definitive agreements are identified and reported, as necessary, on Form 8-K. We provide some practical tips for meeting this and other Form 8-K reporting obligations later in this Chapter.

Optional Filing

A company may elect to voluntarily report other material events under Item 8.01 of Form 8-K.

Regulation FD Disclosure

Regulation FD requires that when a public company discloses material nonpublic information to certain shareholders and investment professionals, it must also make general public disclosure of that information. Regulation FD public disclosure requirements may be met by reporting the information on Form 8-K under Item 8.01 or Item 7.01. (We discuss Regulation FD in detail in Chapter 3.)

Information provided on Form 8-K under Regulation FD, Item 7.01 (and Item 2.02 – "Results of Operations and Financial Condition"), is considered "furnished" rather than "filed." As a result, this information will not be subject to liability under Section 18 of the 1934 Act and will not be incorporated by reference into shelf registration statements filed under the 1933 Act.

Form 8-K Exhibits

Companies file exhibits with the Form 8-K report to the extent required by Form 8-K or Item 601 of Regulation S-K.

Trap for the Unwary: Best Practice May Be to File Material Agreement as Exhibit to Form 8-K When Practicable

The SEC encourages, but does not require, companies to file a copy of the reported material definitive agreement as an exhibit to the Form 8-K. Any agreement not filed as a Form 8-K exhibit will be filed as an exhibit to the company's next periodic report or registration statement.

Because the Form 8-K disclosure must contain sufficient information not to be misleading, and must not contain any material misstatements or omissions, your company should take steps to ensure that all material information concerning an agreement is disclosed on Form 8-K. To ensure compliance with this requirement, many companies file agreements with Form 8-K, where practicable, to ensure that the disclosure is complete. However, if you are seeking confidential treatment of the agreement, you must submit your request for confidential treatment of sensitive information no later than the date that you file the Form 8-K which includes the agreement.

Timing

Mandatory Form 8-Ks generally must be filed within *four business days* of the reported event. An optional report made pursuant to Item 8.01 should be filed "promptly" after the triggering event.

Limited Safe Harbor From 10b-5 Liability. Because several of the Form 8-K disclosure items require management to quickly assess the materiality of an event or to determine whether a disclosure obligation has been triggered, the SEC provides a limited safe harbor from claims under Rule 10b-5 of the 1934 Act for failure to timely file a Form 8-K. (We discuss Rule 10b-5 in Chapter 13.) The safe harbor applies only to these items of Form 8-K:

- Entry into, material amendment to or termination of a material definitive agreement;
- Creation of a direct financial obligation or an obligation under an off-balance sheet arrangement, and triggering

events that accelerate or increase these obligations or arrangements;

- Costs associated with exit and disposal activities;
- Material impairments; and
- The company's determination that a previously issued financial statement should no longer be relied upon due to an error.

The safe harbor extends only until the due date of the next 1934 Act report for the period in which the Form 8-K was not timely filed. The safe harbor does not provide protection against, and the SEC may still bring, enforcement actions against the company under other 1934 Act rules for failure to timely file Form 8-Ks.

Failure to Timely File May Affect S-3 Eligibility. A company that fails to timely file a mandatory Form 8-K generally will lose its eligibility for a period of 12 months to use Form S-3, which is a streamlined registration statement form. (We discuss this registration statement in Chapter 12.) However, companies that fail to file timely reports on Form 8-K required solely by the Form 8-K items for which the limited safe harbor described above applies will not lose their eligibility to use Form S-3. A company must be current in its Form 8-K reports, and have filed the disclosure required by any of these Form 8-K items, on or before the date on which it files a Form S-3.

Practical Tip: Integrate Form 8-K Filing Requirements With Existing Disclosure Control Mechanisms

To meet the challenges of real-time reporting on Form 8-K, work with your Disclosure Practices Committee to monitor your company's current internal disclosure controls and procedures and consider whether to design and implement new controls and procedures to ensure that someone at the company is identifying and evaluating information about events that may be reportable on Form 8-K – in a timely way for the new deadlines.

Practical Tip: Integrate Form 8-K Filing Requirements With Existing Disclosure Control Mechanisms (Cont'd)

Here are steps that may be useful in assessing and considering improvements to existing disclosure controls and procedures:

- Identify officers and others to whom the Board has delegated authority to execute material agreements or otherwise take actions that trigger Form 8-K disclosure obligations. Consider limiting the number of people who have authority to act on the company's behalf, and periodically remind and re-alert this core group to be aware of when their actions can trigger a Form 8-K filing, and how the specific terms of an agreement can affect disclosure requirements.
- Evaluate current procedures for monitoring company wide contracting and compensation activities and events relating to existing contracts and compensatory arrangements. If current monitoring does not occur continuously or at least daily, consider implementing more frequent monitoring.
- Reconsider the size and composition of the company's current Disclosure Practices Committee. Consider forming a smaller "rapid response" subcommittee for Form 8-K disclosure to improve response time.
- Analyze current lines of communication from investor relations and each major function to and from the Disclosure Practices Committee (or the company's general counsel or other appropriate person who staffs the Committee). Do the IR, Finance and other key groups understand these lines of communication? Have you built sufficient redundancy into the system to ensure that information flows to and from the Disclosure Practices Committee, even if one or more of the persons in the line of communication are unavailable?

Practical Tip: Integrate Form 8-K Filing Requirements With Existing Disclosure Control Mechanisms (Cont'd)

- Evaluate existing procedures for identifying required disclosure for quarterly and annual reports. Consider whether additional procedures should be added to ensure that any missed Form 8-K disclosures are included in the Form 10-Q or 10-K.
- Review the company's current material agreements that have been filed as exhibits to reports on Form 10-K, 10-Q or 8-K. Are these all still material?
- Evaluate the activities that the company undertakes that are most likely to trigger required Form 8-K disclosure. Consider whether existing procedures are sufficient to meet new reporting requirements and deadlines.
- Given the company's current financial obligations and off-balance sheet arrangements, determine whether existing processes are sufficient to monitor changes and ensure timely reporting.

Confidential Treatment

Sometimes the exhibit filing mandates of 1934 Act reports require disclosure of information that a company wants to keep confidential, such as pricing information in material contracts. The SEC allows a company to request confidential treatment of proprietary information if disclosure could harm the company's competitive position and adversely affect its business and financial condition.

To make a confidential treatment request (CTR), the issuer submits a written application to the SEC, including a paper copy of the relevant exhibit that identifies its confidential portions, and simultaneously files a redacted version of the exhibit electronically with the 1934 Act report. The SEC will review and comment on the

CTR application, sometimes requiring an amended application in response to its comments. Steps to a successful CTR process include:

- *File It on Time.* Any CTR must be made no later than the date the 1934 Act report is filed.
- *Find Your FOIA Exemption.* To receive confidential treatment, information must fall within one of nine exemptions articulated in the Freedom of Information Act. Most companies rely on the exemption that covers trade secrets and commercial or financial information.
- *Be Reasonable.* Generally redact dollar amounts or formulas rather than entire sections of a contract. At times, when disclosure of the existence of the section would be commercially harmful, it is appropriate to redact the full section.
- *State Your Case.* Describe those aspects of the company's business or the specific contract that will allow the SEC to evaluate the sensitivity and importance of the information.
- *Be Aware of Off-Limits Information.* The SEC usually will not grant confidential treatment for information material to investors, nor will confidentiality be appropriate for disclosure required by Regulation S-K or any other applicable disclosure requirement.
- *Watch for Inadvertent Disclosure of Confidential Information.* Once the company has made information publicly available, even inadvertently, the company will not be able to receive confidential treatment for the disclosed information.
- *Specify Duration for Confidential Treatment.* Confidential treatment beyond the term of an agreement usually is inappropriate, although the company can file an additional CTR to extend the initial period.

SEC Review of 1934 Act Reports

The SEC is required under Sarbanes-Oxley to review a company's 1934 Act reports at least once every three years. The SEC may review a company's 1934 Act reports more frequently, however, often as part of an initiative to monitor specific companies (for example, in 2002 the SEC reviewed 1934 Act filings of all Fortune 500 companies). At other times, the SEC uses review to address specific issues (for example, disclosure of "critical accounting policies" in MD&A). The SEC may also review 1934 Act reports in connection with its review of a company's 1933 Act registration statements.

Any SEC review may generate a comment letter to the company. The company will respond to the comments in a response letter to the SEC. Ultimately, the comment process could cause the company to amend the reviewed report.

As part of the SEC's recent securities offering reforms, beginning on December 1, 2005, accelerated filers and well-known seasoned issuers will disclose, in their Form 10-Ks, written comments from the SEC in connection with a review of a 1934 Act report that:

- The company believes are material;
- Were issued more than 180 days before the end of the fiscal year covered by the Form 10-K; and
- Remain unresolved as of the date of the filing of the Form 10-K.

The disclosure must be sufficient to convey the substance of the comments. Companies may provide additional information, including their position regarding any unresolved comments. (We discuss the SEC's major securities offering reforms, including the definition of a *well-known seasoned issuer*, in Chapter 12.)

Practical Tip: Look to SEC Comment Letters for Disclosure Guidance. But Watch Out: Your Response Letters Are Public Too!

To expand the transparency of the SEC's comment process, beginning in May 2005, the SEC began the process of publicly releasing SEC comment letters and company response letters for filings made after August 1, 2004. These comment and response letters are available on the SEC's website at http://www.sec.gov/answers/edgarletters.htm. Letters will be released by the SEC no earlier than 45 days after the review of the disclosure filing is complete.

Although the SEC notes that comment letters reflect only the SEC Staff's position on a particular filing, do not apply to other filings and are not the official expressions of the SEC, the availability of comment and response letters can be a valuable resource to your company's disclosure team. Prior to making a filing, you will be able to review comments made to similar filings and potentially avoid issues encountered by other companies.

But remember, your response letters will be public too! Consider whether your response letter includes confidential information that should be protected from public disclosure. If so, work with your counsel to develop an appropriate confidential treatment request for the portion of your response letter that contains confidential information.

Amending 1934 Act Reports

Amendments to Form 10-K, 10-Q and 8-K filings bear the letter "A" after the title of the form being amended (e.g., Form 10-Q/A). The amendment sets forth the complete text of the item that is being amended. For example, if Item 1 of Form 10-K (Business) is the only item that requires amendment, the filing need only include Item 1, but it must include the complete text of Item 1. Amendments are signed on behalf of the company by a duly authorized representative.

Applying Plain English Rules to 1934 Act Disclosure

Generally, the SEC's plain English rules technically apply only to prospectuses filed pursuant to the 1933 Act. However, the SEC encourages plain English drafting in all SEC filings, and mandates it in 1934 Act risk factors. As a result, many companies voluntarily use plain English in their 1934 Act documents.

Drafting in Plain English

Draft a plain English document in a clear, concise and understandable manner. Design the text to be visually inviting and easy to read. The SEC provides these guidelines:

- Present information clearly and concisely using short sentences and bullet lists whenever possible;
- Use descriptive headings and subheadings;
- Avoid frequent reliance on defined terms and glossaries;
- Avoid legal jargon, boilerplate language and highly technical business terminology;
- Use the active voice and definite, concrete and everyday language; and
- Use tabular presentations or bullet lists for complex material.

Breaking News:
Use "Plain English" to Draft Those
1934 Act Risk Factors!

Although the plain English rules generally do not apply, as a technical matter, to 1934 Act reports, as part of the SEC's 2005 securities offering reforms, companies must use plain English to draft the mandated risk factors in 1934 Act reports. (We discuss this risk factor disclosure requirement earlier in this Chapter.) Drafters: Use this as an opportunity to convert your entire Form 10-K (and other periodic reports) to the plain English style.

A highly accessible SEC guide to drafting plain English documents is A Plain English Handbook: How to Create Clear SEC Disclosure Documents, available on the SEC's website at http://www.sec.gov/hot/english.htm. The Warren Buffett preface alone is a quick, amusing and useful read.

The EDGAR Filing System

Most documents filed with the SEC, including periodic reports on Forms 10-K, 10-Q and 8-K, must be filed electronically via the SEC's EDGAR (Electronic Data Gathering, Analysis and Retrieval) system. Documents filed via EDGAR are available promptly on the SEC's website.

Companies can obtain the SEC's software package and make filings directly with the SEC or utilize an outside service provider, such as a financial printing company, to convert SEC filings to the EDGAR format and to file the documents on the EDGAR system. Prior to making filings on EDGAR, a company must obtain via application to the SEC a unique identification number, known as a CIK code, and a confidential password, to enable the company to log into, and be identified by, the EDGAR system.

Regulation S-T contains the rules and procedures for filing via EDGAR and supersedes many requirements in other SEC regulations and forms. For example, required signatures in an electronic submission must be in typed form rather than manual format. The company must obtain manually signed signature pages prior to each filing with the SEC and retain them for five years.

Liabilities Relating to Periodic Reporting

Public companies and their officers and directors face potential personal liability resulting from the failure to make required periodic reports or making materially misleading statements in them. Companies and individuals can be subject to SEC enforcement actions or private civil actions, including class actions and derivative actions. (We discuss these liabilities in Chapter 13.)

Practical Tip:
Join a Board But Consider Your Timing

Directors who join a Board shortly before the company files a 1934 Act report may be concerned about potential liability associated with the report, especially if they must sign a Form 10-K. Directors can take steps to minimize this liability and still meet their responsibilities:

- If you are comfortable that you can assimilate the company's business, schedule as many meetings with the company's management and independent auditor as necessary. Sign the report only if you believe that you understand the company and the information in the report.
- If there is not enough time to conduct a sufficient review, wait to join the Board until after the company files the report; or
- Join the Board but decline to sign the first Form 10-K report. (Directors are not required to sign a Form 10-Q, and only a majority of the members of the Board need sign the Form 10-K).

Failing to comply with all securities laws requirements for periodic reporting may also cause an issuer to lose eligibility to use short form 1933 Act registration statements. (We discuss these registration statements and their advantages in Chapter 12.)

Chapter 3

Finding Your Voice: Public Disclosure Practices Under Regulations FD, G and M-A

Managing disclosures to shareholders and to the "street"– equity analysts, investment professionals and the financial press – presents CEOs, CFOs and investor relations officers (IROs) with the daily challenge of controlling the uncontrollable: human communication.

Mandatory and Voluntary Disclosures

Many of an issuer's disclosures are *mandatory*. The 1933 Act, the 1934 Act, SEC rules, NYSE and Nasdaq all require a variety of periodic reports and other filings. In addition, issuers make extensive *voluntary* disclosures – sharing news or facts with the market as part of a financial public relations strategy. The SEC recognized the realm of voluntary disclosures in issuing Regulation FD (short for *Fair Disclosure*), Regulation G (short for *GAAP* or generally accepted accounting principles), and Regulation M-A (short for *Mergers and Acquisitions*).

Public companies are not generally required to publicly disclose all material information at all times. But there are so many "triggers" of mandatory disclosure that it can seem like it! Mandatory disclosures must be made:

- In any 1933 Act registration statement, beginning with an IPO prospectus on Form S-1, and later in an S-3 or other forms;
- In every 1934 Act periodic (Form 10-K or 10-Q) or current (Form 8-K) report;

- Anytime a company is in the marketplace to buy or sell its stock (referred to as the "disclose or abstain" rule);
- When a company needs to confirm or correct a rumor that began with information leaked from the company, causing unusual trading activity likely to impact the marketplace;
- When required by exchange or Nasdaq requirements (Chapters 9 and 10 describe how NYSE and Nasdaq call on companies to promptly release material information and to dispel unfounded rumors); and
- To update prior statements that the market considers current or "evergreen," but which the passage of time has rendered inaccurate or incomplete.

Recently, the SEC has added three new categories:

- Regulation FD disclosure that precedes an intentional disclosure of material nonpublic information or that immediately follows an inadvertent disclosure of material information;
- Regulation G disclosure that accompanies an issuer's voluntary release of pro forma or non-GAAP financial information; and
- Regulation M-A, requiring targets and acquirers in mergers and acquisitions to file all their written communications on the date of first use.

Virtually all other communications by a public company, both formal and informal, are *voluntary*, including:

- Earnings calls in which the senior management team reports on earnings for the quarter or year, may provide guidance regarding future financial results, and responds to analysts' inquiries;
- Analyst conferences that investment banks organize to provide a forum for senior executives to discuss their company's business, earnings and prospects with analysts and investors;
- Annual shareholders' meetings;
- One-on-one discussions with analysts or investors; and
- Press interviews.

Senior executives strive to maintain a dialogue with professional analysts, the financial press and major shareholders in order to help market professionals follow their company's stock and to provide shareholders with access to management. Reports that these equity analysts write and distribute to their customers in turn encourage investor interest and provide information. Yet, private discussions with analysts and major investors can create an imbalance of information – and prior to Regulation FD, institutional shareholders and professional analysts often had more information than other investors. The SEC issued Regulations FD and G to correct this imbalance.

In adopting Regulations FD and G, the SEC recognized the importance of issuers' voluntary, informal disclosures, which often inform investors more thoroughly and more promptly than mandatory 1934 Act reports.

How does Regulation FD seek, in the words of the SEC's adopting release, to put investors "on a level playing field with market insiders"? And how does GAAP-focused Regulation G provide a fairer picture of financial results? Regulation FD expands the quantity of information by requiring issuers to share with the public information that would otherwise be disclosed selectively. Regulation G requires more uniform quality of information by requiring reconciliation to GAAP of pro forma or non-GAAP financial information. Regulations FD and G together address the market's appetite for information by causing issuers to share high-quality information with the public, rather than with a mere handful of market professionals.

Regulation FD's Mandate: Share and Share Alike

Regulation FD requires a company to inform the public when the company, or a person acting on its behalf, voluntarily discloses material nonpublic information to securities market professionals; or security holders, when it is reasonably foreseeable that the holders will trade on the basis of that information.

The timing of the company's public disclosure depends on whether the voluntary selective disclosure was intentional or unintentional.

- If *intentional*, the company must make public disclosure of material information *simultaneously* with any selective disclosure. In practice, companies disseminate material information to the public prior to disclosing the same information to a more limited audience.
- If *unintentional*, the company must make public disclosure *promptly* after the inadvertent disclosure of material information. "Promptly" means by the later of:
  - 24 hours after the inadvertent disclosure; or
  - The next opening of NYSE.

(The SEC's 24-hour clock begins at the moment that a senior official of a company learns of the unintentional disclosure and recognizes the disclosed information to be both material and not publicly available.)

Trap for the Unwary: IR Officers Can't "Go With the Flow" – SEC Penalizes Private Reaffirmation of Earnings Guidances

In a series of public statements from February to September 2002, Flowserve Corporation reduced its full-year earnings projections by more than 30%. The company then reaffirmed its September guidance in a press release issued on October 22, 2002.

During a private meeting almost a month later, on November 19, Flowserve's CEO responded to an analyst's question by again reaffirming the earnings projections last confirmed on October 22. The CEO's response was contrary to the company's disclosure policy:

> Although business conditions are subject to change . . . the current earnings guidance was effective at the date given and is not being updated until the company publicly announces updated guidance.

Trap for the Unwary: IR Officers Can't "Go With the Flow" – SEC Penalizes Private Reaffirmation of Earnings Guidances (Cont'd)

Flowserve's director of investor relations, present at the meeting, remained silent. He neither paused the briefing to clarify the CEO's statement nor stopped to reiterate the company's policy and file a Form 8-K.

The next day, November 20, 2002, an analyst who had attended the meeting issued a report highlighting the CEO's "no change" statement as news. Flowserve's stock rose approximately 6% on 75% greater volume and the company filed a Form 8-K after the close of the markets on November 21 acknowledging that it had reaffirmed its earnings estimates earlier that week.

The SEC concluded that the CEO's reaffirmation was material information. It noted that Flowserve had a trend of lowering its earnings guidance during the course of 2002 – and that the markets reacted to the analyst's "no change" report. In a settlement agreement, Flowserve agreed to pay civil penalties of $350,000 and its CEO paid $50,000. Flowserve, its CEO and the director of investor relations all agreed to a cease-and-desist order.

Flowserve Lessons?

- As an IR officer, speak up to protect your company! When you need to, interrupt your CEO and fellow officers to enforce your Regulation FD policy. Script discussions with professionals or shareholders, summarize your Regulation FD policy at the start of the meeting and set boundaries – including "off limit" topics such as earnings estimates older than a very few days unless you have issued an updating release.

Trap for the Unwary: IR Officers Can't "Go With the Flow" – SEC Penalizes Private Reaffirmation of Earnings Guidances (Cont'd)

- Jump in to a discussion and fix mistakes quickly. Have an understanding with your fellow spokespersons that when the inevitable mistake happens, and a "selective" disclosure occurs, you'll take a "time out". Pause and talk off-line with your IR professional or general counsel. When you start again, reiterate your company's Regulation FD policy and correct the statement. Then disseminate the material nonpublic information in a press release, 8-K or both that day.
- After Flowserve, it's risky to ever reaffirm earnings guidance privately before doing so publicly.

"Curing" Unintentional Disclosures

Unintentional disclosures will happen. When they occur, the company should promptly disseminate the disclosed material nonpublic information through a press release. The company may also wish to include the curative press release in a current report on Form 8-K. Form 8-K includes a Regulation FD item, Item 7.01, designed precisely to "furnish" rather than "file" the information under Regulation FD. Issuers can use this aspect of Form 8-K as a "super-press release" to ensure broad dissemination of the relevant information.

Trap for the Unwary:
Silence and a Poker Face are Golden

In its most subtle of FD enforcement actions, the SEC fined Schering Plough Corporation $1,000,000, and its former CEO, Richard Kogan, $50,000, for both verbal and *nonverbal* selective disclosure of material, nonpublic earnings information.

Trap for the Unwary:
Silence and a Poker Face are Golden (Cont'd)

Schering manufactures Claritin®, a successful allergy drug that was facing the loss of patent protection in 2002. Schering had warned investors that loss of patent protection might have a significant impact on sales.

On September 30, 2002, Mr. Kogan and senior executives learned some bad news: internal earnings forecasts were significantly lower than both Wall Street analysts' consensus estimates and Schering's own published 2002 earnings guidance. Later that day and the next day – weeks before Schering's scheduled release of Q3 earnings – Mr. Kogan and his IR officer met in private meetings with analysts and four institutional investors, including three of Schering's largest shareholders.

Mr. Kogan did not make a formal presentation at the meetings. Instead, in a Q&A, he made new and detailed statements about Schering's plans. As the SEC described it, Mr. Kogan was "downbeat" and he said that the company would take a "hard hit" to earnings and that 2003 would be a "very, very difficult" and "tough" year, in part, due to the loss of the Claritin® patent.

Immediately following the meetings, two analysts downgraded their ratings of Schering's stock. In the three days following the first meetings, Schering's average daily trading volume quadrupled and its share price fell by over 17%. Sales by two of the institutional shareholders who participated in the meetings accounted for over 30% of the trading volume.

Three days later on October 3, 2003, at a private meeting with a larger group of analysts and portfolio managers, Mr. Kogan reiterated many of his September 30 statements, before Schering released earnings guidance for 2002 and 2003 later that day.

Trap for the Unwary:
Silence and a Poker Face are Golden (Cont'd)

The SEC based its enforcement action on this meeting, using it to warn that "[i]ssuers may not evade the public disclosure requirements of Regulation FD by using 'code' words or 'winks and nods' to convey material nonpublic information during private conversations."

The SEC focused on Mr. Kogan's downbeat nonverbal cues, stating that Mr. Kogan disclosed "negative and material, nonpublic information regarding Schering's earnings prospects" at each of the private meetings "through a combination of spoken language, tone, emphasis, and demeanor." The SEC's order described participants' reactions to Mr. Kogan's negative tone and "downbeat" demeanor at the meeting.

Lessons Learned?

- Your mother was right. It's how you say it, not just what you say that counts. The SEC will read emphasis, tone and body language in assessing disclosure of material, nonpublic information.
- The SEC will have the luxury of judging the impact of nonverbal cues with 20-20 hindsight.
- A poker face is golden.

What's Material? Is It Just "Market Moving"?

Regulation FD applies only to the disclosure of material nonpublic information. Although Regulation FD does not itself define what constitutes material information, guidance comes directly from the SEC and the U.S. Supreme Court. Information is material to an investor making an investment decision if "there is a substantial likelihood that a reasonable shareholder will consider it important." There must be a substantial likelihood that the fact "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." The U.S. Supreme Court has rejected any bright-line test for determining materiality. Materiality with respect to contingent events depends

on balancing the probability that the event will occur with the magnitude of the expected event in light of the company's other activities.

When adopting Regulation FD in 2000, the SEC provided a seven-item checklist of information that a company should review carefully to determine materiality. This list represents some of the best guidance the SEC has provided on what constitutes "material" information. The seven "hot buttons" of materiality are:

- Earnings information – historical results or future estimates;
- Mergers, acquisitions, tender offers, joint ventures, and other similar transactions;
- New products or discoveries, or developments concerning customers or suppliers (such as gaining or losing a contract);
- Changes in control and the retirement, resignation or termination of senior management;
- Any change in auditors;
- Events regarding securities, such as defaults in senior securities, splits, dividend changes, or public or private sales of additional securities; and
- Bankruptcy or receivership.

Of these, the most sensitive is *earnings estimates*. Concern over selective disclosure of earnings guidance drove the SEC to adopt Regulation FD.

The SEC's other principal statement on materiality is Staff Accounting Bulletin No. 99 (SAB 99). In SAB 99, the SEC sought to put to rest the practice of using certain dollar or percentage thresholds to judge nonmateriality. SAB 99 asked:

> May a registrant or the auditor . . . assume the immateriality of items that fall below a percentage threshold . . . – to determine whether amounts or items are not material . . . ?

The SEC answered with a resounding "No." Why? Qualitative factors can cause misstatements of even small amounts to be material.

In SAB 99, the SEC gave these examples of issues that might cause information to be material regardless of the dollar amount involved:

- Does it mask a change in earnings or forward-looking trends?
- Was it capable of precise measurement?
- Does it hide a failure to meet analysts' consensus earnings estimates?
- Would it change a loss into an income item or vice versa?
- Does it touch upon a segment or an aspect of the issuer's business that plays a significant role in operations or profitability?
- Would it affect the company's compliance with regulatory requirements?
- Does it affect the issuer's compliance with debt covenants or other significant contracts?
- Does it conceal an unlawful transaction?
- Would it have the effect of increasing management compensation, for example, by satisfying a bonus or option-vesting threshold?

Practical Tip: Use a "Rule of Thumb" Test as a Starting Point

In SAB 99, the SEC acknowledges that there still may be a role for a "rule of thumb" test such as 5%, but only as an initial test of materiality. As a member of your company's Disclosure Committee, you may find this test useful as a starting point. But any percentage threshold can only be a first step toward answering:

Is there a substantial likelihood that a reasonable person would consider this to be important?

SAB 99 notes that stock price volatility is one indicator of materiality. SEC enforcement actions demonstrate that the SEC will assess materiality in hindsight by looking at a company's stock price and trading volume in the period immediately following a selective disclosure of nonpublic information.

Practical Tip: "Follow The Script"

During Siebel Systems, Inc.'s scheduled public earnings call on October 17, 2001, its then CEO, Tom Siebel, stated that the market for information technology products had been soft and that he expected it to remain soft through the end of 2001. On November 5, 2001, the CEO participated in an invitation-only technology conference that Goldman Sachs organized for analysts and institutional shareholders. Siebel's investor relations director prepared talking points for the CEO but none regarding the current state of the IT or software market.

By the time of the Goldman Sachs conference, the CEO knew some good news: Siebel's sales were improving. At the conference when asked about the current state of the software market, Mr. Siebel stated that he was "optimistic" and "seeing a return to normal behavior in IT buying patterns." The conference was not Webcast, and the company did not disclose the CEO's statements via a press release or Form 8-K.

Mr. Siebel's avid listeners wasted no time trading in the company's stock. Siebel's stock price and trading volume increased significantly during the conference and increased even more before the CEO's statements reached the media later that day.

According to the SEC, Siebel violated Regulation FD because the conference was not open to the public and the disclosures made by CEO Siebel at the conference were material. The SEC determined the disclosures were material because:

- The disclosures related to *trends* in the company's business;

Practical Tip:
"Follow The Script" (Cont'd)

- The new statement *contrasted with public* statements made on the company's earnings call; and
- The comments prompted *trading* by attendees at the conference.

Practical Tips?

- Prior to presenting at an analyst conference, disclose material nonpublic information that you wish to be free to discuss in a press release or Form 8-K.
- Arrange for (and pre-announce) a Webcast of the company's presentation.
- Have your IR professional or CFO listen for and help your CEO decline to answer "unscripted" questions that will require disclosure of material nonpublic information.

Exemptions From Regulation FD

Regulation FD applies only to certain communications. Communications exempt from Regulation FD include:

- Discussions with the press. But in practice, most companies treat disclosures to the press as equivalent to disclosure to an analyst. (Some journalists will sign a nondisclosure agreement. Otherwise, make the statements Regulation FD compliant.)
- Disclosure to customers and suppliers.
- Disclosure to persons who owe a duty of trust or confidence to the company (for example, lawyers, bankers, investment bankers assisting with specific transactions, and accountants).
- Discussions with persons who agree expressly to maintain the disclosed information in confidence. This

express agreement may be either written or verbal and may be made before or after the disclosure. It must be more than an implicit agreement or a mere belief on the issuer's part.

- Communications – such as a road show – made in connection with most 1933 Act registered offerings. Most, but not all, 1933 Act registrations are exempt from Regulation FD. For example, both a shelf offering to employee optionees on Form S-8 and a Form S-3 resale registration statement are fully subject to Regulation FD.

Breaking News:
Too Fine a Point? Court Rejects SEC Reg. FD Action Against Siebel

The SEC failed in its initial effort to enforce a Regulation FD action in federal court when, in late 2005, a judge dismissed an enforcement action against Siebel Systems, Inc. In April 2003, in the company's second FD run-in with the SEC, CEO Thomas Siebel had made public statements that linked the company's performance to a weak US economy. The SEC claimed that Mr. Siebel's public statements, on April 4, 23 and 28, were so negative (he described a "tough quarter" with a market "like the apocalypse out there") that somewhat more positive private statements by the company's CFO, made in one-one-one or small group meetings with analysts just a few days later on April 30, were new and materially different. The SEC also sought, and the court rejected, sanctions against a "gatekeeper" – the Investor Relations Officer in charge of FD enforcement – and for an alleged failure of disclosure controls and procedures as a result of the FD violation.

The SEC objected to CFO Goldman's "significantly more positive and up-beat" comments at the private small-group meetings. These private meeting comments, said the SEC, were materially different and so violated Regulation FD when the company did not make simultaneous public disclosure.

Breaking News: Too Fine a Point? Court Rejects SEC Reg. FD Action Against Siebel (Cont'd)

The court disagreed with the SEC's precise parsing of words. To call CFO Goldman's private comments materially different, said the court, put too fine a point on moderate differences of tone, tense and tint of comments. In fact, the 2 officers communicated essentially the same substance, but each in his personal way. For example, it was not fair to allege an FD violation for a difference in verb tense: CEO Siebel said "I suspect we'll see some [software deals] greater than five" million dollars, while CFO Goldman used the present tense to confirm that there were some $5,000,000 deals in the pipeline. FD does not require "that corporate officials only utter verbatim statements that were previously publicly made."

In other words, said the court, FD is – and the SEC should be – somewhat more forgiving of differences in human communication.

Yet there are still 2 key take-away lessons in Siebel II:

- Be careful in private meetings with analysts. Discussing earnings-related information privately is a minefield. The SEC is likely to continue to enforce violations that come from these.
- The SEC will try again to bring actions for failure of Rule 13a-15 disclosure controls and procedures as a result of FD violations. And when it wins its next FD enforcement action, the SEC is likely to use the disclosure control violation to seek sanctions against IROs and other officers.

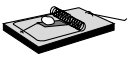
Liability for Selective Disclosure

To prevent Regulation FD from having a chilling effect on issuers' communications to the public, the SEC limited Regulation FD liability:

- An issuer may be liable for knowing and reckless conduct, but not for good faith mistakes in making materiality judgments;
- Regulation FD is not an antifraud rule; and
- Regulation FD does not create private rights of action.

Outside of Regulation FD, liabilities imposed under 1934 Act Rule 10b-5 for selective disclosure continue unchanged. For example, an issuer's failure to make a public disclosure might give rise to liability under a duty to correct or duty to update theory.

Tough Lessons From SEC Enforcements



A review of the SEC's enforcement actions for violations of Regulation FD yields six steps to improve your investor relations practices.

- **Use Extreme Caution in Private Conversations With Analysts.** Be particularly cautious when the discussions relate to earnings guidance! Don't initiate one-on-one calls to interpret information for an analyst. If your company needs to clarify a public statement, do it first in a press release or Form 8-K. Even a clarification or "pointing out" call to an analyst can move the stock price and appear to be material in hindsight.
- **Follow That Script!** "Follow the script" when talking to anyone outside the company. "Talking points" and a script can help you confine commentary to the identified publicly disclosed information.

Tough Lessons
From SEC Enforcements (Cont'd)

- **Internal Communication Is Key.** Discuss selective disclosure issues with your investor relations officer before analyst calls and conferences.
- **Remedy Unintentional Disclosures Promptly.** Expect mistakes – and be ready to correct them. Once you learn of an unintentional disclosure of material nonpublic information, promptly disclose it in a press release or Form 8-K. Don't hesitate to pause mid-call to clarify a statement.
- **Consider Market Reaction in Assessing Materiality.** The SEC may assess materiality in hindsight by looking at changes in stock price and trading volume following disclosure. So in predicting materiality ahead of time, ask "How will our stock price react?" Then if the market reacts to disclosure that you initially concluded was immaterial, reevaluate your analysis. Consider making prompt public disclosure.
- **Demonstrate Good Faith by Consulting With Legal Counsel.** Recently, the SEC declined to take action when Motorola's spokesperson consulted with legal counsel. The SEC disagreed with Motorola's call but did not take action because of this good faith effort to comply with Regulation FD.
- **Regulation FD Training.** Implement a training plan that includes all spokespersons and IR professionals and should include periodic "refresher" sessions.

Regulation G: GAAP and the Earnings Call

With Regulation G, the SEC set bounds around companies' use – popular in the late 1990s – of a confusing variety of pro forma data, which the SEC calls "non-GAAP financial measures." The passage of Sarbanes-Oxley in 2002 gave the SEC the mandate to adopt Regulation G and a parallel Regulation S-K provision that

governs only filed documents. The SEC's requirement that companies furnish earnings data on Form 8-K, as we discuss in Chapter 2, ties Form 8-K disclosure closely to Regulation G.

Regulation G has two principal mandates:

- *Don't confuse or mislead:* Companies may not present non-GAAP financial measures in ways that are misleading to investors.
- *Reconcile to GAAP*: Companies must present the most directly comparable GAAP measures and a clearly understandable reconciliation of the GAAP and non-GAAP measures.

A "non-GAAP financial measure" is a numeric measure of either historical or future performance, financial position or cash flow that:

- Excludes amounts included in the comparable GAAP measure; or
- Includes amounts excluded from the comparable GAAP measure.

Companies may use operating and statistical data, such as same-store sales and number of employees. Companies may also continue to use ratios calculated using only GAAP financial measures. The SEC does not consider these measures to be "non-GAAP financial measures."

Regulation G covers all public releases of material information that contain a non-GAAP financial measure, whether in writing, orally, telephonically or in a Webcast. Its two mandates cover both filed documents and more informal disclosures.

Specific requirements of Regulation G and related rules are:

- *Reconcile to GAAP.* In any release of pro forma data, and usually when incorporating by reference a document that contains pro forma data, present the most directly comparable GAAP information and a reconciliation of the non-GAAP information to the GAAP information.
- *"Furnish" earnings releases on Form 8-K.* "Furnish" (a less formal action than "filing") earnings releases (or similar

disclosures on a completed fiscal period) to the SEC on Form 8-K within four business days after the release.

- *Furnish before any earnings call.* For an earnings call on a completed fiscal period, furnish the Form 8-K for the related earnings release prior to the call (or file a second Form 8-K with the call's contents within four business days after the call).
- *Regulation S-K requirements for "filed" earnings information.* In any disclosure of non-GAAP financial information that is filed (as opposed to furnished) with the SEC, comply with the stricter Regulation S-K requirements.

Trap for the Unwary:
Regulation G (and 8-K Filing)
Apply to All Public Communications

While Regulation G and the new requirement to "furnish" earnings information on Form 8-K will have their greatest impact on earnings releases, the new rules apply to any public communication. This includes press releases, analyst calls and slide shows from investor conferences. Legal, finance and investor relations team members will now screen all public communications for non-GAAP information, both to provide appropriate GAAP reconciliation and to consider whether the communication triggers a need to file under Item 2.02 of Form 8-K ("Results of Operations and Financial Condition").

Regulation G. When publicly disclosing non-GAAP information (whether a formal filing or informal Webcast call), provide the required Regulation G reconciliation in the disclosure. For an oral disclosure, you can do this by:

- Posting the Regulation G-required disclosure on the company's Website; and
- Providing the Website address during the oral presentation.

Trap for the Unwary:
Regulation G (and 8-K Filing) Apply to All Public Communications (Cont'd)

Form 8-K "furnishing." Are you making the first public communication of previously nonpublic material information discussing a historic, completed quarter or year whether or not it includes non-GAAP financial information? If so, your company must "furnish" this nonpublic earnings information on Form 8-K, Item 2.02.

Form 8-K's narrow "safe harbor." Form 8-K has a narrow "safe harbor" exemption that allows an earnings call to proceed promptly after a filed earnings release, without a new Form 8-K filing, *even if the call contains material nonpublic information*. This safe harbor allows a company to disclose new information about a completed earnings period in an oral, telephonic or Webcast communication, typically an earnings call, without having to file a transcript of the call in a new Form 8-K filing if:

- The communication complements, and occurs within 48 hours after, a related written release that has been "furnished" on Form 8-K;
- The company pre-announces the earnings call by a widely disseminated press release, and makes it broadly accessible to the public by dial-in conference call, Webcast, broadcast or similar means; and
- The company posts the financial and other statistical information contained in the communication, and any required Regulation G reconciliation, on the company's Website. (For any new information disclosed on the call, post an audio file of the Webcast itself, or written transcript, slides or Q&As.)

The SEC encourages companies to provide access to Website postings for at least one year. After a brief period, be sure to "archive" the data with appropriate disclaimers on the investor relations area of your Website.

SEC-Filed Documents: Reconciliation to GAAP, Prominence and Explanation

To accompany Regulation G, which applies whenever a company publicly discloses a material non-GAAP financial measure, whether filed or not, the SEC amended Regulation S-K to enhance disclosure in "filed" financial statements. Like Regulation G, S-K requires that companies reconcile the differences between non-GAAP and the most directly comparable GAAP measures. Regulation S-K also requires:

- *Prominence:* Companies must present the comparable GAAP measure with equal or greater prominence than the non-GAAP measure. (For example, headers of earnings releases that contain a non-GAAP number should also contain the comparable GAAP number.)
- *Explanation:* Management must disclose the reasons it believes the non-GAAP measure is useful and, to the extent material, any additional purposes for its use of the non-GAAP measure.

And S-K prohibits:

- *Other than EBIT or EBITDA, measures excluding charges or liabilities requiring cash settlement.* Companies may use EBIT and EBITDA, but otherwise should not use financial measures that exclude charges or liabilities requiring cash settlement.
- *Smoothing.* Companies should not adjust non-GAAP performance measures to smooth nonrecurring or unusual items when the nature of the charge or gain is reasonably likely to recur within two years or a similar charge or gain occurred in the previous two years.
- *Non-GAAP Financial Statements on Face.* Companies should not present non-GAAP financial measures on the face of financial statements (including notes) or pro forma financial statements.
- *Confusingly Similar Titles.* Companies should use titles or descriptions for non-GAAP measures that are clearly different from titles or descriptions used for GAAP financial measures.

Practical Tip: How to Conduct a Regulations FD and G Compliant Earnings Call

Quarterly earnings calls are the best example of the sort of voluntary disclosures for which the SEC designed Regulations FD and G. Prior to each earnings call, a company should take the following steps:

- *Notice.* Issue a press release several days or weeks in advance, notifying the public of the earnings call and Webcast. Include a statement that discussion may also cover any material developments occuring after the date of the notice but before the date of the call. Use a commercial news service to broadly disseminate the time, date and access information, and post access information on the company's Website.
- *Pre-Release.* Announce earnings results by press release prior to the call itself, and furnish the release on Item 2.02 of Form 8-K ("Results of Operations and Financial Condition") for the purpose of both Regulation FD and Regulation G. If possible, do this either immediately following the close of market on the day before the call or before the opening of the market on the morning of the call.
- *Prompt Call.* Conduct your earnings call within 48 hours after the Form 8-K filing. If the call includes new non-public material information and occurs more than 48 hours after the related written earnings release is furnished on Form 8-K, furnish a new Form 8-K containing a transcript of the earnings call within five business days after the call.
- *Webcast or Call-In.* The company's investor relations department should arrange access to the call for the investing public, either by allowing listeners to join the conference call on a listen-only basis or via Webcast. (Generally, press and analysts will be given call-in access with the ability to ask questions. Others will only be able to listen.)

Practical Tip:
How to Conduct a Regulations FD and G Compliant Earnings Call (Cont'd)

- *Post Data.* Post all financial and statistical information provided in the call or presentation on the company's Website before the call. Post any Regulation G-required reconciliations of pro forma data to GAAP.
- *Post New News. Promptly* post an audio file or transcript of any newly disclosed material.

Corporate Disclosure Policy: Forward-Looking Disclosure and the Safe Harbor

Section 21E of the 1934 Act, Section 27A of the 1933 Act (both part of the 1995 Private Securities Litigation Reform Act) and SEC Rule 175 together provide guidelines for companies disclosing *forward-looking information* to the investing community. Forward-looking statements are projections, plans, objectives, forecasts and other discussions – whether oral or written – of future operations. These guidelines provide a safe harbor defense to securities litigation challenging forward-looking statements that fail to predict the future accurately.

Written Forward-Looking Statements

Sections 21E and 27A incorporate a case-law concept known as "bespeaks caution," which provides that a reader or listener needs to take any forward-looking statement in context. If the context provides fair warning of future uncertainties, the reader cannot fairly ignore them. To fall within the safe harbor, the forward-looking statements must be accompanied by:

- Meaningful cautionary language that identifies the forward-looking statements; and
- In the case of written statements, the important factors that could cause actual results to differ materially. Boilerplate disclaimers are insufficient for this purpose.

Practical Tip: Sailing Into the Safe Harbor By Updating Risk Factors

In today's economy, the risks that companies face evolve quickly. Risk factors and other meaningful cautionary statements from last year's or last quarter's Form 10-K or 10-Q (or even from an earlier press release) may be inadequate for the report you are filing today. When preparing to file a new periodic report or press release:

- Review the report or press release to identify its forward-looking statements;
- Specifically tailor cautionary language to the forward-looking information, and make the warnings conspicuous (don't bury cautionary language in legal jargon);
- Clearly disclose the assumptions underlying each specific forward-looking statement, and identify a variety of reasons for possible deviation from projected results;
- Describe the existence of a specific risk and its magnitude; and
- Update and revise the statements to remain current, and add any new cautions or risks that your Disclosure Committee, Audit Committee or managers can identify.

Oral Forward-Looking Statements

For oral forward-looking statements, meaningful cautionary language must include a declaration that additional information concerning factors that could cause actual results to vary materially is contained in a readily available written document, such as a recent Form 10-K or 10-Q. As with written forward-looking statements, boilerplate disclaimers are insufficient.

Regulation M-A: Merger and Acquisition Communications

A company in the midst of a business combination transaction – such as a stock-for-stock merger, cash merger, or tender offer – will need to file with the SEC many communications that relate to the transaction.

Regulation M-A is a series of rules that fashion "safe harbors" permitting companies to communicate freely about planned business combination transactions (both before and after a registration statement is filed) so long as the company files its written communications with the SEC.

What communications must a company file with the SEC? Any written communication made in connection with, or that relates to, a business combination transaction that is provided to the public or to persons not a party to the transaction. For example:

- Written materials that are used by parties to the transaction to communicate information about the transaction to the public; or
- Written information about a proposed business combination transaction that is provided to a company's employees generally.

In contrast, a company does not need to file:

- Factual business information that relates solely to ordinary business matters;
- Internal communications that are provided solely to parties to the transaction; and
- Oral communications. If, however, a company posts an audio or video clip or slides of a conference call on its Website, then Regulation M-A requires it to file a transcript of the recording with the SEC.

Regulation M-A's filing requirement begins with the first public announcement of the transaction and continues until the transaction closes. During that period, written communications produced in connection with the business combination transaction must be filed with the SEC on or before the "date of first use." Each Regulation M-A written communication must include a prominently displayed legend. The legend must:

- Advise investors to read the relevant registration statement, proxy statement or tender offer statement for important information; and
- Direct investors to the SEC's Website for copies of the relevant documents.

Practical Tip:
Interplay Between Regulations M-A and FD

Regulation FD and Regulation M-A have overlapping, but slightly different, timing and disclosure requirements. Regulation M-A requires filing of a written, public communication on the "date of first use." In contrast, Regulation FD requires public disclosure of all material nonpublic communications simultaneously with (and, as a practical matter, prior to) any selective disclosure of the information. When both M-A and FD apply, use a format that satisfies Regulation M-A, but for timing, follow FD with a prior or simultaneous filing.

While Regulation M-A has similar requirements for all types of business combination transactions, different rules of Regulation M-A operate to impose these requirements depending on the type of business combination proposed and the role of the company making the filing in the business combination. For example, in a stock-for-stock merger, the acquiring company must file under "Rule 425" and the target company must file under "Rule 14a-12."

Practical Tip: Develop "Best Practices" for Disclosure

Most public companies will want to adopt a corporate disclosure policy and investor relations practices that comply with Regulations FD, G and M-A, and that take full advantage of the safe harbor for forward-looking disclosures. A Regulation FD, G and M-A compliant disclosure policy will include some variation of the following elements:

1. General Guidelines

Spokespersons. The company should designate only specified individuals (for example, the chairman, chief executive officer, chief financial officer and chief investor relations officer) as spokespersons.

Approval of Public Releases. A spokesperson (and when sensitive, counsel) should approve all press releases and scripted communications prior to any public release.

2. Determination of Materiality and Need for Disclosure

The spokespersons, with the assistance of company counsel as necessary, will determine whether information is material and whether it needs to be disclosed.

(Here the company can provide applicable examples of material information from the SEC's checklist that we provide earlier in this Chapter.)

3. Use Cautionary Language

State the company's Regulation FD policy at the beginning of private meetings and set boundaries for discussions, including "off limit" topics, such as statements regarding earnings estimates.

Practical Tip:
Develop "Best Practices" for Disclosure (Cont'd)

Include appropriate cautionary language in every financial press release and in every prospectus, registration statement, 1934 Act report, and every other company statement, oral or written, that contains or may contain forward-looking statements.

4. Earnings Calls

(The policy can outline the procedures we suggest earlier in this Chapter for earnings calls that comply with Regulations FD and G.)

5. One-on-One Calls or Meetings

Timing of One-on-One and Limited-Access Conversations. Whenever practicable, the company should limit the timing of conversations with analysts and/or investors to the period following an earnings conference call up until a blackout period.

Limited Subject Matter Addressed. The spokespersons should strictly limit their responses in these conversations to elaboration of previously disclosed or generally known information, so as not to disclose any material nonpublic information. Want to discuss something new? OK, but first make it public by issuing a press release before the call!

Conduct of One-on-One and Limited-Access Conversations. Whenever possible, two spokespersons should be present during any one-on-one or limited-access conversation with an analyst or investor. When speaking with an analyst or investor on a one-on-one or limited-access basis, the spokespersons should ensure that the analyst or investor understands that the company does not intend to disclose material information selectively.

Practical Tip: Develop "Best Practices" for Disclosure (Cont'd)

6. No Comment on Analyst Projections or Previous Earnings Guidance

The company generally should not comment on or confirm previous earnings guidance or individual analyst projections, nor should it refer to or distribute individual analyst projections. The spokespersons may comment on "street" consensus in giving guidance, but take care to comply with Regulations FD and G.

7. No Comment on Transactions or Unusual Market Activity

Unless required by law, the company should not respond to inquiries regarding potential financings, restructurings, acquisitions, mergers or other transactions or unusual market activity.

8. Interviews With News Media

Treat the media as if communications were subject to Regulation FD.

9. Merger and Acquisition Transactions

The company should file any written communication that relates to a business combination transaction under the appropriate rule of Regulation M-A. In order to comply with Regulation FD, the company should file the communication before it publicly discloses the information. Each communication should have an appropriate legend advising investors to read relevant documents on the SEC's Website for important information.

Chapter 4

Insider Reporting Obligations and Trading Restrictions

The directors, executive officers and significant shareholders of a public company are subject to a number of limitations and reporting obligations in their ownership and trading of the company's securities. Compliance with these rules requires strong procedures for both the company and the insider. This Chapter suggests ways in which a public company and these individuals can best comply with these reporting requirements and trading limitations.

Section 16 Reporting Obligations of Directors, Executive Officers and 10% Beneficial Shareholders

Who Is an Insider?

Directors and Officers. Section 16(a) of the 1934 Act requires directors and certain officers of a public company to report their beneficial ownership of the company's stock to the SEC and to the public. An "officer" for this Section 16(a) reporting purpose generally includes the company's executive officers, as that term is used in the rules governing proxy statements and other SEC disclosure documents:

- President and chief executive officer;
- Any vice president in charge of a principal business unit, division or function (such as sales, administration or finance);
- Principal financial officer;
- Principal accounting officer (or if there is none, the controller); and

- Any other person who performs similar policy-making functions for the company.

Section 16 officers also include officers of the company's parent or subsidiaries, if those officers perform significant policy-making functions for the company.

More Than 10% Beneficial Shareholders. In addition to directors and officers, Section 16(a) requires that beneficial owners of more than 10% of a company's common stock report their stock ownership. In determining who is a more than 10% holder, Section 16(a) uses the concept of *beneficial ownership* rather than legal or record ownership. A person's voting or investment power over a security is a key factor in determining beneficial ownership. For example, a person with sole or shared voting or investment power over securities will usually beneficially own the securities for Section 16(a) 10% ownership purposes.

What Do Section 16(a) Insiders Report?

Beneficially Owned Shares. For Section 16(a) insiders, the SEC uses a second beneficial ownership test to determine which holdings and transactions the insider must report. Beneficial ownership for purposes of reporting holdings and transactions to the SEC (and for short-swing profit liability) is based on the insider's *direct or indirect pecuniary interest* in the securities. This test is based on an insider's ability to profit from purchases or sales of securities.

Household Members. An insider is considered to have indirect beneficial ownership of securities held by members of the insider's immediate family sharing the same household. These immediate family household members include grandparents, grandchildren, siblings and in-laws, as well as the insider's spouse, children and parents.

Trust Shares. An insider is considered a beneficial owner of shares in a trust for Section 16 purposes if the insider has or shares investment control over the trust securities and the insider is a:

- Trustee, and either the trustee/insider or a member of his immediate family (whether or not they share the same household) has a pecuniary interest in the trust securities;

- Beneficiary; or
- Settlor and the settlor/insider has the power to revoke the trust.

Partnership or Corporation. An insider who has control or a controlling influence over a partnership or corporation will generally have beneficial ownership of the securities held by that partnership or corporation.

Derivative Securities. Section 16 applies not only to a company's common stock but also to derivative securities. Derivative securities include options, warrants, convertible securities, stock appreciation rights or similar rights with an exercise or conversion privilege at a price related to an equity security.

Derivative securities also include third-party contracts: puts, calls, options or other rights to acquire the company's stock that an insider enters into with a person other than the company.

How Does an Insider Report Beneficial Ownership?

Initial Report – Form 3. Each insider first files a Form 3, as the initial report with the SEC listing all the insider's holdings of the company's securities, including stock options. The insider files a Form 3 within ten days of the event triggering compliance, for example, within ten days after a person becomes an officer, director or more than 10% shareholder of a public company. The insider – for example, a newly hired CEO – must file a Form 3 even if she does not have a pecuniary interest in any stock of the company at the time of the filing. Insiders of newly public companies file a Form 3 on the date the company becomes a reporting company under the 1934 Act.

Current Report – Form 4. Generally, any change that occurs in an insider's beneficial ownership of the company's securities is reported on Form 4. Insiders must file a Form 4 within two business days after a change in beneficial ownership. The two-day reporting period begins when a transaction is executed, not when it settles.

Practical Tip: When to File Form 4?

If an executive vice president places an order to purchase or sell company securities with a broker on a Monday morning in Los Angeles, she must file the Form 4 current report with the SEC no later than 10:00 p.m. Eastern time on Wednesday (7:00 p.m. Pacific time). The Form 4 must indicate the officer's total direct and indirect ownership after the reported transaction. In accordance with company compliance procedures discussed later in this Chapter 4, the officer should notify the company compliance officer at least two days before placing the order to enable the company to begin preparing a Form 4 on her behalf.

Practical Tip: Awards at Hire/Initial Board Election

Insiders often receive option grants or other awards at the time of hire, or at the time of election to the Board. The Form 3 filed upon becoming an insider should report only securities owned *immediately prior* to becoming an insider. Report the awards granted *as a result of* becoming an insider on Form 4. In this situation, the Form 4 would be due before the Form 3, so the better practice is to file the Form 3 and the Form 4 at the same time (within two business days), even though the Form 3 would not technically be due until ten days after the triggering event.

The Form 4 two-day filing deadline applies to any transaction between an insider and the company, including transactions that are exempt from short-swing profit recovery under Rule 16b-3 of the 1934 Act, such as the grant, exercise or conversion of stock options or other derivative securities.

The SEC provides modest timing flexibility for transactions under Rule 10b5-1 plans (we describe these later in this Chapter 4 and in detail in Chapter 5) and discretionary transactions under

employee benefit plans. In these cases, if the insider did not select the date of execution and did not have prior notice of the transaction, the insider may file a Form 4 within two business days after the date the insider is notified of the transaction or the third business day following the transaction, whichever is earlier.

Three transactions are exempt from the Form 4 two-day reporting requirement:

- Gifts;
- Inheritances; and
- Small acquisitions other than from the issuer within a six-month period that do not exceed in the aggregate $10,000 in market value.

The insider will report these transactions at the end of the fiscal year on a Form 5 annual report. (We discuss Form 5 later in this Chapter.)

In addition, insiders are not required to report on Form 4 or 5 transactions that effect only a change in the form of the insider's beneficial ownership of securities without changing the insider's pecuniary interest in the securities. For example, a distribution to the insider of securities previously beneficially owned by the insider through an employee benefit plan merely changes the form of the insider's beneficial ownership (from indirect to direct) and is exempt from Form 4 and Form 5 reporting requirements. Likewise, a pro rata distribution of securities from a partnership to its partners is a mere change in the form of ownership, exempt from Forms 4 and 5 reporting. This "change in form" exemption does not apply to:

- The conversion or exercise of a derivative security (which must be reported on Form 4); or
- A transfer of securities to a person whose holdings are attributed to the insider, such as a gift to a minor child or a transfer to a family trust (the insider must report the transfer on a Form 5 or may report it earlier on a Form 4).

Even though a mere change in the form of an insider's beneficial ownership does not in itself trigger a Form 4 or 5 reporting obligation as a separate line item, the insider must reflect the resulting changed ownership in the total direct and indirect beneficial ownership column in the next Form 4 or 5 the insider files.

Annual Report – Form 5. Insiders must file any required Form 5 within 45 days after the end of the company's fiscal year. Any person who was an insider at any time during the fiscal year must file a Form 5 unless either she had no reportable transactions during the year or had already filed one or more Forms 4 during the year covering all transactions required to be reported on a Form 4 or 5. A Form 5 must include all those reportable transactions that, as they fit into an exemption from Form 4 reporting, were not reported earlier. A Form 5 will also indicate all holdings or transactions that should have been reported on Form 3 or 4 during the fiscal year but were not.

Acquisitions of company securities in ongoing, tax-conditioned employee benefit plans (for example a broad-based employee stock purchase plan or 401(k) plan) generally are exempt from Section 16(a) reporting. But the insider needs to reflect her current holdings in these plans in the "Total Beneficial Ownership" column on all subsequent Forms 4 and 5. By contrast, sales of securities acquired under employee benefit plans, as well as transfers into and out of company stock funds in those plans, must be reported on Form 4.

Consequences of Late Filing: Embarrassment, Publicity and Fines

Civil Penalties. Failure to timely file a Form 3, 4 or 5 can result in substantial penalties to the insider. The SEC can seek fines in judicial enforcement actions of up to $6,500 for each violation by an individual and up to $65,000 for corporations and other entities. If the violation includes fraud or deceit or deliberate disregard of a regulatory requirement, the fine can be as much as $130,000 for an individual and $650,000 for a corporation. (These amounts are subject to adjustment for inflation.) The SEC can also issue cease and desist orders in administrative proceedings against

future violations. Failure to file reports also prevents the two-year statute of limitations from running on suits against insiders to recover any profits due to the company under Section 16(b).

Proxy Statement and Form 10-K Disclosure. A public company must disclose in its proxy statement any insiders who reported transactions late or failed to file required reports during the fiscal year. In addition, the company must note on the cover of its Form 10-K that the proxy statement discloses late Section 16 reports.

Trap for the Unwary:
"You Mean the Company Needs to Disclose My Delinquent Filing in the Proxy Statement?"

Early in 2006, Anna Andrews, a Director of XYZ Inc., gifted shares of XYZ stock to her children. Because this was a Form 4 exempt transaction, Ms. Andrews decided not to file a Form 4 reflecting the change in her beneficial ownership, and instead opted to report the transaction on a year-end Form 5. During the balance of the year, Ms. Andrews conducted some non-exempt transactions and reported these changes in beneficial ownership on Form 4 within two days after the transaction. At year-end, Director Andrews forgot about the gift to her children and failed to file a Form 5 on time.

Because of this mistake, XYZ had to indicate on the front cover of its Form 10- K for the year ended December 31, 2006, that the company would be reporting delinquent Section 16 filers in its proxy statement. XYZ then had to name Anna Andrews and disclose the delinquent filing in the proxy statement.

Mandatory Electronic Filing and Website Posting of Beneficial Ownership Reports

Electronic Filing. Insiders must file Section 16 reports electronically. The reports are due by 10:00 p.m. Eastern time on the filing deadline. The SEC has implemented a new on-line filing system through its Website that is easy enough for insiders to use directly.

While many companies and third-party service providers continue to submit Section 16 reports on behalf of insiders, the insiders remain legally responsible for their electronic filing obligations.

Website Posting. Section 16 rules mandate that companies post on their corporate Websites all Forms 3, 4 and 5 filed by their insiders and 10% beneficial owners by the end of the business day after the date of filing. Companies must keep the reports posted for 12 months. Although companies may post the reports directly, most post by hyperlinking to third-party service providers or to SEC.gov. The hyperlink is permitted if:

- Access to the forms is free;
- All information in the forms is retrievable;
- The manner of access is not so burdensome as to effectively bar access;
- Access includes exhibits and attachments;
- The forms are located at the Web address typically used for posting information to company investors;
- The link is directly to the forms or a list of the forms, not to a home or general search page; and
- The link caption clearly indicates access to insiders' Section 16 reports.

Practical Tip:
Hyperlink to www.SEC.gov

To easily and efficiently satisfy the Website posting requirements, link to the EDGAR database on the SEC's Website. The advantage is that the EDGAR link will not require an update each time a new Section 16 report is filed and will capture reports of 10% beneficial owners that the company might not otherwise notice. To create a link to the Section 16 reports for your company, visit the SEC's Website at www.sec.gov/edgar/ searchedgar/companysearch.html.

Practical Tip: Implement Section 16(a) Compliance Procedures

As a best practice, we suggest that your company implement the following procedures to ensure that your insiders comply with their Section 16(a) reporting obligations:

- *Require Preclearance.* Require all Section 16 insiders to preclear their transactions with the company's chief financial officer, general counsel or other designated compliance officer at least two days before they (or any of their family members sharing their household) initiate any transaction in the company's equity securities.
- *Broker Interface Procedures.* Establish coordinated procedures with knowledgeable brokers and encourage your insiders to use those brokers to facilitate trading in company securities.
- *Powers of Attorney.* Have each director and officer execute a power of attorney authorizing at least two of the company's officers to sign Forms 4 and 5 on behalf of the director or officer.

Section 16(b) – Short-Swing Profit Liability

Section 16(b) of the 1934 Act makes an insider of a public company liable to the company for "short-swing trades": that is, for any profits the insider receives from the purchase and sale (or sale and purchase) of registered securities of the company within a period of less than six months. The insider is liable for profit realized in both cash and noncash form, such as securities. Under Section 16(b), the company or a shareholder, acting on behalf of the company, may bring an action against the insider for disgorgement of the realized profit. Section 16(b) applies to all Section 16(a) insiders (i.e., directors, executive officers, and more than 10% beneficial shareholders).

The test for Section 16(b) liability is purely objective: an insider who purchases and sells (or sells and purchases) registered securities within a period of less than six months is liable for the profits received as a result of the transactions. It does not matter whether the insider was aware of confidential information, whether the

confidential information was material, whether the insider relied on the information in making a transaction or whether the insider acted in good or bad faith.

Trap for the Unwary:
Indirect Ownership

Insiders need to understand the way in which they may be liable under Section 16(b) for transactions in shares that they hold indirectly as well as directly – particularly for shares held by household members.

An insider is deemed to have *indirect beneficial ownership* of securities held by members of the insider's immediate family sharing the same household, including the insider's spouse, children, parents, grandparents, grandchildren, siblings and in-laws. As a result, if an insider's spouse or relative living with the insider sells the company's stock, and the insider then purchases lower-priced shares within six months of the sale, the insider is liable for short-swing profits.

This is true even if the insider was not aware that his or her spouse or household-sharing relative had sold the shares. Liability will follow from the insider's being deemed to have beneficial ownership of the shares held by the spouse or relative.

Transactions Exempt From Section 16(b) Liability

Transactions Between the Company and Its Officers or Directors. Transactions between the company and its officers or directors may be exempt from Rule 16(b) short-swing liability. For example, a grant of stock options to a director will not be treated as a purchase under Rule 16b-3, if the company's Board of Directors, a committee of nonemployee directors or the shareholders approve the grant, or if the director holds the stock options for at least six months. The director's exercise of the stock options will also be exempt. Similarly, a director's sale or disposition of securities back

to the company generally will not be treated as a sale for purposes of Section 16(b) if the Board or a committee of nonemployee directors approves the sale or disposition.

Stock Options and Other Derivative Securities: Purchase Occurs at Time of Grant. Shares subject to stock options and other types of derivative securities are deemed to be "purchased" for Section 16(b) purposes upon the grant of the stock option or other acquisition of the derivative security rather than exercise or conversion. This is because a derivative security is treated as the functional equivalent of the underlying security into which it can be exercised or converted. For example, the grant of an option to purchase common stock is treated as the functional equivalent of the insider's purchase of the common stock. The exercise, conversion or vesting of a derivative security is generally an exempt transaction.

Although exempt from Section 16(b) liability, insiders must report the grant and the exercise or conversion of an option or other derivative security on Form 4 within two business days after the transaction.

Calculating Profit Realized in a Short-Swing Transaction

When applying Section 16(b) to a single purchase and single sale of securities within a six-month period, the profit calculation is straightforward: the aggregate purchase price of the securities is subtracted from the aggregate sale price.

For multiple sales and purchases within a six-month period, the profit realized is calculated under the lowest-in, highest-out method. The following example illustrates the application of the rule:

Assume that Director Bertrand Brass purchases 100 shares of his company's common stock in January for $40 a share, purchases an additional 100 shares in February for $45 a share, sells 100 shares in March for $60 a share, purchases 100 shares in April for $50 a share, sells 100 shares in May for $55 a share, and sells 100 shares in June for $80 a share. Under the lowest-in, highest-out approach, the January purchase ($40 per share) would be matched with the June sale ($80 per share), the February purchase ($45 per share) would

be matched with the March sale ($60 per share), and the April purchase ($50 per share) would be matched with the May sale ($55 per share). Mr. Brass would be liable for $6,000 in realized profits.

Trap for the Unwary:
The Six-Month Shadow:
Continuing Obligations and Liability of Former Directors and Officers

Former directors and officers continue to have Section 16(a) reporting obligations (and Section 16(b) short-swing profit liability) for non-exempt trades that they make, after termination, if the trade follows within six months of a non-exempt opposite-way transaction (i.e., open market purchase vs. sale) that the insider effected before termination. The former insider must report these post-termination, opposite way transactions on a Form 4 (indicating the short-swing violation).

Former directors or officers who did not engage in any trades during their last six months in office have no Form 4 reporting obligations after termination of service. However, no later than 45 days after the end of the fiscal year in which the director or officer ceased service, she is required to report on Form 5 any exempt transactions (such as gifts) that occurred while the individual was still an insider and that were not reported earlier. It is a "best practice" for companies to require former directors and officers who have no Form 5 reportable transactions to certify that no Form 5 is due. On the Form 4 or 5 filed after termination of service, former directors and officers must check the "exit" box indicating that their insider status has terminated.

Schedules 13D and 13G Reporting Requirements for 5% Shareholders

Entirely apart from any Section 16(a) reporting obligations they may have, shareholders who beneficially own more than 5% of a public company's stock must report their stock ownership to the SEC on Schedules 13D and 13G.

Initial Schedule 13G Report

Within 45 days following the end of the calendar year in which a company completes its IPO, every person (including directors and officers) that beneficially owned more than 5% of the company's stock at the time of the IPO must report that ownership to the SEC on a short-form Schedule 13G. These initial 5% shareholders are referred to as "exempt shareholders" because their shares were acquired prior to the company's IPO.

Schedule 13D or 13G Filings Once the Company Is Public

After a company is public, any exempt shareholder who acquires over 2% of the company's stock in a 12-month period, or any other shareholder who acquires 5% or more of the company's stock (following its IPO), may be required to file a Schedule 13D – more lengthy than Schedule 13G. Shareholders who are passive investors can file or continue to file reports on Schedule 13G, avoiding this more burdensome Schedule 13D. A passive investor is a shareholder who beneficially owns less than 20% of the company's common stock, provided the investor did not acquire the securities for the purpose, or with the effect, of changing or influencing control of the company. A person in a control position – such as a director or executive officer – will not qualify as a passive investor.

In general, an investor must amend Schedule 13G annually to show any change in beneficial ownership. Whenever a passive investor acquires greater than 10% of the subject securities, the investor must amend the Schedule 13G "promptly" after the date of the acquisition. From then on, the passive investor must file an amended Schedule 13G promptly after the date on which its beneficial ownership increases or decreases by more than 5%. A nonpassive investor must amend its more detailed Schedule 13D promptly to show any change of 1% or more in beneficial ownership.

A passive investor loses Schedule 13G eligibility – and must file a Schedule 13D – if the investor acquires 20% or more of a class of securities or no longer passively holds the shares. In either case, the investor must file a Schedule 13D within ten days of the acquisition. The investor may not vote the shares or acquire more shares

during the period that begins at the time of the change in investment purpose or the acquisition of 20% or more of the company's shares, and ends ten days after the Schedule 13D is filed.

The Schedule 13G/D filer is obligated to file copies of the reports with the company. The Schedule 13D filer must file a copy with each national securities exchange where the security is traded.

Rule 144 Restrictions on Trading Restricted Stock and Stock Held by Directors, Executive Officers and Controlling Shareholders

Most shareholders of public companies can freely resell their securities in market transactions because the shares they hold have been issued in a transaction registered under the 1933 Act. Some shareholders, however, may hold *restricted* or *control* securities that are not freely tradable, even if the securities have been issued in a registered transaction. The holder must register the resale of these securities with the SEC unless an exemption from registration is available. Rule 144 provides the most frequently used exemption for the resale in market transactions of restricted and control securities.

Although the company generally has no liability for an insider's non-compliance with Rule 144, it is a best practice to alert persons subject to Rule 144 to the resale limitations, and to assist with compliant Rule 144 resales. (See our Practical Tip at the end of this Chapter for our suggestions.)

Securities Subject to Rule 144

Rule 144 covers two types of securities: restricted securities and control securities.

- *Restricted securities* are generally securities that have been issued in a private placement exempt from registration. A stock certificate evidencing restricted securities typically bears a restrictive legend which states that the securities are not registered and cannot be offered or sold unless they are registered with the SEC or the transaction is exempt from registration.
- *Control securities* are securities that *affiliates* have acquired in any manner, including on the open market, from the

company pursuant to a public offering or upon the exercise of a stock option. The term *control* refers to ownership by the affiliates, who are presumed to control the issuing company.

Who Are Affiliates?

Under Rule 144, *affiliates* generally are directors, executive officers and major shareholders of a company that can influence the company either individually or in concert with others.

Other persons considered affiliates under Rule 144 are:

- The spouse or any relative of the affiliate who lives in the same household as the affiliate;
- Certain trusts or estates of which the affiliate (or a member of the affiliate's family sharing her household) is a trustee, executor or 10% beneficiary;
- Certain corporations, partnerships or other entities in which the affiliate or her family owns a 10% interest; and
- Affiliates of companies acquired in Rule 145 transactions even if they do not become affiliates of the acquiring company. (We discuss Rule 145 transactions in Chapter 12.)

Requirements of Rule 144

Under Rule 144, all the following conditions must be met before restricted or control securities may be sold to the public.

- *Current Public Information.* There must be adequate public information available concerning the issuer of the securities. This means that the company must have filed all SEC-required reports during the 12 months immediately preceding the proposed sale.
- *One-Year Holding Period for Restricted Securities.* With certain very limited exceptions, the seller must have owned the restricted securities for a period of at least one year. This time period does not begin to run until the seller has fully paid the purchase price for the securities. For example, if the stock has been purchased with a promissory note, the note must be full recourse and must

be secured by collateral, other than the stock, having equal value to the shares to start the one-year holding period. The note must also be paid in full before the stock is sold.

- *Volume Limitation.* The seller will be limited to selling a number of restricted and control securities during any three-month period that is no more than the greater of 1% of the outstanding securities of the class or the average weekly reported trading volume for the previous four calendar weeks. (For most insiders this is a generous cap that does limit sales.)
- *Manner of Sale.* Restricted or control securities must be sold in unsolicited brokers' transactions or in transactions directly with a market maker. The seller may not solicit or arrange for the solicitation of orders to buy the stock or make any payment in connection with the sale of the stock to any person other than ordinary commissions payable to the broker who executes the order to sell the stock. In a brokers' transaction, the broker must do no more than execute the order to sell the stock and receive no more than the usual and customary broker's commission. The broker must neither solicit nor arrange for the solicitation of customers' orders to buy the stock. (Most national brokerage firms have a 144 sales unit that will ensure compliance with this manner of sale requirement.)
- *Notice of Sale.* If the seller intends to sell more than 500 shares or expects to receive sale proceeds of over $10,000, the seller must file Form 144, "Notice of Proposed Sale of Securities" with the SEC no later than the first day of the sale. The purpose of the filing is to serve as a nonbinding notice to the public that a significant number of additional shares are likely to enter the market. The filing is effective for 90 days. If the seller wishes to extend the selling period or sell additional securities, he or she must file a new Form 144. The seller has the option to submit the Form 144 in paper form to the SEC or electronically.

Nonaffiliates who have held restricted stock for at least two years (and who were not affiliates during the three months preceding the sale) may sell the stock free of Rule 144 requirements.

Insider Trading and Rule 10b-5

The antifraud provisions contained in Rule 10b-5 of the 1934 Act prohibit directors, officers, employees and others who are aware of material nonpublic information from trading while aware of that information. Disclosing material nonpublic information to others who then trade while aware of such information is also a violation of Rule 10b-5, and both the person who discloses the information and the person who trades while aware are liable. These illegal activities are commonly referred to as "insider trading." In the context of insider trading, the term insider covers all employees and anyone else who is aware of the material nonpublic information, such as consultants, in addition to Section 16 insiders.

Penalties

Insider Liability: For Trading. Potential penalties for insider trading violations include imprisonment for up to 20 years, civil fines of up to three times the profit gained or loss avoided by the trade and criminal fines of up to $5,000,000.

Issuer Liability: For Inaction. The company, as well as directors and officers, may be subject to controlling-person liability under federal securities laws. Controlling-person liability may apply if the company or the director or officer knew, or recklessly disregarded, that a person directly or indirectly under the company's or the responsible person's control was likely to engage in insider trading and the company or person failed to take appropriate steps to prevent such trading. The penalty for inaction is a civil fine of up to the greater of $1,275,000 (subject to adjustment for inflation) or three times the profit gained or the loss avoided as a result of the insider trading violations as well as a criminal penalty of up to $25,000,000.

Company Insider Trading Policy

The best way to protect a company and its insiders from potential liability under the insider trading laws is to adopt and implement and enforce a clear policy that defines insider trading and prohibits employees and insiders from trading while aware of material nonpublic information. The insider trading policy should apply to all directors, officers, employees and consultants of the company.

Establish Blackout Periods. The policy should establish trading blackout periods. A trading *blackout period* is a time period in which the company prohibits Section 16 insiders and other employees and consultants who have access to material nonpublic information about the company from buying and selling the company's securities. Blackout periods generally begin two to four weeks before the end of the quarter and end after the second full business day following the company's earnings release for that quarter. If a material event occurs outside a blackout period, the company should consider imposing an event-specific blackout period while the event remains material and nonpublic.

Require Preclearance. Section 16 insiders and certain other employees and consultants with access to material nonpublic information should notify and seek approval from a company compliance officer before any transactions by them or their family members in company stock.

Rule 10b5-1 Trading Plans

SEC Rule 10b5-1 provides a defense for insiders who sell securities pursuant to previously established Rule 10b5-1 plans, even when the insider is aware of material nonpublic information at the time of the trade. (We discuss Rule 10b5-1 plans in detail in Chapter 5.) A company's insider trading policy will generally permit insiders to adopt a Rule 10b5-1 plan when they are not aware of material nonpublic information and only if they preclear the plan with a compliance officer during a period of time outside a blackout period. The insider trading policy should exclude trades under the plan from the preclearance policy and blackout periods.

Prohibition on Personal Loans Under Sarbanes-Oxley and Cashless Exercises

Sarbanes-Oxley prohibits a public company from extending credit in the form of a personal loan – or arranging for the extension of credit – to or for directors and executive officers. Loans outstanding before July 30, 2002 continue to be permitted so long as they are not materially modified or renewed.

This prohibition may prevent certain types of broker-assisted cashless exercises of stock options, which could be deemed a temporary extension of credit or personal loan arranged by the company. While the SEC has not provided guidance on this issue, and companies are proceeding with caution, many permit executive officers and directors to engage in broker-assisted cashless exercises. The most practical way for companies to effect this is to implement cashless exercise programs with three key elements:

- *T+3 settlement.* Ensure cashless exercises are settled in a normal T+3 manner. T+3 means that the broker (on behalf of the exercising optionee) and the issuing company simultaneously deliver the cash exercise price and the stock within three days after the option exercise.
- *Offer multiple independent brokers.* Permit directors and officers to choose one from among several designated brokers. The company will designate brokers who have shown the capacity to execute insider stock option exercises.
- *Be alert to SEC guidance.* Closely monitor SEC guidance and be prepared to modify or suspend a program based on that guidance.

The Sarbanes-Oxley loan prohibition only applies to directors and executive officers. Other employees may continue to use the company's general broker-assisted cashless exercise program.

Insider Trading During Pension Plan Blackout Periods Prohibited

The trading by executives of Enron and other financially troubled companies of compensatory stock when rank and file employees of these companies could not trade in their pension funds

because of blackout periods inspired another Sarbanes-Oxley innovation – the SEC's Regulation Blackout Trading Restriction (BTR). Under Regulation BTR, executive officers and directors may not, during any pension plan blackout period, directly or indirectly (including through a family member) acquire, sell or transfer any company equity securities that the director or executive officer acquired in connection with her employment or service as a director or executive officer.

A BTR blackout period means any period of more than three consecutive business days during which pension plan participants cannot trade in securities held in their individual accounts, but only if this suspension affects at least 50% of the participants in all of the company's "individual account plans."A Regulation BTR blackout period does not include:

- Any regularly scheduled trading suspension that the company incorporates into the pension plan's governing documents and timely discloses to employees before they become participants; or
- A temporary trading suspension imposed by the pension plan in connection with individuals becoming (or ceasing to become) participants in the plan by reason of a corporate merger, acquisition or similar transaction.

A variety of transactions over which directors and executive officers have no control fall outside Regulation BTR. For example, transactions under Rule 10b5-1 plans, changes that result from a stock split or dividend, and compensatory grants and awards under plans that clearly set out the amount, price and timing of awards or include a formula for determining these items are all exempt.

To satisfy Regulation BTR and notify the directors, executives and the public, companies must within specific time frames:

- Provide their directors and executive officers with a Regulation BTR notice of pension plan blackout periods; and
- File the Regulation BTR notice on Form 8-K.

Practical Tip: Help Your Directors and Officers With a Trading Compliance Checklist

In addition to implementing an insider trading policy and Section 16(a) and Rule 144 compliance procedures, providing your insiders with this Trading Compliance Checklist (modified for your company) will serve as a basic reminder of trading prohibitions and SEC filing requirements:

1. Comply With Our Insider Trading Policy

Anytime you engage in a transaction involving company securities, you must comply with the company's insider trading policy and applicable insider trading laws. Our insider trading policy requires that transactions by insiders be precleared with the company's compliance officer and that insiders trade only during periods that are not blackout periods. Before effecting any transaction in company securities, you should ask:

- Is the company in a blackout period?
- Am I aware of any material nonpublic information?
- Have I precleared the transaction with the company's compliance officer?

Practical Tip: Help Your Directors and Officers With a Trading Compliance Checklist (Cont'd)

2. Short-Swing Profit Matching Liability Under Section 16(b) and Reporting Under Section 16(a)

Any non-exempt trade you make that effects a purchase within six months of a sale or a sale within six months of a purchase results in a violation of Section 16(b). The profit will be determined by matching the highest-priced sale with the lowest-priced purchase within six months of the sale. Even if you do not realize this profit in an economic sense, the company or any shareholder acting on behalf of the company may recover this profit from you. It makes no difference how long you held the shares, that you were not aware of inside information, that you had no harmful intent or that one of the two matchable transactions occurred after you were no longer an insider. Before effecting any transaction in company securities, you should ask:

For Sales:

- Have I, my immediate family members or any trust, partnership or corporation that I am affiliated with made any purchases within the past six months?
- Do I anticipate that I, my immediate family members or any trust, partnership or corporation that I am affiliated with will make any purchases within the next six months?

For Purchases:

- Have I, my immediate family members or any trust, partnership or corporation that I am affiliated with made any sales within the past six months?
- Do I anticipate that I, my immediate family members or any trust, partnership or corporation that I am affiliated with will make any sales (including sales occurring through a broker-assisted cashless option exercise) within the next six months?

Practical Tip: Help Your Directors and Officers With a Trading Compliance Checklist (Cont'd)

Before Any Transaction in Company Securities:

- Have I notified the company's compliance officer at least two days prior to engaging in the transaction for purposes of facilitating Section 16 filings?

3. Compliance With Rule 144

Rule 144 places certain limitations on sales of company stock by insiders and requires the filing of a Form 144. Before effecting any transaction in company securities, an insider should ask:

- Has a Form 144 been prepared?
- Have I reminded my broker to sell under Rule 144?

Chapter 5

Get With the Program: Setting Up a Rule 10b5-1 Trading Plan

One cost of inside knowledge for a public company director or executive is illiquidity. He or she cannot sell shares during a trading blackout period, and never when in possession of material inside information. (We describe trading blackout periods in Chapter 4.) For many senior executives, these blackout periods may leave little or no time in which to trade during a quarter. The SEC, by adopting Rule 10b5-1 in 2000, opened a path that can bring transparency and order to insider selling, and so both ease this liquidity squeeze and help ensure compliance with the antifraud provisions of Rule 10b-5.

Rule 10b5-1 begins by clearly stating that anyone trading in a company's securities while aware of material nonpublic information engages in unlawful insider trading. The rule then goes on to provide limited safe harbors (technically, affirmative defenses) that, when closely followed, create a shield from liability. These affirmative defenses include allowing insiders to adopt (at a time when he or she is not aware of material nonpublic information) a written trading plan that will permit future sales (even when those future sales may occur at times that the insider is aware of material nonpublic information). These Rule 10b5-1 trading plans are relatively easy to understand, establish and administer.

Benefits to the Company and Its Insiders of Adopting Rule 10b5-1 Trading Plans

In addition to helping establish protection from liability, written Rule 10b5-1 trading plans can:

- Enable insiders to make orderly dispositions of stock for diversification, estate planning or other personal needs, and to facilitate stock option exercise and sale programs;
- Reduce the number of times a company faces a decision about whether material nonpublic information exists that requires the company to prohibit trading in its stock by insiders;
- Help market perceptions by bringing transparency and advance disclosure to insiders' sales of company shares; and
- Protect executives from the risk of "conduit theory" liability for gifts to charitable organizations or others when the executive knows the donee is likely to sell the gifted securities in the near future.

The Three "Legs" of a Rule 10b5-1 Trading Plan

A successful Rule 10b5-1 trading plan stands on three legs. First, generally, the trading plan must be established when the insider is not aware of material nonpublic information.

Second, the trading plan must be in writing and must:

- Specify the amount (either number of shares or dollar value), price (market price on a particular date, a limit price or a specified dollar price) and date of the trades (this may be the day on which a market order is to be executed or on which "best execution" begins or on which a limit order is in force); or
- Include a formula, algorithm or computer program for determining the amount, price and date of the trades to be made; or
- Delegate to another person sole discretion to determine the amount, price and date of the trades to be made, provided that person is not aware of material nonpublic information.

Third, the trade should comply with the trading plan. The insider must not alter or deviate from the trading plan (by changing the amount, price or timing of the trade) or enter into or alter a corresponding or hedging transaction or position with respect to the securities.

In addition to these three elements, the insider must enter into the trading plan in good faith and not as part of a scheme to evade the prohibitions of Rule 10b-5.

Drafting a Rule 10b5-1 Trading Plan

The legal or compliance department of the insider's broker-dealer will take the lead in drafting the insider's Rule 10b5-1 trading plan. The insider and the company must then closely review and tailor the draft plan to ensure it fits their requirements. The plan should first establish the amount, price and date of the trades, or a method to determine the amount, price and date. Next, a Rule 10b5-1 trading plan will state explicitly in writing that:

- *No Inside Information*. When the insider enters into the trading plan, the insider is not aware of material nonpublic information with respect to the company or its securities. An insider may be able to establish a written trading plan while aware of material nonpublic information, if the plan does not become operational until that information is public or is no longer material. But, the safest route is to wait to establish a trading plan at a time when the insider does not possess material nonpublic information.
- *Waiting Period.* The first transaction under the plan will take place after a waiting period (at least two weeks to three months from the date the plan is executed). This helps solidify the insider's good faith in establishing the trading plan.
- *No Hedge.* The insider has not entered into or altered a corresponding or hedging transaction with respect to the stock to be traded under the trading plan and agrees not to enter into any such transactions while the plan is in effect.
- *Rule 144.* The insider and the broker will take any steps necessary to comply with Rule 144 under the 1933 Act.

- *Filings.* The insider will be responsible for making all filings, if applicable, under Sections 13(d) and 16 of the 1934 Act, and the broker will supply the insider with all the information necessary for such filings on a timely basis.
- *Independent Broker.* The insider acknowledges that the insider does not have any authority, influence or control over any actions by the broker and will not attempt to exercise any authority, influence or control, and the broker will not seek advice from the insider with regard to the manner in which it acts under the trading plan.
- *Purpose.* The trading plan has a specified purpose, for example, to permit the orderly disposition of a portion of the insider's holdings or to facilitate the exercise of options and sale of the option stock.
- *Good Faith.* The insider is entering into the trading plan in good faith and not as part of a plan or scheme to evade the provisions of Rule 10b5-1.
- *Intent.* The trading plan is intended, and will be interpreted, to comply with Rule 10b5-1(c) and related SEC interpretations

Review by the Issuer

A company's insider trading policy should require insiders to submit Rule 10b5-1 trading plans to the company's compliance officer for review before adoption. The compliance officer generally should ensure that the plan is adopted outside a trading blackout period and otherwise complies with the company's insider trading policy. (We discuss insider trading policies in detail in Chapter 4.)

Prohibition on Personal Loans to Insiders and Cashless Exercises

Sarbanes-Oxley prohibits a company from extending credit in the form of personal loans – or arranging for the extension of credit – to or for directors and executive officers. Many 10b5-1 plans anticipate that shares will be sold in part through broker-assisted cashless exercises of stock options. As discussed in Chapter 4, the SEC has not clarified whether the Sarbanes-Oxley loan limit prohibits this. Many companies, with their eyes open to the risk, permit

directors and executive officers to engage in broker-assisted cashless exercises under Rule 10b5-1 trading plans, following the procedures outlined in Chapter 4.

Public Disclosure; Filing the Right Forms

If the trading plan relates to a senior executive and a material number of shares, the company should consider disclosing the establishment of the executive's Rule 10b5-1 trading plan in order to maximize transparency, pre-empt market reaction and alleviate shareholder concerns. A company makes the public disclosure through some combination of a Form 8-K, Form 10-Q, press release, or Website posting.

Companies should implement procedures to ensure that insiders report the 10b5-1 plan transactions in timely filings of Forms 4, 5, 144 and, as required, Schedule 13D or 13G. The Form 144 filing (filed when the first trade under the trading plan is executed or a sell order is placed) must state that the trade is being made pursuant to a previously established trading plan, provide the date the plan was established and indicate the insider's representation that he was not aware of material nonpublic information as of the date of the establishment of the plan (rather than the date of the trade or sell order). In the Form 4 to report the transaction, insiders should also note that the trade was pursuant to a Rule 10b5-1 trading plan.

Practical Tip: Seven Simple Steps

These seven reminders can serve as a checklist for the insider, the insider's and the company's legal counsel, and the company's compliance officer in implementing a Rule 10b5-1 trading plan:

- Ask the broker-dealer that will be executing the insider's trades for a copy of the broker's current form plan. This will be the starting place for drafting a Rule 10b5-1 trading plan. The company's counsel or a compliance officer should then review the draft for compliance with the company's insider trading policy and to ensure that the plan protects the company's interests.

Practical Tip: Seven Simple Steps (Cont'd)

- An insider can terminate a trading plan. But do it with caution. Termination may call into question whether the plan was entered into in good faith and not as part of an effort to evade insider trading rules.
- An insider may modify a plan, provided that the insider is not aware of material nonpublic information at the time of the modification. But any modification is, in effect, creating a new trading plan. Frequent modifications, like terminations, can call into question the good faith of the insider.
- An insider may make trades outside the trading plan provided the insider is not aware of material nonpublic information. Trades outside the trading plan are not protected by Rule 10b5-1's affirmative defense and must not hedge trades made under the plan.
- Carefully review the insider's contractual lock-up agreements. Underwriters, for example, may have prohibited or restricted any trades for a set period, such as after an offering.
- A trading plan, even one that meets all the requirements of Rule 10b5-1(c), only provides an affirmative defense in an enforcement action or lawsuit alleging unlawful insider trading. It does not prohibit someone from bringing the enforcement action or lawsuit.
- A trading plan should provide for automatic suspension or termination upon specified events. These may include the insider's death or bankruptcy, imposition of an underwriter's lock-up or the announcement of a tender offer for issuer's stock or a merger.

Chapter 6

Proxy Solicitation and the Annual Report to Shareholders

A public company's proxy statement for its annual meeting of shareholders pairs with its annual report to shareholders to play a critical role:

- They provide an annual, formal communication from management to the company's shareholders; and
- They serve as an annual corporate governance check-up: not just for compliance with Sarbanes-Oxley, but also for other governance and disclosure mandates.

The Proxy Statement

Prior to a shareholders' meeting, a public company will solicit proxies from its shareholders through the delivery of a proxy statement and a proxy card. A proxy is a power of attorney allowing the company's management (or another designee) to vote the shares owned by a shareholder for a particular purpose and in a particular manner. The proxy statement informs shareholders about the agenda for a shareholders' meeting and solicits a proxy from each shareholder to vote the shareholder's shares at the meeting in the manner specified in the proxy card. Proxy solicitation allows shareholders to exercise voting rights without being physically present at the shareholders' meeting.

Regulation 14A of the 1934 Act governs any communication by a public company reasonably calculated to cause a shareholder to grant, withhold or revoke a proxy. Regulation 14A requires disclosure of material facts and prohibits fraud in connection with a proxy solicitation. State corporate law, as well as the provisions of each company's certificate of incorporation and bylaws, also governs aspects of proxy solicitation.

Information Included in the Proxy Statement

The SEC's Schedule 14A outlines the information that a company must include in its annual proxy statement. This schedule goes well beyond issues that relate strictly to election of directors and includes:

- *The Meeting.* The date, time and place of the meeting and the deadline for submitting shareholder proposals.
- *Voting Information.* A description of the shareholder vote required for approval of each matter, the shares entitled to vote, the method for counting votes and the record date.
- *Proxy Solicitation.* The identity and information regarding certain substantial interests of the party for whom the solicitation is made, the revocability of the proxy and information about the cost of the solicitation.
- *Board of Directors Elections.* Detailed background information about the director nominees and incumbent directors.
- *Executive Compensation.* Detailed information concerning compensation of the chief executive officer and the other four most highly compensated executive officers for the last fiscal year, and a Compensation Committee Report discussing executive compensation.
- *Stock Performance.* A graph comparing the company's stock performance over the last five years to a broad equity market index and to a peer group or line-of-business index.
- *Related-Party Transactions.* A description of material transactions between the company and any director, director nominee, executive officer or 5% shareholder, or any of their immediate family members.
- *Equity Compensation Plans.* In a proxy statement for a meeting in which shareholders will consider approval of an equity compensation plan, a disclosure table of all company equity compensation plans, plus narrative descriptions of non-shareholder-approved plans.

Breaking News: SEC Proposes Significant Changes to Executive Compensation and Other Director/Officer Disclosures

In January 2006, the SEC proposed sweeping changes to many of the disclosure requirements affecting information generally included in annual proxy statements, primarily relating to executive compensation. The proposed changes were drafted in an attempt to make disclosure about executive and director compensation and benefits, as well as some other corporate governance-related matters, more straight forward and easier for shareholders to follow. The proposed changes include:

- *Compensation Discussion and Analysis,* which would replace the Compensation Committee Report on executive compensation and the stock performance graph, and is aimed at providing a plain English discussion of objectives and implementation of executive compensation programs and the underlying reasons for the programs (basically, MD&A for executive compensation).
- *Revised Named Executive Officer Compensation Tables and Narrative,* which are meant to provide more meaningful disclosures about cash and equity compensation, including perquisites, retirement and severance benefits, as well as provide shareholders with an annual "bottom-line" total compensation amount, for named executive officers.
- *Director Compensation Table,* which would more clearly set out in tabular form the directors' compensation and benefits.
- *Director Independence Disclosures,* which, like NYSE and Nasdaq requirements, would require discussion of director, director nominee and Board Committee independence.

Breaking News: SEC Proposes Significant Changes to Executive Compensation and Other Director/Officer Disclosures (Cont'd)

- *Other Corporate Governance Disclosures,* which would include revisions to the related party transaction and the security ownership information requirements relating to executive officers and directors.

Although it cannot be certain in what form these SEC proposals will ultimately be adopted, it is expected that their final form will require significant changes to the format and substance of the information provided in future annual proxy statements.

Increased Focus on the Board of Directors

Under the revised NYSE and Nasdaq rules, a majority of a listed company's Board of Directors must now satisfy higher independence standards and all nonmanagement directors must meet in regular executive sessions. See Chapters 9 (NYSE) and 10 (Nasdaq). Proxy statements need to include the names of the directors a company's Board has found to meet the applicable independence requirements, and, for NYSE companies, the relationships those directors have with the company. NYSE companies also need to disclose which director presides at executive sessions (or the manner that the Board chooses which director will preside at those sessions).

In order to provide shareholders greater access to and understanding of board operations, companies also need to describe the director nomination processes and any procedures for shareholder communications with directors. This disclosure complements the recently expanded NYSE and Nasdaq nominating/governance committee requirements.

Each proxy statement now fully discloses the director nomination processes that the nominating/governance committee uses to identify and evaluate potential nominees for the Board of Directors. This disclosure includes:

- *"Minimum Qualifications" of Director Candidates.* A description of the "minimum qualifications" needed by a director nominee in order to be recommended by the nominating/governance committee. Are there "any specific qualities or skills required?"
- *Shareholder-Recommended Director Candidates.* Does the company have a policy regarding consideration of shareholder-recommended director candidates? If so, the proxy statement must describe the material terms of this policy, including whether the nominating/governance committee considers shareholder-recommended candidates and, if so, what the procedures are for recommending them. (And if there is no such policy, then the proxy statement needs to explain why not.)
- *Source and Evaluation of Director Candidates.* A description of the nominating/governance committee's process for identifying and evaluating potential director nominees, including shareholder-recommended candidates. If shareholder-recommended candidates are evaluated on a different basis from other candidates, companies must disclose and explain these differences. For all new director nominees proposed by the nominating/governance committee for election, companies must disclose who recommended each of the nominees. The proxy statement must also disclose the identity and role of any third party, such as a headhunter, whom the company has engaged to identify or evaluate potential director candidates.
- *5% Shareholder-Recommended Director Candidates.* If a 5% or greater shareholder (or group) that has held its position for at least a year timely recommends a director candidate, the company must disclose the name of the candidate and the recommending shareholder, and whether the company nominated the candidate. This disclosure requires, however, the written consent of the 5% shareholder and the candidate.

Finally, how do shareholders communicate with the Board of Directors? The company should describe whether this can be done, and explain how shareholders can send communications to the

Board or to specific individual directors. (In the unlikely event that there is no method to communicate with the Board, the proxy statement should explain why not.)

Audit and Compensation Committee Reports (and Other Information)

As two core elements of the Board of Directors' direct communications to shareholders, each of the Audit Committee and the Compensation Committee publishes its own report in the proxy statement. These reports get great attention from the directors who author them (as well as from the full Board), and from shareholders for whom the reports are drafted. The reports contain both substantive data and critical indications of the company's governance standards.

The Audit Committee Report and Other Disclosure

- *Report of Actions and Recommendation of Inclusion of Audited Financials.* Over the names of each of its members, the Audit Committee must confirm in its report whether it has:
  - Reviewed and discussed the audited financial statements with management;
  - Discussed a set of required matters with the company's independent auditors;
  - Received appropriate and mandated disclosures from the auditors regarding the auditors' independence; and
  - Based on its review, recommended to the Board of Directors that the company's audited financial statements be included in the company's Form 10-K. (This last requirement is at the heart of the Audit Committee's responsibilities.)
- *Audit Committee Charter.* The Audit Committee must indicate whether the Board of Directors has adopted a written Audit Committee charter, as required by both NYSE and Nasdaq. The company should include a copy of the charter in its proxy statement every third year, as well as in any annual proxy statement following material changes to the charter.

- *Audit Committee Independence.* Companies must confirm whether all members of the Audit Committee meet the applicable NYSE or Nasdaq independence requirements. (Recent NYSE and Nasdaq listing standards have significantly increased attention on the independence of directors and Audit Committee members. See Chapters 9 and 10.)
- *Financial Expertise.* Has the Audit Committee determined whether one of its members is an "audit committee financial expert?" Most companies make this disclosure in their proxy statement. (Although technically required disclosure in the Form 10-K, most companies incorporate it by reference into their 10-K.)
- *Relationship with Independent Auditor (including Reporting of Audit Fees).* The proxy statement must discuss the independence of the company's outside auditor and the services it performs. Companies report, and institutional investors review with care, the fees billed for the last two fiscal years in four service categories: audit, audit-related, tax and other. The category a service falls into is particularly critical due to the strict requirements for auditor independence; not only are some non-audit services now prohibited from being done by independent auditors, but the historical concern has been that non-audit fees may indicate too close a tie between the auditor and the company. The proxy statement must also disclose the Audit Committee's policies and procedures for pre-approving both audit and permitted non-audit services.

The Compensation Committee Report and Other Disclosure. In its report, the Compensation Committee (or, if no Compensation Committee exists, the Board) describes the company's compensation policies for executive officers, including the specific relationship of corporate performance to executive compensation. While Compensation Committee reports vary, each includes six basic elements:

- *The Report Belongs to the Compensation Committee.* The Compensation Committee must caption and identify its report as a Compensation Committee report on executive

compensation, and publish it in the proxy statement over the names of each of its members.

- *Performance-Based Compensation and Company Performance.* The report discloses executive compensation policies. It should spell out the extent to which compensation is performance-based and the performance measures used. The stock performance graph showing the company's total shareholder return during the past five years should appear next to the Compensation Committee report.
- *Specificity and Total Compensation.* The report identifies and explains the different categories of compensation, such as salary, bonus, stock options and other long-term compensation, and evaluates total compensation, including benefits, such as perquisites and retirement benefits.
- *Size of Compensation Packages.* The Compensation Committee should try to provide as much detail as possible in explaining the size of the compensation packages awarded. For example, if a pay package is based on competitive standards, identify the competition, how the Compensation Committee determined what was competitive and how the comparator company relates to the companies in the peer index in the performance graph.
- *CEO Compensation.* The report discloses the factors on which the CEO's compensation is based and specifically discusses the relationship of the company's performance to CEO compensation, including a description of each measure of company performance on which CEO compensation is based.
- *Tax-Deductibility.* The report includes a discussion of the company's policy with respect to qualifying compensation for deductibility under Section 162(m) of the Internal Revenue Code.

Compensation Committee Independence. The proxy statement should confirm whether all members of the Compensation Committee meet the applicable NYSE or Nasdaq independence requirements. See Chapters 9 and 10.

Filing and Distributing Proxy Materials

Some proxy materials relate only to routine matters, such as the election of directors, the adoption or amendment of a stock option plan or ratification of accountants. Companies can file these routine proxy statements with the SEC in final form either prior to or concurrently with distributing them to shareholders.

Proxy materials relating to nonroutine matters (such as authorizing additional shares or otherwise materially amending the charter or approving a merger) must be filed in preliminary form at least ten days prior to distributing them to shareholders. These preliminary proxy materials are subject to review and comment by the SEC. The SEC will promptly (usually within ten calendar days) advise a company if it intends to review the preliminary proxy materials. If the SEC advises that it will not review the materials, the company may distribute the definitive proxy materials to its shareholders and concurrently file them with the SEC. If the SEC comments on the preliminary proxy materials, the company may be required to file amended proxy materials for review or make appropriate amendments to its definitive proxy statement if it has already been distributed.

Filing Fees

Generally, there is no SEC fee for filing routine proxy materials. Nonroutine proxy statements that relate to an acquisition, merger, consolidation, proposed sale or other disposition of substantially all of the assets of the company require a fee, which is generally equal to $1/50^{th}$ of 1% of the value of the transaction.

Distributing the Proxy Statement to Shareholders

State corporate law and a company's charter documents establish the time period for delivery of notice of an annual or special shareholders' meeting. The notice period is generally no less than ten days (20 days for business combinations) and no more than 60 days prior to the shareholders' meeting. The notice is usually included as part of the company's proxy statement.

In practice, well-organized companies distribute proxy materials as far in advance of the meeting as permitted by applicable notice requirements. Early distribution allows sufficient time for

proxy materials to reach beneficial owners, helps ensure the presence of a quorum at the meeting and gives the company time to follow up with shareholders regarding voting.

Breaking News:
Proxies and Technology –
Enhanced Relationship Proposed

The Internet and electronic mail have been playing an increasingly important role in proxy solicitations and shareholder voting allowing for more efficient and cost-effective means of communicating with shareholders.

New SEC Proposal: In December 2005, the SEC proposed for comment new proxy rules that would make it easier for proxy solicitations to be done using the Internet. This "notice and access" proposal would allow companies and others soliciting proxies to post proxy solicitation materials, such as a proxy statement, annual report to shareholders and proxy, on a Website (other than the SEC's Website), without physically furnishing the materials to the shareholders. All that would be required to be sent to shareholders is a "Notice of Electronic Proxy Materials," which would include information such as the date of the shareholders' meeting, an electronic location for access to the proxy materials, a toll-free number and email address where shareholders could request physical copies of the proxy materials, and a description of the matters to be voted on at the meeting.

The SEC believes that if the proposed proxy rules were approved, companies and others soliciting proxies would benefit from a more cost-effective proxy solicitation process. The proposed rules would not affect state law notice and annual meeting requirements, and would not apply to business combination transactions.

Practical Tip: Proxies and Technology – Enhance Relatinship Proposed (Cont'd)

Current Use: As it currently stands (prior to any new SEC rules), companies may distribute proxy materials electronically so long as:

- The proxy materials arrive in adequate time to provide notice;
- The proxy materials provide access to information comparable to what recipients would have received in paper copies;
- The company has a shareholder's informed consent to electronic delivery by written, electronic or telephonic means (provided there is a record of the consent); and
- The company obtains evidence of receipt of the proxy materials.

However, while federal securities laws govern disclosure and delivery of proxy solicitations, state law governs the voting process, including whether electronic voting is permitted and whether a manual signature is required on a proxy. Accordingly, a company should review the laws of its state of incorporation and its charter documents when considering whether to distribute proxy materials electronically.

The Proxy Card

A shareholder appoints a proxy by completing and executing the proxy card that accompanies the proxy statement. Rule 14a-4 under the 1934 Act sets forth the specific form and content requirements for the proxy card.

Trap for the Unwary: Remember Those Optionees

Although the primary purpose of a proxy statement is to solicit votes from shareholders, companies must deliver proxy statements and annual reports to holders of stock options and other benefit plan participants who do not own stock and therefore cannot vote. Companies do so to satisfy Rule 428(b) under the 1933 Act, which includes an easy-to-overlook requirement relating to information that must be delivered to optionees and other benefit plan participants.

Shareholder Proposals Submitted for Inclusion in Proxy Materials

Under certain conditions described in Rule 14a-8 under the 1934 Act, a public company must include in its proxy materials "qualifying" proposals from a shareholder at no expense to that shareholder. These rules provide a means for shareholders to seek shareholder consideration of actions not otherwise proposed by the Board of Directors. If the proposal does not meet the procedural and substantive requirements outlined in Rule 14a-8, the company may exclude the proposal from its proxy materials. If the Board does not favor a qualifying proposal, the company may include a statement in opposition to the proposal.

Procedural Requirements

A shareholder must satisfy four procedural requirements to be eligible to include a proposal in a company's proxy materials:

- *Stock Ownership.* For at least one year prior to submitting the proposal, the shareholder must have continuously held at least $2,000 in market value or 1%, of the company's securities entitled to be voted on the proposal. The shareholder must continue to hold the securities through the date of the annual meeting.
- *One-Proposal Limit.* The shareholder may not submit more than one proposal. The SEC interprets this limitation to prohibit the submission of a proposal that includes numerous unrelated subproposals.

- *500-Word Limit.* The shareholder's proposal and accompanying supporting statement cannot exceed 500 words.
- *Notice.* The shareholder's proposal must be delivered to the company's principal executive offices not less than 120 days prior to the anniversary of the date on which the company distributed its proxy statement for the prior year's annual meeting. This deadline is generally printed in the prior year's proxy statement.

If a shareholder fails to satisfy any of these requirements, the company may exclude the proposal on procedural grounds, but only after it has notified the shareholder of any defects within 14 calendar days of receiving the proposal and permitted the shareholder an opportunity to cure the defects. The company need not provide a shareholder notice of a defect if the defect cannot be remedied, such as if the shareholder failed to submit a proposal by the company's properly determined deadline.

Is the shareholder a no-show? If the shareholder, or a representative of the shareholder, does not personally appear at the shareholders' meeting to present the proposal, the company may exclude any proposals submitted by that shareholder from its proxy materials for the following two years unless the shareholder can demonstrate good cause for failing to attend.

Substantive Requirements

Rule 14a-8 also includes several substantive bases on which a company may seek to exclude a shareholder proposal:

- *Improper Subject for Shareholder Action or Violation of Law.* The proposal is not a proper subject for action by shareholders under the laws of the jurisdiction of the company's incorporation or action on the proposal would, if implemented, cause the company to violate any state, federal or foreign law to which it is subject.
- *Violation of the Proxy Rules, including False or Misleading Statements.* The proposal or supporting statement is contrary to any of the SEC's proxy rules, including Rule 14a-9, which prohibits materially false or misleading statements in proxy soliciting materials.

- *Personal Grievance.* The proposal relates to the redress of a personal claim or grievance against the company or any other person, or is designed to result in a benefit to the proponent shareholder not shared by the other shareholders at large.
- *Insignificant Operations, Ordinary Business Operations or Beyond Company Control.* The proposal relates to operations that account for less than 5% of the company's total assets, net earnings and gross sales; relates to the company's ordinary business matters (excluding matters of significant social policy, e.g., senior executive compensation); or proposes actions beyond the power or authority of the company to implement.
- *Election to Office as a Director.* The proposal relates to electing a member to the Board of Directors.
- *Substantially Implemented.* The company has already substantially implemented the proposal.
- *Duplicative, Conflicting or Previously Rejected.* The proposal is duplicative of another proposal, directly conflicts with a proposal of management or was previously rejected by a specific percentage of shareholders. The percentage is determined by the number of times the proposal has been submitted.
- *Dividends.* The proposal relates to specific amounts of cash or stock dividends.

No-Action Letter Requests

If a company intends to exclude a shareholder proposal from its proxy materials on procedural or substantive grounds, it must submit its reasons for doing so to the SEC, with a copy sent simultaneously to the shareholder proponent. This submission is referred to as a "no-action letter request" and must be submitted to the SEC no later than 80 calendar days prior to filing the company's definitive proxy statement. Whether the company is ultimately able to exclude the proposal from its proxy statement will depend on the SEC's response to the company's no-action letter request.

Statement in Opposition to Qualifying Proposal

If a company intends to make a statement in the proxy in opposition to a shareholder proposal, the company must provide a copy of the statement to the proponent at least 30 days before filing the definitive proxy statement. If the SEC's no-action letter request response requires the proponent to revise a proposal, the company must provide a copy of the statement in opposition no later than five calendar days after the company receives a copy of the revised proposal.

Breaking News: Clarification on Exclusion of False or Misleading Statements

In the 2005 proxy season, the SEC staff denied almost all no-action requests for exclusion or modification of false and misleading statements in shareholder proposals. In the past, the SEC had often permitted exclusion or modification of those types of statements. As a result of the new practice, a company that is not successful in negotiating with proponents to exclude or modify false or misleading statements must instead address the offending language by a general disclaimer or specifically in the Board's opposition statement.

Identification of Proponent

The proxy statement must include either the proponent shareholder's name, address and share ownership or indicate that the company will provide this information upon request. Although in the past most companies did not identify shareholder proponents, many companies are now including this identifying information in their proxy statements.

Practical Tip:
Get Out Your Calendars!

The shareholder proposal process is deadline-sensitive. Begin communicating with a proponent as soon as you receive a shareholder proposal. Create a "countdown" calendar using these key deadlines:

- *Shareholder Proposal Submission Deadline.* 120 calendar days prior to the one-year anniversary of the date on which you sent your prior year's proxy statement to shareholders.
- *Procedural Defects Notice.* 14 calendar days after receiving the shareholder proposal.
- *No-action Letter Requests.* 80 calendar days before you file your definitive proxy statement with the SEC.
- *Statements in Opposition.* 30 calendar days before you file your definitive proxy statement with the SEC, or within five calendar days of receiving a revised shareholder proposal.

Shareholder Proposals Not Submitted for Inclusion in Proxy Materials

Under certain conditions a shareholder may submit a proposal for consideration at an annual meeting even though the proposal does not meet the procedural requirements for inclusion in the company's proxy statement. The requirements for such submissions are described in the company's bylaws or, in the absence of applicable bylaw provisions, in Rule 14a-4(c). Companies should be aware of the deadlines for these types of shareholder proposals, which are usually provided for in the company's advance-notice bylaw provisions, and the applicable deadlines should be disclosed in the company's proxy statement. In addition, a company can generally retain discretion to vote proxies it has received on this type of shareholder proposal if it includes in its proxy statement advice on the nature of the proposal and how it intends to exercise its voting discretion.

The Proxy Contest: Election Contests and Takeover Transactions

As with shareholder proposals, there are various ways that management may appropriately anticipate and manage proxy contests with shareholder groups. A proxy contest typically involves a challenge to existing management by a third-party acquiror or shareholder group seeking control of the company. Often, the challenger has obtained a significant ownership position in the company and seeks either to (a) control the company through the election of a majority of the directors or (b) propose a merger or tender offer for shares. (Although a detailed discussion of takeover transactions and defenses is beyond the scope of this Public Company Handbook, we summarize structural defenses in Chapter 11.)

Breaking News: Board Election Reforms

Prior to 2005, reform efforts relating to public company boards included recommending voting for shareholder proposals to declassify boards and supporting the SEC's 2003 direct proxy access proposal. The SEC access proposal would have granted shareholders direct access to a company's proxy statement to nominate their own candidates if a director received a "withhold" vote of more than 35% of the applicable vote or if the shareholders approved a direct access proposal by a majority of the yes/no votes.

From 2003 to 2005, the momentum for the SEC access proposal dissipated and the reform movement turned to demanding that companies replace plurality voting with some form of majority vote standard. However, there was and still is uncertainty as to how true majority vote standards, if adopted, should or would be implemented. Concerns include the risk of a "failed" board election if a majority of the candidates or the entire board does not receive the required majority vote, and the risk that companies could become noncompliant with exchange or market listing standards, such as board independence and board committee requirements, because some or all of their board members do not get the

Breaking News:
Board Election Reforms (Cont'd)

required majority vote. These concerns are heightened by agitation for changes to NYSE rules that would eliminate discretionary broker voting for directors. (We discuss voting standards at shareholders meetings in Chapter 7.)

As of January 2006, a number of companies have adopted corporate governance guidelines that give effect to a majority-vote election concept by requiring a director to submit his or her resignation if he or she fails to receive a majority vote. A lesser number of companies have adopted majority vote standards in their certificate of incorporation or bylaws.

Stay tuned, however, as director voting reforms are still very much under the microscope. New and alternative proposals are expected to emerge as various companies, shareholders and other groups continue to study and act on the board election issues.

Directors' and Officers' Questionnaire

A company's proxy statement, Form 10-K and annual report to shareholders will provide a variety of detailed information about its directors and officers, including employment history, compensation, security ownership in the company, transactions with the company and Section 16 reporting history. Even if a company believes it already knows all of the relevant information, the company should ask its directors and officers each year to complete a director and officer (D&O) questionnaire to elicit or confirm the required information. Companies will want to review and update as necessary their D&O questionnaires annually to incorporate changes to applicable SEC requirements and NYSE and Nasdaq rules. Companies should provide the D&O questionnaires to directors and officers sufficiently in advance to allow adequate time for responses to be incorporated into the proxy statement, Form 10-K and annual report. A helpful approach is to include a copy of relevant extracts from the prior year's proxy statement, Form 10-K or annual report with the D&O questionnaire and request that the directors and officers update and edit the information.

In addition to responding to the requests in the D&O questionnaire, a director or officer may know information about the company or its operations, including its transactions with related parties, which may be disclosable in the proxy statement but may not necessarily involve the director or officer personally. In those cases, the director or officer should confirm with the company's legal counsel whether the information needs to be disclosed in the company's proxy statement or other periodic reports.

Trap for the Unwary:
Director Alert –
Understand and Properly Disclose
"Compensation Packages"

Three recent SEC actions or court decisions (as well as the SEC's recent proposal relating to executive compensation disclosure) highlight the need for Boards to understand and have properly disclosed the value of perquisites and compensation packages.

Recently, the SEC brought enforcement actions against General Electric (GE) and Tyson Foods relating to inadequate disclosure of payment of executive perquisites, which payments, in the SEC's view, are a critical part of a complete executive compensation picture.

General Electric. GE consented to an SEC order in which the SEC concluded that GE's 1997 to 2002 proxy statements and annual reports failed to fully and accurately disclose substantial retirement benefits provided to GE's former CEO and Chairman, Jack Welch. In 1996, GE entered into a post-retirement agreement that gave Mr. Welch access to services comparable to those he had enjoyed as CEO, including access to company aircraft, cars and apartments. From 1997 to 2002, GE's proxy statements and annual reports disclosed that Mr. Welch was entitled to "continued lifetime access to Company facilities and services comparable to those which are currently made available to him by the Company."

Trap for the Unwary: Director Alert – Understand and Properly Disclose "Compensation Packages" (Cont'd)

GE appended the agreement to its 1996 proxy statement and referenced it in each Form 10-K until 2002. But GE neither quantified the value of the benefits nor detailed the forms of compensation in its proxy statements or annual reports. In fact, the SEC determined that in his first year of retirement, Mr. Welch received approximately $2.5 million in benefits.

The SEC determined that by failing to quantify or provide details of these benefits, GE's proxy statement and Form 10-K disclosures "failed to fully describe the substantial benefits" that Mr. Welch received and that the agreement itself did not provide complete disclosure. Accordingly, GE's disclosure was inadequate and violated the proxy disclosure and periodic reporting requirements of the federal securities laws.

Tyson Foods. In April 2005, the SEC settled an enforcement action against Tyson Foods and its former Chairman and CEO Donald "Don" Tyson. The SEC charged Tyson Foods with making misleading disclosures in proxy statements filed from 1997 to 2003 relating to perquisites and personal benefits provided to Mr. Tyson, both prior to and after his retirement as Senior Chairman in October 2001. Mr. Tyson was separately charged with causing and aiding and abetting the company's disclosure violations. Tyson Foods and Don Tyson agreed to pay penalties of $1.5 million and $700,000, respectively.

Other Developments. The recent Disney decision, although finding that the Board lived up to its duties as they existed before Sarbanes-Oxley and related developments, underscores the need for a Board to inquire into the total cost of the executive compensation package that it is approving.

The Annual Report to Shareholders

In the annual report, senior executives have an opportunity to communicate directly with the company's shareholders. Unlike the corporate governance focus of the annual proxy statement, the annual report conveys information regarding the company's business, management and operational and financial status.

Content Requirements of the Annual Report

The annual report has similar content requirements to Form 10-K, but serves a different purpose. Form 10-K fulfills the year-end reporting requirement to the SEC and is not necessarily designed to communicate with shareholders. The annual report is intended principally as a communication device – the most direct message from the company to its shareholders – and is generally issued in an attractive format to facilitate this purpose.

Rules 14a-3 and 14c-3 under the 1934 Act specify the minimum content requirements for an annual report, which include:

- *Financial Information.* Audited balance sheets for the two most recent fiscal years, audited statements of income and cash flows for the three most recent fiscal years, other selected and supplemental financial data, a discussion of material uncertainties and disagreements with accountants on accounting and financial disclosure, MD&A detailing financial condition and results of operations, and disclosures about market risk.
- *Stock and Dividend Information.* Identification of the principal markets in which the company's shares are traded, quarterly highs and lows in stock price, number of common shareholders, and frequency and amount of cash dividends declared over the previous two fiscal years.
- *Operation and Industry Segment Information.* A description of the company's principal products produced or services rendered, accompanying markets and distribution methods, foreign and domestic operations, export sales, industry segments, and classes of similar products or services.

- *Director and Officer Information.* Identification of the company's directors and executive officers along with their principal occupation, including the name of their employer.

Companies are free to include information in an annual report that goes beyond the minimum content requirements. Companies generally include a letter from the president or chairman of the Board summarizing the company's operations, strategy, projected performance, key personnel changes and other highlights for the year. Because the annual report is furnished to the SEC and generally made publically available, any information included in the annual report, even if not required, may be the source of legal liability if found to be materially misleading.

Format Requirements of the Annual Report

Format requirements for the annual report to shareholders are minimal. The SEC permits virtually any format but encourages innovative presentation, including the use of tables, graphs, charts, schedules and other graphic illustrations useful to presenting operational and financial information in an easily understandable manner. Some of the financial information included in the body of the annual report must be presented in tabular form.

Timing of the Annual Report

The SEC requires an annual report to shareholders to accompany or precede a company's proxy statement for any shareholders' meeting (annual or special) at which shareholders will elect directors. While a company need not prefile its annual report with the SEC (unlike with proxy materials), each company does need to furnish seven copies to the SEC upon distributing the annual report to its shareholders, as well as furnishing copies to NYSE or Nasdaq, as applicable. NYSE requires that a company deliver its annual report no later than 120 days after the close of the fiscal year or 15 days in advance of a company's annual meeting.

Practical Tip: "10-K Wrap" or "Super Proxy"

An increasingly common and practical format is the Form 10-K "wrap" annual report: eight or so glossy pages of company message materials (e.g., president's or chairman's letter, photographs of company, management or products) that simply wrap around and are stapled to the Form 10-K. This avoids duplication between the annual report to shareholders and the 10-K, reduces costs and gets a valuable SEC-filed report into shareholders' hands. A similar practical and cost-saving approach is to append all SEC and exchange-mandated annual report information to your proxy statement. A company can always decide at a later date to issue a glossy report that does not need to comply with SEC requirements and does not need to be mailed (expensively) in one package with the proxy statement.

Chapter 7

Annual Meeting of Shareholders

During the first several months of each year, a public company's senior management and professional advisors will spend significant energy preparing for the company's annual meeting of shareholders. Agreement on a premeeting timetable can bring order to this process and help ensure timely completion, as many of the tasks to be included in the timetable will require significant lead time.

Practical Tip:
Create a Calendar or Time and Responsibility Schedule and Update During the Planning Period

The Annual 1934 Act Reporting Calendar at Appendix 2 can help you plan your annual meeting process. Your calendar or time and responsibility schedule (T&R) should identify the group or individual in charge of each task, and set a due date for accomplishing the task. One person should take responsibility to update and recirculate the calendar or T&R on a regular basis during the planning period to reflect the current status or completion of the necessary tasks. Be sure not to mark a task as done until it is actually completed.

Tailor your company's calendar or T&R to the rules and regulations that govern the proxy statement, the annual report to shareholders and the annual shareholders' meeting. These rules derive from:

- Federal securities laws regulating proxy solicitations, annual reports and public disclosure generally;

Practical Tip:
Create a Calendar or Time and Responsibility Schedule and Update During the Planning Period (Cont'd)

- Exchange and market rules and regulations;
- The company's governing documents, such as its certificate of incorporation, bylaws, Board guidelines and Committee charters; and
- State corporate law.

The calendar or T&R for each company will be different and will require some judgment. For example, a company's bylaws may require the company to deliver notice to its shareholders of the annual meeting date earlier than the SEC's proxy rules or applicable state corporate law may require, or the company's certificate of incorporation may require a supermajority vote (such as two-thirds) on a particular proposal while applicable state corporate law requires only a simple majority. Each company should work with its counsel to identify and comply with the most restrictive applicable requirements.

Pre-Meeting Planning

Setting the Record Date

Only shareholders of record on the record date for the annual meeting are entitled to notice of, and to cast votes during, the meeting. Shareholders that acquire a company's stock after the record date have no voting or notice rights with respect to the meeting. A company's Board of Directors sets the record date for the annual meeting. State corporate laws set the maximum and minimum number of days between the record date and the meeting date. In Delaware, for example, the record date may not be more than 60 nor less than ten days before the meeting. Some companies' bylaws may also set limits on the record date.

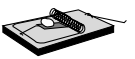
Setting the Meeting Date

The determining factors in setting an annual meeting date are:

- State corporate law;
- The prior year's annual meeting date; and
- The company's certificate of incorporation and bylaws. (These charter documents either set the annual meeting date or give the Board of Directors discretion to choose a date.)

State corporate law sets forth a time frame during which companies must hold an annual meeting. For example, if a Delaware company fails to hold an annual meeting within 30 days after the date fixed for the company's annual meeting in its charter documents (or, if that date is not fixed, 13 months after its previous annual meeting), a shareholder or director can bring an action in the Delaware Court of Chancery to force the company to hold its annual meeting.

Trap for the Unwary:
What's the Holdup?



Recently, a West Coast-based Delaware public company decided that it would hold its annual shareholders' meeting 15 months after its most recent shareholders' meeting. The company announced that it had retained an investment banker to advise it on its strategic alternatives, including searching for a possible merger partner. In setting the meeting date, the Board intended to allow sufficient time to present any proposal resulting from the investment banker's efforts to the company's shareholders for their approval at the annual meeting.

A group of shareholders threatened to sue to compel the Company to hold the annual meeting earlier than the company's announced date and within 13 months after the company's prior year's annual meeting.

Trap for the Unwary: What's the Holdup? (Cont'd)

The Delaware Court of Chancery's power to force a meeting is discretionary. The Court considers a number of factors when deciding whether to compel a meeting to be held at the request of a complaining shareholder or director. If the company has a valid reason for delay (such as taking a merger proposal to its shareholders) and is taking steps to hold the meeting promptly, the Court generally refrains from compelling an earlier meeting.

In this case, the company completed the strategic analysis with its financial advisor as promptly as possible and rescheduled its annual meeting to within 14 months after its most recent meeting. By the time the original 13-month period expired, the company had mailed its notice and proxy statement, and no shareholder brought suit.

Notifying Shareholders, Exchanges and Markets

State corporate law requires a company to notify its shareholders in writing of the annual meeting date, time and place. Notice periods vary from state to state. In Delaware, the notice period is at least ten days and no more than 60 days prior to the annual meeting. Failure to adhere to notice requirements can have significant consequences. In Delaware, for example, unless notice is waived, a company's failure to adhere to notice requirements voids any action taken at the meeting. Each company should also comply with any notice provisions in its charter documents.

The exchange or market on which a company's shares are listed or traded may also require notice of each shareholders' meeting. For example, listed companies must provide NYSE with at least ten days' notice prior to the record date established for the meeting. The notice must indicate the meeting and record dates and describe the matters to be voted at the meeting. Although NYSE may not widely publicize this notice, it can publish annual meeting information in its weekly bulletin to listed companies.

Reaching Past "Street Name" to Contact Beneficial Owners

Because many owners of public company stock hold their shares in "street name" (i.e., by having a brokerage firm, bank or other "nominee" hold the shares in its name for the benefit of the actual investor), a public company cannot contact its shareholders directly by simply using its transfer agent's list of record holders. To facilitate this contact, the SEC, the exchanges and markets, and the nominees themselves have developed rules, practices and procedures to make sure the materials will eventually be delivered to the investors (beneficial owners) that have economic ownership of shares held in street name.

Rule 14a-13 under the 1934 Act and exchange and market requirements require companies to send a sufficient amount of shareholder materials to the nominees for them to distribute to beneficial owners. Under Rule 14a-13(a)(3), companies must contact institutional nominees at least 20 business days before the record date to learn the number of copies of the proxy and other soliciting materials needed for distribution to beneficial owners.

Once a company has its proxy statement ready for mailing, Rules 14b-1 and 14b-2 under the 1934 Act require nominees to distribute proxy materials to beneficial owners within five business days of receipt from the company. Many nominees outsource proxy distribution to third-party service providers, such as ADP Investor Communications Services.

Shareholders that intend to solicit proxies in opposition to a proposed action to be taken at a shareholders' meeting have the right to access information regarding beneficial ownership. Delaware courts have ruled that soliciting shareholders are entitled, in addition to a list of record holders, to other information readily obtainable by the company that identifies beneficial owners, provided they take the necessary steps in time to obtain the information.

Who Attends the Annual Meeting?

Shareholders. Many public companies have a large and geographically dispersed group of shareholders. As a result, and because many shareholders vote by proxy rather than attend the meeting, frequently only shareholders who live in the vicinity of the meeting, together with employee shareholders, attend.

Management and Board Members. Senior management and some or all members of the Board of Directors typically attend the annual meeting. Their attendance provides shareholders an opportunity to meet and provide feedback to the Board and management team.

Practical Tip:
Webcast the Meeting

If your company wishes to present a general business update that may include material nonpublic information at its annual shareholders' meeting, you should make arrangements to Webcast the meeting to ensure compliance with Regulation FD. To Webcast your annual meeting:

- Include in the press release announcing the meeting a notice that the company will discuss general business updates;
- Arrange for, and pretest, Webcast media facilities at the meeting's site;
- On the day of, but prior to, the meeting, issue a press release with the text of the company's planned presentation, or at least the material nonpublic portions;
- Comply with Regulation G by posting any required GAAP information and reconciliations on the company's Website;
- Begin the business update with cautionary language on forward-looking disclosures; and

Practical Tip: Webcast the Meeting (Cont'd)

- Post any questions and responses in the same manner as after an earnings release.

See Chapter 3 for a full discussion of Webcasts and shareholder or analyst calls.

Inspector of Elections. The company should arrange for an inspector of elections to tabulate votes and certify results. Sometimes the inspector is a company employee. More often, the inspector is a representative of the company's transfer agent or independent auditors.

Practical Tip: Where to Hold the Meeting? Consider the Company's Offices

As early as a year in advance, you should anticipate the number of shareholders who will attend the annual meeting and reserve an adequate facility.

Consider holding the meeting at your company's offices. Companies often overlook this option, assuming a large space will be required. The price savings can be great, and you will be on familiar ground with everything from audio/visual equipment to security. Plus, a meeting at your company's offices provides shareholders the opportunity, during or after the meeting, to see new product demonstrations or to take a facility tour.

Counsel and Auditors. Representatives from the company's legal counsel and independent auditors usually attend the annual meeting. The independent auditors can field questions regarding the company's financial statements. Legal counsel attends to address any voting, agenda or procedural issues that may arise.

Practical Tip:
Can Shareholders Ratify Choice of Auditors?

Many companies, although not required to do so, ask shareholders to ratify the selection of independent auditors. Yet Sarbanes-Oxley requires the Audit Committee to have the sole oversight of auditors. Can you continue to seek shareholder ratification?

Yes. Many companies will continue to ask for shareholder ratification. The proxy statement, however, must make clear that the shareholders will ratify the decision of the Audit Committee, not the Board, to recommend and approve the independent auditors.

Board Meeting or Board Consent to Address Matters Pertaining to the Annual Meeting

Three to four months prior to the annual shareholders' meeting, a company's Board of Directors should:

- Fix the annual meeting's time, date and place;
- Set the record date;
- Establish the purposes of the annual meeting (generally, to elect directors, vote on specified matters and transact other business as may properly come before the annual meeting);
- Select director nominees; and
- Designate proxies.

At the same time, the Audit Committee should indicate what firm it has selected as the company's auditors if it has not done so already. The Audit Committee may also recommend that its appointment of the auditors be submitted to the shareholders for ratification.

Practical Tip: Hold a Board Meeting in Connection With the Annual Shareholders' Meeting

Most companies hold a meeting of the Board of Directors either just prior to the annual shareholders' meeting, to discuss matters that may be presented at the shareholders' meeting, or just after the annual shareholders' meeting, when the officers will not be distracted by preparation for the annual shareholders' meeting. Holding a Board meeting on the annual meeting date helps ensure Board member attendance at the shareholders' meeting.

Script, Agenda and Rules of Conduct

Most companies prepare a script, agenda and rules of conduct for the annual meeting. It is good practice to distribute the agenda and rules of conduct to attending shareholders as they arrive.

Script and Agenda. The script will cover all items on the agenda and all statements that the scheduled speakers will make during the meeting, as well as draft answers to any questions that management can anticipate. An agenda typically includes the following:

- Chairperson's opening remarks and call to order;
- Introduction of management, directors and advisors in attendance;
- Establishment of quorum;
- Introduction of items to be voted on;
- Voting instructions;
- Call for inspector of elections report/announcement of voting results;
- Closing remarks and adjournment of formal portion of annual meeting;
- Management presentations regarding the company's business; and
- Question-and-answer period.

Follow The Script! Regulation FD. The script plays a critical part in complying with Regulation FD by anticipating questions that may call for an answer that would reveal material nonpublic information. The company's investor relations officer should carefully review these areas and either:

- Propose issuing a press release prior to the meeting disclosing material nonpublic information that can reasonably be expected to be discussed; or
- Flag the topics for the CEO and CFO, and draft a response that does not disclose material nonpublic information.

Speakers will want to rehearse the script before the shareholders' meeting and should pay particular attention to warnings on disclosure of previously undisclosed material information.

Rules of Conduct. Rules of conduct typically limit shareholders' time to address the meeting, describe how the company will handle unscheduled proposals and address how to handle unruly shareholders.

Practical Tip:
Calming the Contentious Shareholder

While shareholders have an opportunity to be heard at an annual meeting, a company should take measures to prevent a shareholder from monopolizing other shareholders' time and impeding the meeting's progress. Management can best prepare to calm a contentious shareholder with clear rules of conduct and thorough planning. Rules of conduct should address the types of activities that may cause the company to remove a shareholder. The chairperson of the meeting should immediately inform a disorderly shareholder that the shareholder's actions are out of order. If preliminary steps do not restore order, the chairperson should follow planned steps to remove the disorderly attendee and, if necessary, adjourn the meeting or call for a recess.

Voting and Quorum Requirements

Voting in Person or by Proxy

A shareholder with voting power may vote at the annual meeting by attending in person and casting a ballot or by designating a proxy to act on the shareholder's behalf. In general, a proxy holder has broad discretion to vote the shares covered by the proxy. In Delaware, for example, a proxy generally allows the proxy holder to vote shares in the proxy holder's discretion on any issue that is properly raised at a shareholders' meeting, unless the proxy specifically limits the holder's authority.

Quorum

Before shareholders can conduct business at a meeting, a quorum must be present. Quorum requirements generally are governed by state corporate law and the company's certificate of incorporation and bylaws. Usually, a quorum consists of a majority of the shares entitled to vote at the meeting. Shares count for quorum purposes if present at the meeting either in person or by proxy.

Broker Nonvotes

When beneficial owners fail to instruct the company or the record holders' nominee how to vote on noncontroversial matters (such as uncontested director elections), the nominee may vote the shares for or against the proposal in its discretion. Matters on which a nominee may vote a beneficial owner's shares in its discretion are known as discretionary matters.

Exchange or market rules prevent brokers and other nominees from voting a beneficial owner's shares on certain significant matters without specific authorization from the beneficial owner. These nondiscretionary matters include stock plan matters, a change of control of the company and other major transactions, and contested director elections. In a change of control situation, even the decision to adjourn a meeting to seek more votes may be a nondiscretionary matter.

Each nominee ultimately sends a proxy to the company containing the cumulative result of beneficial owners' instructions and the nominee's votes on those discretionary matters for which it did not receive instructions. Broker nonvotes are votes that a broker cannot cast with respect to a particular nondiscretionary matter.

Practical Tip: Stock Plan Matters No Longer Discretionary

NYSE and Nasdaq rules determine when brokers, lacking instructions from a beneficial owner, may use their discretion to vote on a proposal. Consider contacting the exchange or market directly for guidance if it is unclear whether a particular matter is discretionary. Under rule changes adopted by NYSE and Nasdaq in 2003, approval of a stock plan is no longer a discretionary matter. Instead, a beneficial owner must give specific authority to the record holder to vote on stock plan matters or else the shares cannot be voted.

The practical impact of the rule change is to make it more difficult for a public company to obtain approval of new stock plans and amendments to existing plans. To obtain approval of plan matters, companies with a large number of shares held in street name should aggressively solicit voting instructions from all holders. This effort may increase proxy costs and solicitation expenses.

Abstentions

A person with voting power (whether as a beneficial owner of shares, a designated proxy holder or a broker with discretionary authority to vote shares) who is present at a shareholders' meeting has the discretion to abstain from voting.

The Effect of Abstentions and Broker Nonvotes

Each company's proxy statement must describe how abstentions and broker nonvotes count towards the tabulation of each proposal presented at a meeting of shareholders.

Quorum. Delaware and Model Business Corporation Act (MBCA) states count both abstentions and broker nonvotes as "present" for the purpose of establishing a quorum.

Voting. The effect of abstentions and broker nonvotes on the outcome of a shareholder vote will vary based on:

- The state's corporate law treatment of abstentions and broker nonvotes; and
- The vote required to approve the shareholder action, which may be governed by state corporate law, a company's certificate of incorporation or bylaws, or exchange or market rules.

Vote Required: Fixed Percentage of Shares Present and Entitled to Vote. Under Delaware corporate law, most routine shareholder actions, other than the election of directors, require the affirmative vote of a fixed percentage (usually a majority) of the voting shares that are present, either in person or by proxy, and entitled to vote on the matter presented at the meeting. Because abstentions are present and entitled to vote on the matter presented at the meeting, they have the effect of counting as votes against the proposal – they add to the pool of votable shares without contributing to the affirmative votes required to approve the shareholder action. Broker nonvotes, however, while present for purposes of a quorum, are not entitled to vote on the matter presented at the meeting. Broker nonvotes, therefore, are excluded from the pool of votable shares and have no effect on the outcome of the shareholder vote.

It is important to refer to the corporate law of a company's state of incorporation for its treatment of abstentions and broker nonvotes. For example, under New York corporate law, abstentions are treated differently than they are treated under Delaware law – abstentions in New York have no effect on approval of a proposal that requires the affirmative vote of a fixed percentage of the votes present and entitled to vote on the matter presented at the meeting.

Vote Required: Fixed Percentage of Outstanding Shares. Approval of some shareholder actions requires the affirmative vote of a fixed percentage of the company's outstanding voting shares, whether or not such shares are present at the meeting.

Under Delaware corporate law, mergers, sales of substantially all the company's assets, amendments to the company's certificate of incorporation and dissolutions all require the affirmative vote of a majority of the outstanding voting shares. For these proposals, abstentions and broker nonvotes are the same as votes against the proposal because both are included in the pool of the company's overall voting shares, although they do not count toward the affirmative vote needed to approve the shareholder action.

Vote Required: Plurality of Votes Cast at a Meeting. The corporate laws of both Delaware and MBCA states require only the affirmative vote of a plurality of votes actually cast at the meeting to elect directors and, in MBCA states, to approve most other routine shareholder matters. This means that more votes must be cast in favor of the action than votes cast for any other alternative, whether or not the approving votes constitute a majority or other fixed percentage. Where a plurality vote is required, neither abstentions nor broker nonvotes affect the vote's outcome – they are neither votes for nor against the action.

Practical Tip:
Explain Abstentions and Broker Nonvotes in Plain English

If you find abstentions and broker nonvotes confusing, imagine your poor shareholders! To reduce confusion, your company's proxy statement should provide a plain English explanation of the impact of abstentions and broker nonvotes on the different matters up for shareholder vote. Here, for example, are explanations under the corporate laws of Delaware and MBCA states of the impact of abstentions and broker nonvotes on a nondiscretionary proposal to amend a company's stock option plan:

- ***Delaware.*** Assuming a quorum is present, approval of the amendment to our stock option plan requires the affirmative vote of at least a majority of the shares present at the meeting, either in person or by proxy, and entitled to vote on the proposal. Abstentions will have the same effect as votes against the proposal

Practical Tip: Explain Abstentions and Broker Nonvotes in Plain English (Cont'd)

because they are treated as present and entitled to vote for purposes of determining the pool of votable shares, but do not contribute to the affirmative votes required to approve the proposal. Proxies that reflect broker nonvotes (shares held by a broker or nominee that does not have the authority, either express or discretionary, to vote on the matter) will be treated as unvoted for purposes of determining approval of the proposal. They will have the effect of neither a vote for nor a vote against the proposal, and therefore will have no effect on the outcome of the vote.

- ***MBCA.*** Assuming a quorum is present, approval of the amendment to our stock option plan requires that the votes cast in favor of the amendment exceed the votes cast against the amendment. Abstentions and broker nonvotes (shares held by a broker or nominee that does not have the authority, either express or discretionary, to vote on the matter) will have the effect of neither a vote for nor a vote against the amendment, and therefore will have no effect on the outcome of the vote.

The explanations differ because of the different shareholder vote required for approval. In Delaware, approval requires a fixed percentage (a majority) of the voting shares present and entitled to vote on the matter, while the MBCA requires a simple plurality. Remember that the required vote may also be affected by provisions in your company's certificate of incorporation or bylaws, or by exchange or market rules. Although it might be helpful to look at proxy statements from other public companies for guidance when drafting your disclosure on abstentions and broker nonvotes, never simply cut and paste from one of these precedents!

Shareholder Actions by Written Consent in Lieu of an Annual Meeting

In some states, shareholders may act by written consent in lieu of an annual meeting. Although technically permitted, action by written consent in lieu of an annual meeting has little practical value for the public company. Under Delaware corporate law, for example, shareholders may act by written consent to elect directors in lieu of an annual meeting, but only if the consent is unanimous or, if not unanimous, if all directorships to which directors could be elected at an annual meeting held at the written consent's effective time are vacant (by way of resignation or removal) and filled by such written consent.

Section 14(a) of the 1934 Act extends the proxy rules to solicitations of written consents, and exchange and market rules may also apply. For example, NYSE reviews requests to act by written consent on an individual basis and reserves the right to refuse approval.

Chapter 8

Corporate Governance: Best Practices in the Boardroom

The Board of Directors bears ultimate responsibility for the oversight of a company's business and affairs. The Board makes fundamental decisions about strategic focus, establishes significant policies and approves the hiring and firing of executive officers that manage day-to-day business operations. Directors monitor financial reporting and public disclosure, and oversee internal controls and compliance with laws. The Board also sets the tone for ethical business conduct. This Chapter describes how members of a Board, and its Audit, Compensation and Nominating & Governance Committees, can best fulfill their duties.

While our discussion uses concepts from Delaware law, similar defenses are permitted by most other states.

Practical Tip:
Best, and Better Still: Monitor the Moving Standards of Corporate Governance

Today, companies and their officers and directors face a sometimes bewildering array of corporate governance requirements. Where do they come from?

- *State Law.* Corporations are governed, first, by the corporate statutes and court decisions of their states of incorporation. State corporate law controls all aspects of corporate life, from the very simple – shareholder notice and voting requirements – to the very complex – director fiduciary duties and liability.

Practical Tip: Best, and Better Still: Monitor the Moving Standards of Corporate Governance (Cont'd)

- *Federal Law.* Federal law, primarily through Congress and the SEC, regulates the governance of public companies, mandating, for example, entirely independent Audit Committees and codes of ethics for CEOs and senior financial officers.
- *NYSE and Nasdaq.* NYSE, Nasdaq and other exchanges impose governance standards on their listed companies, requiring independent Audit, Compensation and Nominating & Governance Committees, a majority of independent directors and executive sessions of non-management directors.
- *Institutional Investors.* Institutional investors have applied increasing pressure on public companies to adopt corporate governance practices that the investors believe are in the best interests of shareholders, including the elimination of staggered Boards, the appointment of lead independent directors, and the adoption of "majority vote" procedures for annual shareholder meetings.

Initiatives from Congress (through Sarbanes-Oxley) and the SEC, NYSE and Nasdaq have heightened governance standards for public companies. Yesterday's "best practices" have become today's baseline requirements. And best practices continue to evolve as companies, regulators, institutional investors and corporate governance commentators refine, and improve on, the many new governance rules and standards that apply to public companies.

Practical Tip: Best, and Better Still: Monitor the Moving Standards of Corporate Governance (Cont'd)

This Chapter reviews "best practices" of corporate governance at the time this Public Company Handbook went to press in early 2006. And, in Chapters 9 and 10, we describe in detail the governance standards of NYSE and Nasdaq. We also make suggestions that may help your company to stay abreast of "best practices" of corporate governance that are sure to evolve in the years to come.

Board Composition

The composition, size and structure of a public company Board will vary considerably with each company's circumstances. The Board of a Fortune 500 company will be different from that of a younger technology company still led by its founders. And both of those Boards will differ from that of a family-dominated company.

A well-assembled Board will consist of a diverse collection of individuals who bring a variety of complementary skills relevant to the company's business and objectives. In selecting director nominees, the Nominating & Governance Committee (or a majority of the independent directors, or other Committee responsible for nominations) should consider the candidates' financial and business understanding, industry background, public company experience, leadership skills and reputation. The Committee should also monitor and seek appropriate diversity in geography, race, gender, age and skills.

Every year, a Nominating & Governance Committee (or a majority of the independent directors or other Committee responsible for evaluations) will assess the existing Board's effectiveness in light of evolving company needs, and recommend appropriate nominees to address new circumstances.

Practical Tip:
What Makes a Good Director?
"Noses In, Fingers Out"

Establish your expectations for Board members from the outset. Candidates should be prepared to devote ample time to learn and give guidance to company officers, while knowing when to stop short of usurping management. An effective director will:

- Learn about the company and stay informed by visiting sites and asking questions of management and others with relevant information;
- Review (or, as Chair or Lead Director, develop) agendas and related materials in preparation for Board and Committee meetings;
- Attend and participate in Board and Committee meetings;
- Respond promptly in crisis situations; and
- Ask tough, probing questions and expect clear and responsive answers.

In short, "noses in, fingers out."

Independence

Most public company Boards include both inside and outside (or independent) directors. An "independent director" is an individual who can exercise judgment as a director independent of the influence of company management. An independent director will be free from business, family or personal relationships that might interfere with his independence. Many institutional investors suggest that a "substantial" majority of a company's directors be independent. NYSE and Nasdaq require that a majority of directors be independent and have tightened their definitions of an "independent director." (We discuss these definitions of an "independent director" in Chapters 9 and 10.)

The three core Board Committees – Audit, Compensation, and Nominating and Governance – will generally consist exclusively of independent directors. Independence standards for Audit Committee membership are more stringent than those for membership on a Board or other Board Committees. In general, Boards have the responsibility to determine whether a director is independent.

Board Size

The size of a company's Board will range from as few as four directors to as many as 15 or more, depending on the size and complexity of the company. A company's charter documents may set the size of the Board or provide for a permitted range, allowing the Board to set the size within the permitted range.

Larger Boards can provide increased diversity, better continuity and greater flexibility in staffing Board Committees with independent directors. But larger Boards have a cost. They may prove administratively unwieldy and diminish the opportunity for active and meaningful involvement by each director. Board Committees can bridge this gap, and increase the effectiveness of a larger Board.

Board Structure and Director Terms

The corporate laws of most states permit Boards to be divided into two or more classes of directors. Directors serving on an unclassified Board serve for one-year terms and stand for election at each annual shareholders' meeting. Directors serving on a "classified" or "staggered" Board – one with multiple classes of directors – serve term lengths equal in years to the number of classes of directors.

The number of directors assigned to each class is divided as equally as possible given the size of the Board. Staggered Boards typically are composed of three classes (the maximum permitted by NYSE rules and most state corporate statutes), with shareholders annually electing directors of one of the classes to serve three-year terms. This results in staggered termination dates for the director classes, enhancing Board continuity.

A staggered Board may reduce flexibility in changing Board membership because directors on a staggered Board typically may be removed only for cause and stand for election only every two or three years. As discussed in Chapter 12, staggered Boards may provide some anti-takeover protection.

Trap for the Unwary:
Pressure Mounts to Abandon Staggered Boards, Adopt 'Majority Voting"

Staggered Boards have increasingly fallen out of favor with some institutional investors and their advisors, like Institutional Shareholder Services. ISS and others have also encouraged companies to require "majority" rather than "plurality" voting for directors. Critics contend that annual elections for all directors together with majority voting, holds the directors accountable every year. In addition, some investors and shareholder activists argue that staggered Boards can limit a target company's stock value in the takeover bidding process. Although the debate continues, Dow Chemical, FedEx, Merck and other large public companies have recently abandoned their staggered Boards, and Pfizer and others have adopted corporate governance guidelines requiring nominees to tender their resignation if they fail to receive a "majority"vote.

Some companies have adopted term limits or age restrictions for their directors. Term or age limits have the advantage of being a simple, objective mechanism to bring greater age diversity to a Board and, at times, to remove a noncontributing director. However, age limits can trigger removal or prevent the company from nominating a committed, highly qualified director who has the time to devote to serving on the Board and its core Committees. Implementing term or age restrictions as nonbinding guidelines, rather than as charter document provisions, can provide greater flexibility.

Board Leadership

Board leadership rests primarily with the Chair and, if appropriate, a lead independent director. Increasingly, Boards are either designating an independent director as Chair, or asking an independent director to share Board leadership with an internal Chair/CEO. This shared role may be as a "Lead Director" or as a "Presiding Director" to preside over meetings and executive sessions of independent directors.

Typical duties of the Chair include:

- Developing agendas, in consultation with management and other directors, and presiding over Board meetings;
- Conducting shareholders' meetings;
- Taking the lead in ensuring Board compliance with corporate governance policies and in setting the tone for ethical business conduct;
- Interviewing potential director candidates, and coordinating with the Nominating & Governance Committee on director, Committee and Chair appointments; and
- Subject to any independence limitations, sitting as an ex officio member of Board Committees of which the Chair is not otherwise a member.

If the Chair is an independent director, then the Chair's role will also include:

- Chairing regular meetings of independent directors;
- Serving as a liaison between the independent directors and management on sensitive issues, including compensation; and
- Taking the lead in setting short- and long-term goals for management and evaluating progress in meeting expectations.

When the CEO serves as the Board Chair, many companies designate an independent Lead (or Presiding) Director to coordinate the activities of the independent directors and:

- Provide input to and assist the Chair in developing Board agendas;

- Coordinate with the Chair regarding information to be provided to the independent directors in performing their duties;
- Chair the regular meetings and executive sessions of independent directors;
- Act as a liaison between the independent directors and the Chair; and
- Take the lead in setting short- and long-term goals for the CEO and in evaluating the CEO's performance.

Board Meetings and Process

Directors may meet in person or, when appropriate, by telephone or videoconference. When no further material discussion is required, a Board may also act by unanimous written consent in lieu of a meeting. A director's failure to attend at least 75% of the Board meetings (and meetings of any Committee on which the director serves) held within a fiscal year generally will trigger disclosure in SEC filings.

Less formal Board gatherings may include annual retreats with senior management to review company strategy, plans and practices, and orientations for new directors to introduce them to the company, its management and corporate governance practices.

The format and frequency of Board meetings will depend on the nature of the company and the powers and duties that the Board delegates to Board Committees.

Practical Tip: Understand "Group" Decisionmaking to Improve Board Behavior

Convening a group of intelligent individuals to make a joint decision is an asset of corporate Boards. However, the failures in board decisionmaking in Enron, WorldCom and other recent corporate governance scandals appeared to arise, in significant part, through flawed group decisionmaking.

Practical Tip: Understand "Group" Decisionmaking to Improve Board Behavior (Cont'd)

Boards can improve decisionmaking by understanding that each director will make decisions in a different manner when serving as part of a group than he or she does when acting individually. For example, studies show that responsible and capable people take less responsibility in group settings, in effect becoming "bystanders," than they would individually. Stress, from time constraints or the importance of a decision, can accentuate human factors that lead to flawed group decisionmaking. Boards can take practical steps to avoid the potential pitfalls of group decisionmaking:

- Keep your Board small or use Board Committees and executive sessions to minimize "bystanders" by discussing decisions in smaller groups;
- Assign a "devil's advocate" role to a director or group of directors to analyze the downside of critical decisions;
- Create a nonconfrontational way for newer or more junior members of the Board to make suggestions, raise questions and give their opinions – especially in that critical first year;
- Assign individual directors areas of focus, on Committees or on a task force in an area of specific concern for the company; and
- Identify anomalies or issues as they emerge and before they become crises.

Regular Meetings of Board

Most Boards schedule regular meetings at least quarterly to review and discuss company activities and to consider various proposals made by Board Committees and management. At regular meetings, a Board may:

- Review financial and operating results and business developments;
- Approve fundamental company plans, strategies and objectives;
- Review management performance and approve senior officer compensation packages;
- Meet with auditors and review accounting policies and internal controls;
- Review and approve SEC filings; and
- Evaluate the company's corporate governance practices and the effectiveness of the Board.

Practical Tip:
Executive Sessions - the Best Things in (Post Sarbanes-Oxley) Life Are Free

Unlike some more costly aspects of Sarbanes-Oxley, executive sessions of independent directors, as a group or as a Committee, serve a vital governance function at virtually no cost. In light of NYSE and Nasdaq mandates requiring executive sessions of non-management and independent directors, companies should adopt a practice of routinely holding executive sessions of independent directors at each Board meeting. NYSE and Nasdaq have few specific requirements as to the timing, format and substance of executive sessions of non-management directors. An ideal format is to schedule an executive session as the final agenda item at each regularly scheduled Board meeting. Some Boards, however, prefer to break out executive sessions as separate meetings entirely.

Practical Tip:
Executive Sessions - the Best Things in (Post Sarbanes-Oxley) Life Are Free (Cont'd)

The Presiding Director and fellow non-management directors set the tone for these meetings. Before each session, the Presiding Director will develop an agenda based on matters before the regular Board meeting or current pressing concerns. While directors usually do not have authority to make decisions while in executive session, they can reach a consensus and carry the discussion back into the formal Board meeting. A good Chair or Lead Director will work with both management and fellow directors to use executive sessions to address critical Board issues over the course of the year.

Executive session proceedings can be informal, sometimes without an agenda. Minutes, if taken at all, reflect only the attendees and time of the meeting.

Special Meetings of Board

A Board will also call special meetings to act on important matters such as possible mergers, acquisitions or divestitures, joint ventures, or securities offerings or other significant financings.

Board Committees

A strong Committee system will allow a Board to function effectively. Sarbanes-Oxley, NYSE and Nasdaq standards and SEC rules prescribe the existence, composition and many of the activities of the three core Committees.

Types of Committees

The three core Board Committees are Audit, Compensation, and the Committee variously known as Nominating, Corporate Governance, or Nominating & Governance. All public companies will have an Audit Committee. NYSE requires, and Nasdaq suggests, an independent director Compensation Committee. NYSE

requires a Nominating & Governance Committee, while Nasdaq requires either a Nominating & Governance Committee or that independent directors meet in executive session to deal with director nominations. (We discuss NYSE's and Nasdaq's Committee requirements in detail in Chapters 9 and 10.)

Audit Committee

Purpose and Authority. The Audit Committee fulfills the Board's oversight responsibilities related to the company's internal controls, financial reporting and audit functions. The Audit Committee is directly responsible for the appointment, compensation and oversight of the company's outside auditor and may engage independent counsel and other advisors as it deems necessary.

Duties. An Audit Committee has four areas of responsibiity:

- *Assessment of the Independent Auditor.* The Committee selects, determines the compensation, monitors the performance of and, when necessary, replaces the outside auditor. Responsibilities include discussing the outside auditor's independence, including objectivity and lack of bias. One critical task for the Audit Committee is to preapprove all audit and any nonaudit services (including tax services) that SEC regulations permit the independent auditor to provide.
- *Review of Financial Statements.* The Audit Committee reviews annual and quarterly financial statements and financial disclosures. The Audit Committee will discuss with management and/or the outside auditor:
    - The MD&A section of the company's periodic reports, including descriptions of critical accounting principles and policies;
    - Management judgments and accounting estimates;
    - Alternative GAAP treatments that the outside auditor has discussed with management;
    - Off-balance sheet structures; and
    - Material communications between the auditor and management, including management letters or disagreements between management and the auditor.

- *Internal Controls and Disclosure Practices.* The Audit Committee has oversight responsibility for internal controls and financial disclosure practices – including overseeing the company's internal audit function. The Committee will review management's and the outside auditor's reports about the company's internal controls, and meet with the company's internal auditors and its Disclosure Practices Committee to evaluate the effectiveness of the company's internal control over financial reporting and disclosure controls and procedures. The Committee should inquire into and be comfortable with the basis for the certifications of the company's CEO and CFO included in periodic reports filed with the SEC.
- *Whistleblower Process.* The Audit Committee is the "buck stops here" reviewer for whistleblower complaints. The Committee sets procedures for, and receives, retains and treats:
    - Internal and external complaints about accounting, internal accounting controls or auditing matters; and
    - Confidential submissions by employees of accounting and auditing concerns.

The Audit Committee has other annual tasks, including self-evaluation and preparing an annual report for the company's proxy statement. As part of the Board's role in setting an ethical tone, the Audit Committee will coordinate with the Board's Nominating & Governance Committee, or a majority of the Board's independent directors, to monitor compliance with the company's:

- Code of ethics for the CEO and senior financial officers (a Sarbanes-Oxley and SEC requirement); and
- Code of Business Conduct and Ethics for employees, officers and directors (a NYSE and Nasdaq mandate).

The Audit Committee defines its duties in a publicly available charter. The Board should approve the charter, and the Audit Committee should annually review and reassess it. The company then files a copy of its Audit Committee charter with its annual proxy statement at least every three years.

Composition. NYSE and Nasdaq require that Audit Committees consist of at least three members. With a few exceptions, all members of the Committee must be independent and financially literate. At least one member should qualify as an "audit committee financial expert," (as we discuss below).

Independence. Audit Committee members must meet two overlapping independence standards, one established by Sarbanes-Oxley, the other by NYSE or Nasdaq. The critical issue is independence from management of the company. (We discuss the NYSE and Nasdaq Audit Committee independence requirements in Chapters 9 and 10.)

Sarbanes-Oxley (and implementing SEC rules) have only two criteria for Audit Committee independence:

- *No Compensation Other Than for Board Service.* Audit Committee members may not accept consulting, advisory or other compensation from the company or an affiliate of the company, except in the director's role as a member of the Board or a Board Committee. This prohibits such indirect payments as payments to spouses or other close family members, or payments to an accounting, consulting, legal, investment banking or financial advisor affiliated with the director.
- *No "Affiliate" or "Affiliated Person."* Audit Committee members may not be "affiliates" or "affiliated persons" of the company. An "affiliate" is any person that directly or indirectly controls, is controlled by, or in common control with the company. An "affiliated person" is a director, executive officer or principal of an affiliate, or anyone whom the affiliate places on the Board to serve as the affiliate's alter ego. The SEC provides a safe harbor to allow a person who owns, or is an executive of an owner of, up to 10% of the outstanding shares to serve on the Audit Committee. Anything above 10% ownership will be tested on a facts and circumstances analysis with the critical test being "is he or she independent from management?"

Financial Literacy. Audit Committee members must be able to read and understand fundamental financial statements, including balance sheets and income and cash flow statements.

Audit Committee Financial Expert. SEC rules implementing Sarbanes-Oxley require that companies disclose in their Form 10-Ks (or in a proxy statement incorporated by reference into the 10-Ks) the names of one or more members of the Audit Committee who qualify as "audit committee financial experts." If the Audit Committee does not have at least one audit committee financial expert, the company must explain why not in the Form 10-K or proxy statement incorporated by reference.

Practical Tip:
"Audit Committee Financial Expert"
Casts a Wide Net

The SEC has adopted a pragmatic definition of "audit committee financial expert." Investment bankers, venture capital investors, stock analysts and others may qualify, along with finance professionals. An audit committee financial expert is a person who has all five of the following attributes:

- Understands GAAP and financial statements;
- Has the ability to assess the application of GAAP to accounting for estimates, accruals and reserves;
- Has experience:
  - Preparing, auditing, analyzing or evaluating financial statements with accounting issues comparable in breadth and complexity to those that can reasonably be expected to be raised in the company's financial statements; or
  - Actively supervising someone engaged in those activities;
- Understands internal control over financial reporting; and
- Understands Audit Committee functions.

Practical Tip: "Audit Committee Financial Expert" Casts a Wide Net (Cont'd)

The Board will need to make a finding that an audit committee financial expert has developed the five attributes through any combination of:

- Education and experience as a CFO, principal accounting officer, controller, public accountant or auditor performing similar functions;
- Experience actively supervising a person in those positions;
- Experience overseeing or assessing the performance of companies or public accountants regarding the preparation, auditing or evaluation of financial statements; or
- Other relevant experience that the Board determines to be adequate (and which it must publicly disclose).

Trap for the Unwary: NYSE and Nasdaq Financial Expertise Requirements

Sarbanes-Oxley and SEC rules allow a company, if it chooses, to disclose that its Audit Committee does not have an audit committee financial expert. However, NYSE and Nasdaq rules *require* that the Committee have a member with accounting and financial management expertise (NYSE) or employment experience or other comparable experience resulting in financial sophistication (Nasdaq). A director who meets the audit committee financial expert requirements under SEC rules is presumed to satisfy the NYSE and the Nasdaq requirements.

Limitation on Multiple Audit Committee Service. NYSE rules generally encourage Boards to limit their directors to serving on an aggregate of three public company Audit Committees – that is, the company's plus two others. If a NYSE company does not limit Audit Committee members to three or fewer, the Board must make an annual determination that such simultaneous service will not impair the director's ability to effectively serve on the Audit Committee. Although Nasdaq imposes no similar limitation, as a practical matter, a limit of three is an excellent rule of thumb.

Meetings. Many Audit Committees will meet eight or more times per year. For example, a Committee may schedule one in-person meeting every quarter to review the company's proposed earnings release and draft financial statements and text of any earnings release. The Committee may then follow with a second telephonic meeting in the same quarter to review and comment on the Form 10-Q prior to filing. Many Audit Committees hold another longer meeting or retreat at least once per year, at a time when there is no pressure to review financial statements, to consider:

- Critical accounting policies and practices;
- Internal financial controls; and
- Disclosure practices and procedures.

The Audit Committee's own "annual meeting" is the one at which the Committee approves the Audit Committee's report for the proxy statement, and audited financial statements that will be part of the Form 10-K annual report. At the meeting, the Audit Committee will consider:

- The auditor's report;
- Auditor independence;
- Procedures and other issues related to financial statements and disclosure;
- Management's internal controls report;
- The draft Audit Committee report culminating in its approval of the financial statements; and
- The appointment of the outside auditor for the new year.

Practical Tip: Use Your Audit Committee in Conflict of Interest Situations

Often, a Board will face a situation requiring action by its independent directors. For example, only disinterested directors should approve a transaction between the company and a director. In fact, Nasdaq requires that the Audit Committee or another Committee of independent directors approve related party transactions, and NYSE advises a similar process. Rather than form a Special Committee of disinterested directors for each situation, the Board may ask Audit Committee (or another existing independent Committee) to review interested director transactions.

Compensation Committee

Purpose and Authority. A company's Compensation Committee develops criteria and goals for, and then reviews and approves, the compensation of the company's senior management. The Committee also develops and establishes equity and other benefit plans, and may review and establish director compensation. Its charter should provide the Committee sole authority to retain, compensate and terminate consultants and advisors to assist the Committee in fulfilling its responsibilities.

Duties. The Compensation Committee will:

- *Set Goals and Objectives.* Review, approve and evaluate achievement of performance goals and objectives by the CEO and other executive officers in connection with their cash and equity compensation. Set compensation levels to motivate management to achieve stated objectives. Align the executives' interests with the long-term interests of the company and shareholders.
- *Establish and Oversee Equity and Benefit Plans.* Establish, administer and review compensatory benefit plans for executive officers and directors and, to a lesser extent, employees generally. Grant or delegate power to grant stock options and restricted stock awards. Ensure that the plans yield benefits in proportion to performance.

- *Recommend Stock Plan Approval.* Recommend Board or shareholder approval of incentive compensation and equity-based plans.
- *Monitor Compliance With Law.* Monitor the regulatory compliance of benefit plans.
- *Approve Public Disclosure.* Review and approve public disclosure, including the Committee's annual executive compensation report in the proxy statement.

Charter. The Compensation Committee should adopt and periodically review a charter that describes its duties.

Independence. The Compensation Committee should be composed of independent directors. NYSE requires a Committee of all independent directors (at least three), and Nasdaq requires either a Committee composed exclusively of independent directors (with a limited exception) or that a majority of independent directors on the Board meet in executive session to perform Compensation Committee duties. To preserve independence, companies will want to avoid interlocking Compensation Committee memberships. An "interlock" occurs when executives serve on the Compensation Committees of one another's companies. Interlocks create an appearance of inappropriate influence and call for appropriate public disclosure.

Independence of Compensation Committee members is important for federal income tax purposes as well. A Compensation Committee should consist entirely of two or more nonemployee directors to allow the company to maintain deductibility of executive compensation under Internal Revenue Code Section 162(m). (Section 162(m) limits the deductibility of compensation over $1,000,000 per year, except for performance-based compensation approved by nonemployee directors.) Having only independent directors on the Committee will also allow the Committee's approval of option grants to executive officers and directors to qualify as exempt purchases under Rule 16b-3 under the 1934 Act.

Compensation Committee Report. In the company's annual proxy statement, the Compensation Committee submits an annual report that describes the bases for the compensation paid to the CEO and other executive officers. Developing the Compensation Committee report is an annual part of the Committee's duties. (We discuss practical tips for drafting the report in Chapter 6.)

Meetings. The Compensation Committee will generally meet at least quarterly. Its "annual" meeting will be held when fiscal year-end results are available, to assess how the company's executive officers performed against corporate and personal goals and objectives for that year and to set new goals and objectives for the new year. The Compensation Committee will also meet as needed to establish or recommend changes to compensation plans.

Trap for the Unwary:
The Compensation Committee After *Disney*

In August 2005, the Delaware Court of Chancery absolved directors of liability for the 1995-96 hiring and firing of former Disney president Michael Ovitz. The Board had approved for Mr. Ovitz a severance package of approximately $140 million for his 14-month tenure. While not finding Disney's directors personally liable, the court sharply criticized their action (and inaction) as falling short of best corporate governance practices. Many lessons of what not to do, wrote the court, could be learned from the Disney Board's conduct.

- *Engage Your Independent Directors at an Early Stage.* Don't deliver decisions on a silver platter! In *Disney,* half of the Compensation Committee was active in negotiations and the other half came in "very late in the game." Engage your entire Compensation Committee in the "many" early stages of critical employment negotiations.

Trap for the Unwary: The Compensation Committee After *Disney* (Cont'd)

- *Seek Expert Advice.* In *Disney*, the court allowed the Compensation Committee to rely on an expert, even though the expert's analysis may have been incomplete or flawed, because the Committee selected him with reasonable care, his analysis was within his professional competence, and the directors had no reason to question his conclusions. So make sure your Committee has the authority to solicit advice, and does, from independent employment compensation experts!
- *Provide Directors With Sufficient Notice and Materials Prior to the Meeting.* Provide notice and materials well in advance of any meeting at which an executive employment agreement is to be discussed, including:
  - A plain English term sheet summarizing the key provisions of the agreement (and, when appropriate, a full draft of the proposed agreement).
  - An analysis of the cost to the company of termination of employment, change of control, etc., including information relating to reasonableness of terms. Make sure your Board knows the bottom line! What's the true value of the compensation provided?
- *Allow Sufficient Time for Discussion and Document the Process.* The *Disney* court focused on the length of board discussions. Insist that your Committee spend sufficient time, and document it! The *Disney* court noted how helpful it would have been had the Compensation Committee minutes shown that the discussion relating to Ovitz was longer than discussion of other issues.

Trap for the Unwary: The Compensation Committee After *Disney* (Cont'd)

- *Establish Succession Planning.* Ovitz came to Disney after an unexpected death of Disney's president and the discovery of the CEO's heart ailment precipitated a too-rapid search. The Compensation Committee can take the lead to implement a robust succession planning process.

Nominating & Governance Committee

Third in the triumvirate of "core" Board Committees sits the Nominating & Governance Committee – to monitor the Board itself.

Purpose and Authority. The Nominating & Governance Committee takes the lead in selecting directors, Committee members and Chairs or Lead Directors. The Committee may also develop corporate governance principles and policies and recommend them to the Board. The Nominating & Governance Committee should have the ability to retain, compensate and terminate its own advisors, including any search firm used to identify director candidates.

Duties. The Nominating & Governance Committee will:

- *Select the Director Slate.* Identify, evaluate and recommend nominees for directors. Recommend Committee members, Chairs, and Lead Directors.
- *Oversee Board Governance.* Develop, review and evaluate the effectiveness of corporate governance principles, including director and Committee member selection guidelines and procedures and director performance criteria.
- *Develop Meeting Procedures.* Assist the Chair or Lead Director in developing Board meeting practices and procedures.

- *Evaluate.* Periodically evaluate the effectiveness of the Board and coordinate periodic evaluations of Board Committees with Committee Chairs.

Either the Compensation Committee or the Nominating & Governance Committee will:

- Establish director compensation practices; and
- Determine procedures for the selection, review, development and succession of executive officers.

The Nominating & Governance Committee may assist the Audit Committee in monitoring ethical codes: the Sarbanes-Oxley code of ethics for the CEO and senior financial officers, and the NYSE- or Nasdaq-mandated code of business conduct for employees, officers and directors.

Charter. The Board should approve, and the Nominating & Governance Committee should annually review, a written charter describing the Committee's duties.

Composition. Like the Audit and Compensation Committees, the Nominating & Governance Committee should be composed of independent directors. NYSE requires a Committee of all independent directors (at least three). Nasdaq mandates either a Committee composed exclusively of independent directors (with a limited exception) or that a majority of independent directors on the Board make director nominations.

Meetings. The Nominating & Governance Committee will meet periodically to discuss and set governance procedures, and to evaluate or select the nominees for election as directors at the annual meeting of the company's shareholders. There is no set recommended number of meetings for the Committee.

Practical Tip: Mirror, Mirror: How Does the Board Evaluate Itself?

Evaluating the Board and its core Committees on an annual basis has rapidly become a "best practice" for public companies. NYSE's listing standards require this in corporate governance guidelines and Committee charters, and many Nasdaq companies conduct evaluations as part of a healthy corporate regimen. No single method has emerged as the "best" evaluation practice. Yet these five practical tips have emerged as consistent guideposts:

- *Choose a Leader to "Own" the Process: Have a Single Director Conduct Each Evaluation.* For the Board, this should generally be the Chairperson (if independent), the Lead Director or the Chairperson of the Nominating & Governance Committee. For each Committee, it will be the Chair. This director has a number of decisions to make, the discussions are sensitive, and the evaluation needs to get done – all good reasons to entrust the process to one person.
- D*ecide: Written or Oral – or Both?* The director responsible for the evaluation process should make a threshold decision as to whether the inquiry and the results should be written or oral. Talk to the CEO, Board Chairperson and general counsel, as there are many opinions – and no perfect answers. Often, the questions are written, the evaluation itself is a live interview, and a summary of the results – including how your Board will address any shortfalls – is in writing. Alternative formats include written questionnaires and a single Board or Committee meeting focused on self-evaluation.

Practical Tip: Mirror, Mirror: How Does the Board Evaluate Itself? (Cont'd)

- *Board Performance: Assessing the Overall Board.* Ask your fellow directors: how is the Board performing responsibilities of strategic planning, financial and risk oversight, succession planning, executive evaluation and compensation.
- *Individual Director Performance: Assess Independence and Suitability for Committees Annually; and Overall Performance Periodically.* The most difficult part of any Board self-evaluation is the assessment of individual director performance. On an annual basis, the Board needs to make independence assessments and determine suitability of the directors for service on its core Committees (Audit, Compensation and Nominating & Corporate Governance). A Board could assess individual directors' performance annually. But it is probably sufficient to make these assessments every second or third year as part of a regular re-nomination process.
- *Shortcomings? Address Them – Promptly.* Self-evaluation will almost certainly reveal some shortcomings. Before completing the evaluation process, develop proposed solutions. And ask the director who "owns" the process to report back to the Board at an appropriate time on success in addressing any issues.

Other Committees

Other standing Board Committees may include:

- *Finance Committee.* A Finance Committee usually reviews the company's financing policies and procedures, and recommends potential debt or equity financings and similar activities. The Board may also delegate to a Finance Committee the authority to approve certain kinds of transactions when approval is required between regularly scheduled Board meetings.

- *Executive Committee.* An Executive Committee typically makes decisions for the company on administrative situations or in an emergency, when the full Board is not readily available to act.
- *"Special" Committee of Independent Directors.* The Board may establish a Special Committee of disinterested directors to evaluate litigation, transactions or other special situations that require arm's-length review. These may include shareholder litigation, a management buyout, contracts with or special compensation to a director or a director affiliate, allegations of wrongdoing by a director or an officer, a change of control, or any other situation in which management or other directors have a conflict of interest.

Board Compensation

Public companies compensate nonemployee directors for Board and Committee service with a combination of cash and securities. Some companies also permit their nonemployee directors to participate in company-deferred compensation or other benefit plans. Outside director compensation varies considerably from company to company. Employee directors generally receive limited or no additional compensation for Board service.

In the current environment, with its increased focus on the time and care that directors should devote to Board service, companies have increased director compensation. Directors who assume the highest level of responsibility, including Lead Directors, Committee Chairs and Committee members earn more, in proportion to their responsibilities. The Board or the Nominating and Governance Committee should periodically evaluate their director compensation package against peer companies to ask: "Are we competitive? Do we appropriately match rewards to Board effort, risk and results?"

Cash Compensation

Most companies pay their directors an annual cash retainer for Board and Committee service. Cash for Board service ranges from about $10,000 to up to $100,000 or more per year. Directors may receive additional compensation for meetings, Committee service and service as a Committee Chair or Lead Director. For example, a Board may pay:

- An annual retainer to Board Committee Chairs;
- An additional retainer to Audit Committee members; and
- Per-meeting attendance fees.

Equity Compensation

Most public companies make initial option or restricted stock grants to directors upon commencement of Board service. Directors then often earn additional grants as part of an annual compensation package. Many public companies pay annual retainers exclusively with equity grants, rather than cash. It is common for initial option or restricted stock grants to be larger and have longer vesting periods (e.g., two to four years), and for annual grants to be smaller and have shorter vesting periods (e.g., one year or immediate vesting).

Practical Tip:
Stock Ownership Goals

Does equity or cash compensation provide better incentive to directors? In the wake of Enron and other corporate scandals, there has been increasing debate.

Some companies believe equity-based compensation may encourage directors to act in ways that may increase the short-term value of their equity stake at the expense of the company's long-term interest. Other companies believe that equity can better align the interests of directors with those of shareholders. These companies may:

- Establish minimum goals (based on a number of shares or dollar amount) for stock ownership by directors;
- Integrate these goals with a compensation plan that allows directors to elect to receive a portion of their annual compensation in stock; and
- Give each director two to five years to achieve the stock ownership goal.

Director Responsibilities

State statutes, court decisions and, increasingly, federal laws and regulations define the duties of directors. Yet even after the wave of new regulations, the basic duties of directors remain unchanged.

Although there are nuances in the duties imposed by various states, most generally hold directors to fiduciary duties of care and loyalty. In recent years, some courts have imposed an additional duty of candor.

Duty of Care

Directors owe the company and its shareholders a duty to exercise the care that an ordinarily prudent person in a like position would exercise under similar circumstances. A director is not presumed to have special management skills, but is expected to exercise common sense and apply the skills he or she possesses. Time devoted to the exercise of this duty will increase in proportion to the importance and complexity of the proposed corporate action. Significant decisions, such as these, will require substantial diligence:

- Merging or selling the company;
- Establishing or waiving anti-takeover defenses;
- Hiring, terminating or setting compensation for management;
- Approving debt or equity offerings, or other material financings;
- Entering into new lines of business; and
- Approving an annual budget or business plan.

Due care requires directors to inform themselves of all reasonably available material information prior to making a business decision. A director can best assess each proposal's strengths and weaknesses by taking these steps:

- Expect advance notice of the purpose of each Board meeting;
- Review documentation describing the rationale and key terms of any proposed transaction;
- Discuss any proposed transaction with the company's legal and financial advisors;
- Attend meetings; and
- Make sufficient inquiry – ask questions prior to and at the Board and Committee meetings – in order to discuss and understand as fully as possible all the relevant issues.

Practical Tip:
No Speeding!

You may want to use this image to illustrate the duty of care for your Board:

"Directors get in trouble for speeding, not for running the car off the road."

In other words, the Board should act in good faith to make its best thoughtful, considered and informed decision. Assuming no conflicts of interest exist and the Board follows an appropriate process, courts usually will not second-guess the directors if, in hindsight, the Board makes a wrong choice or takes a wrong turn, even if the company appears to have been harmed.

In making decisions, a director may generally rely on information and reports from the company's officers and employees, legal, financial and other advisors, and Board Committees. However, reliance should be prudent. Each director should assess the qualifications of the parties providing information and advice, examine the work product and not have knowledge that would make reliance unreasonable. In reviewing material, the three best rules of thumb are simply:

- Ask;
- Ask; and
- Ask.

Duty of Loyalty

A director owes the company and its shareholders a duty of loyalty to give higher priority to corporate interests than to his or her personal interests in making business decisions. If a director has a personal interest in a matter, he or she must fully disclose the interest and will often abstain from voting on or participating in discussion of the matter. Similarly, directors should not pursue, other than through the company, business opportunities that relate

to the company's existing or contemplated business unless disinterested members of the Board, after full disclosure, have decided that the company will pass on the opportunity.

Conflicts of Interest. Conflicts of interest and corporate opportunities shadow the day-to-day conduct of a Board's business. A director may, for example, have a corporate opportunity or conflict of interest as a result of:

- An inside director's employment or severance arrangement;
- Passive investments that are material to the director's portfolio; or
- An interest in the potential purchaser in a change-of-control transaction.

The frequency of conflicts of interest has given rise to a host of mechanisms to manage conflicts. Using them should permit a Board to act responsibly. Ways to manage conflicts of interest include:

- *Approval by a Majority Vote of the Board, With Interested Directors Abstaining.* If only one director, or a small number of directors on a larger Board, has a conflict of interest, a majority of the disinterested directors may approve the transaction. In this situation, a director with a conflict should fully disclose his or her conflict, including all facts that would be relevant to the Board's decision, remove himself or herself from discussion at appropriate times, and abstain from voting.
- *Approval by an Independent Committee.* The Board may establish an Independent Committee of disinterested, independent directors to approve a particular transaction. Either the Board Chair or disinterested directors will take the lead in establishing the Committee. The Board may either delegate the final decision to the Independent Committee or ask the Committee to make a formal recommendation to the Board for approval. The Committee should act independently, with an adequate budget to seek independent legal counsel and financial advisors, as the Committee feels appropriate.

- *Approval by Shareholders.* If all or nearly all directors have a conflict of interest, the Board may ask for shareholder approval of a particular transaction. The proxy statement disclosure to shareholders should describe the transaction and fully disclose all conflicts of interest and other relevant information. The Board may either recommend the transaction to the shareholders or call for a shareholder vote without a Board recommendation.

In unusual situations, where all or virtually all directors have a conflict, and where shareholder approval is impractical or the shareholders themselves have conflicts of interest, the Board may take an action that it believes to be "entirely fair" to the company. It is rare for a public company to act on this basis. Shareholders have the right to challenge this transaction. A court will uphold the action if it establishes that the action was fair to the company at the time the Board approved it.

Duties to Other Stakeholders

The interests of the company and its shareholders, while primary, are not the sole consideration of the Board. Many states have adopted "constituency statutes" that now permit directors to consider the interests of other constituents, including employees, customers, suppliers and communities when making business decisions. In addition, when a company becomes or is likely to become insolvent, the director's duty of loyalty may shift primarily to the company's creditors.

Duty of Candor

Delaware judicial decisions have articulated a duty of candor or disclosure. This additional responsibility derives from both the duty of care and duty of loyalty. The duty of candor calls on directors to disclose to their fellow directors and the company's shareholders all information known to them that is relevant to the decision under consideration. In judging whether a director has satisfied his or her duty of candor, courts will examine the materiality of all undisclosed or underdisclosed information.

Judicial Review: Business Judgment Rule

Courts apply the business judgment rule in reviewing most decisions made by directors. Under the business judgment rule, courts defer to the decisions of disinterested directors absent evidence that the directors did not act in good faith or were not reasonably informed, or that there is no rational business purpose for the decision that promotes the interests of the company or its shareholders.

Enhanced Scrutiny

Courts in Delaware and other states apply a more stringent "enhanced scrutiny" standard when reexamining transactions involving the adoption of anti-takeover measures, implementation of deal protection mechanisms such as lock-up options, a change of control or a breakup of the company. In defending its adoption of anti-takeover or deal protection measures, the Board must show two things:

- The Board had reasonable grounds for believing that a threat to company policy and effectiveness existed; and
- The measures the Board adopted were proportional in relation to the threat posed.

If the Board can establish both elements, the action should receive the protection of the business judgment rule. If the Board elects to pursue a change of control or breakup of the company, the Board has a duty to obtain the highest value reasonably available for shareholders (commonly referred to as the *Revlon* standard).

Practical Tip: Obtain a Fairness Opinion

Courts give special deference to Boards that seek truly independent third-party advice, such as that of an investment bank, valuation consultant or law firm, to assist disinterested directors in assessing a transaction. An opinion from a reputable third party financial advisor that a transaction is fair to the company and its shareholders from a financial point of view may substantially reduce the risk of successful challenge to the Board's decision under any standard of review. A fairness opinion can also help independent directors make an informed decision.

Without a fairness opinion, directors may find themselves in the unfortunate position of the directors of Trans Union Corporation. In the 1980's, Trans Union directors approved a sale of their company. In the case *Smith v. Van Gorkom*, a Delaware court held that the Board breached its fiduciary duties by acting without adequate information or independent third-party advice. The court concluded that the Board's decision to accept a market premium without first determining the intrinsic value of Trans Union's shares left the directors vulnerable to personal liability to the company's shareholders to the extent a fair price exceeded the sale price.

In 2005 the *Disney* court placed weight on the Compensation Committee's reliance on an independent compensation expert. The Committee was entitled to rely even though the expert's analysis may have been incomplete or flawed. The Committee had selected the expert with reasonable care, the analysis was within his professional competence, and the directors had no reason to question his conclusions.

Entire Fairness

The most demanding judicial standard of review – entire fairness – applies when independent directors have not approved or cannot approve a transaction, and the approving directors have a financial interest in, or other conflict with respect to, a transaction. Under the entire fairness standard, courts conduct a broad substantive inquiry into whether the transaction is fair to the company and its shareholders, in light of all the relevant facts and circumstances that existed at the time of the transaction. Transactions are also reviewed for entire fairness when a court finds a breach of the duty of care, or if the Board fails to meet the enhanced scrutiny standard.

Trap for the Unwary: Reliance on Experts Is NOT a Safe harbor

As *Smith v. Van Gorkom* and *Disney* show, as a director you have traditionally been able to demonstrate good faith and due care by relying on reports prepared by expert advisors to the company, such as bankers and accountants, regardless of your personal qualifications. But, there are limits to the "safe harbor" for a director who "should have known better."

In the recent *Emerging Communications* case, a Delaware court determined that an outside director who, as an investment banker, possessed special expertise had no right to rely on a fairness opinion of the company's independent investment banker. The court found that the director violated his duties of loyalty and/or good faith in approving a transaction because, given his background he should have known that the transaction was unfair to minority shareholders. The key take-away:

- Although directors are generally permitted to rely on reports prepared by third-party advisors, if you possess special knowledge or skill, you may be held to a higher standard than your peers.

Liabilities and Indemnification Provisions

A public company's directors and officers may be subject to personal liability under statutes relating to employee benefits, tax, antitrust, foreign trade, environmental and securities matters. As discussed above, directors are also liable for breaches of their duties of care, loyalty and candor. To encourage individuals to serve as directors and officers, state laws permit companies to limit director liability and indemnify their directors and officers against some of this exposure.

Limiting Director Liability

Delaware and Model Business Corporation Act states permit charter documents to include "raincoat" provisions that eliminate the personal liability of a director to the company or its shareholders for monetary damages for some breaches of director duties. However, corporations cannot limit directors' liability in situations that involve:

- Breaches of the duty of loyalty;
- Intentional misconduct;
- Unlawful payment of dividends;
- Transactions from which the director derived an improper personal benefit; or
- Breach of the duty of good faith (no limitation permitted in Delaware, but is allowed in most Model Business Corporation Act states).

Practical Tip:
The Best Way to Limit Liability? Keep Informed

Even the most robust charter provisions limiting director liability are subject to limitations, particularly in today's dynamic legal and business environment. The most effective way for you as a director to reduce your exposure to fiduciary claims is to:

- Adopt effective corporate governance and compliance procedures;
- Monitor compliance with those processes; and
- Actively oversee the business and operations of your company.

Actively inquire into and inform yourself about the corporate decisions that the Board will consider. Comply with the duty of loyalty to the company and create a robust record that demonstrates that you and your colleagues have met your duties of care and loyalty. Do these, and the business judgment rule should protect you from personal liability.

Indemnifying Directors and Officers

The corporate laws of nearly all states provide for mandatory and permissive indemnification of directors and officers, and related rights.

Mandatory Indemnification. A company typically must indemnify a director or officer who is successful on the merits for incurring any expense in an action or claim brought as a result of the individual's status as a director or officer. Some states require the director or officer to be wholly successful on the merits, while other states, including Delaware, provide for mandatory partial indemnification to the extent of the individual's successful defense.

Permissive Indemnification. The corporate laws of most states permit a company to indemnify its directors and officers against expenses incurred in specified actions if they acted in good faith and in a manner they reasonably believed to be in, or not

opposed to, the company's best interests. Directors and officers may receive indemnification in a criminal action or proceeding if they had no reasonable basis to believe their conduct was unlawful. However, indemnification usually is not available for actions by the company for amounts paid in settling derivative actions, or when the directors or officers are found to be liable to the company.

Advancement of Expenses. Most states also permit a company to advance defense costs to its directors and officers. State law typically provides that the company may require the director or officer to sign an agreement (an "undertaking") to repay any advanced amounts if it is ultimately determined that the individual's conduct did not meet the applicable standard of conduct to entitle him to indemnification.

The Sarbanes-Oxley provision that prohibits personal loans to directors and officers has led to the follow-up question: "Are indemnification advances – by their very nature an advancement of funds – prohibited loans?" The answer is "Probably not." Nothing in Sarbanes-Oxley suggests that Congress intended to curtail the long-established practice of indemnification advances.

Practical Tip: Not Yet Public?
Add D&O Coverage Prior to the IPO

D&O insurance coverage is subject to exclusions similar to those that apply under state law to corporate indemnification obligations, including:

- Claims arising out of personal benefits to which the director or officer was not legally entitled;
- Claims arising out of criminal or fraudulent acts;
- Losses arising out of illegal payments to directors and officers; and
- Losses arising out of violations of insider trading laws.

Practical Tip: Not Yet Public? Add D&O Coverage Prior to the IPO (Cont'd)

An insurance broker can provide detailed information and recommendations regarding appropriate D&O coverage. Independent insurance industry experts can also analyze your company's D&O insurance needs. Liability counsel can advise your company on the terms of D&O coverage, particularly terms relating to retentions and exclusions. The Board should periodically evaluate the coverage to ensure that it continues to meet the evolving needs of the company.

Indemnification Agreements

In addition to implementing charter document indemnification provisions, some companies enter into indemnification agreements with their directors and officers. To the extent a company's charter documents provide for broad indemnification rights and specifically state that these rights are contractual, indemnification agreements may not seem to provide substantial additional protection.

But in reality, an agreement may provide great comfort to directors and officers. It adds clarity and provides protection against future alterations of charter documents. If any contractual rights are broader than those provided by statute, courts may subject them to review on public policy or reasonableness grounds.

Director and Officer (D&O) Insurance

Most public companies purchase insurance to cover liabilities arising from their directors' and officers' actions on behalf of the company. D&O insurance provides a potential source of reimbursement to the company for indemnification payments it makes to its directors and officers. D&O insurance also motivates individuals to serve as directors and officers by reducing their exposure to personal liability from potential gaps in the availability of indemnification, and in situations such as insolvency where the company cannot adequately indemnify its directors and officers. Most D&O

policies include "entity" coverage, which also insures the company directly for its liability on certain defined claims without diluting available coverage for directors and officers.

In addition to D&O policies that concurrently cover directors, officers and the company, many companies also purchase supplemental "side-A" coverage that covers only directors and officers. This avoids a claim in a bankruptcy context that D&O proceeds of the general policy are assets of the debtor's estate and are not available to indemnify directors and officers.

Practical Tip:
Five D&O Questions to Ask
Your General Counsel Annually

Help ensure that your company has taken necessary steps to reduce exposure to liability of the company and its directors and officers. Ask your company's legal counsel these five questions annually:

- *Would you do anything, if you had the authority, to improve our internal financial controls or our disclosure practices and procedures?* Have we established and kept current reliable policies, controls and procedures for gathering, assessing and timely reporting of financial and other 1934 Act information and for communicating with investors?
- *Do you believe that we have a current and effective policy on insider trading?* Do we have policies and practices to protect the confidentiality of material nonpublic information?
- *Would you suggest any changes to our certificate or articles of incorporation and bylaws to provide the maximum liability limitations and indemnification permitted by law?*

Practical Tip: Five D&O Questions to Ask Your General Counsel Annually (Dont'd)

- *Are our D&O insurance coverage limits high enough?* (This question is especially pertinent if the company's market capitalization is growing quickly and might outstrip earlier coverage.)
- *Are the terms of our D&O coverage sufficiently broad?* What are the limits? Did we negotiate aggressively to expand coverage?

Chapter 9

Governance on the "Big Board": NYSE Listing Standards

When a company agrees to list its securities on the New York Stock Exchange, it agrees to adhere to listing rules and regulations designed to achieve a high standard of corporate governance and disclosure. For example, in addition to SEC disclosure requirements, NYSE companies agree to follow strict standards regarding Board and Board Committee independence, promptly disseminate to the public information that would reasonably affect an investor's decision to trade in a company's securities and notify the exchange of specified material events.

This Chapter presents an overview of the obligations that NYSE requires of its listed companies, including:

- Initial and continued quantitative and corporate governance listing requirements;
- The need to notify NYSE upon the occurrence or anticipated occurrence of certain events; and
- Disclosure of material, or otherwise specified, information to NYSE and the public.

While some of these requirements mirror those imposed by the SEC, they are in fact independent contractual obligations. A company and its counsel must ensure that the company satisfies both SEC and NYSE requirements.

Listing Requirements

NYSE imposes quantitative and qualitative (including corporate governance) standards, both initially and on an ongoing basis. Quantitative standards require issuers to meet objective financial and share distribution criteria. Qualitative standards consider the ongoing corporate status and the corporate governance of NYSE companies.

Initial Listing Requirements

A company seeking to list its securities with NYSE must comply with a set of initial quantitative and qualitative listing requirements as a precondition to listing. As we describe in Appendix 4, NYSE provides alternative sets of some of the initial quantitative listing requirements. A NYSE company must also comply with qualitative requirements, which the company will work through with NYSE during its initial listing.

Continued Listing Requirements

NYSE requires that listed companies continue to meet minimum quantitative and qualitative listing requirements in order to remain listed. A company's failure to maintain these standards over a specified period of time triggers delisting procedures that may ultimately result in removing a company's securities from NYSE.

A company will be considered non-compliant with NYSE standards if it falls below the following criteria:

NYSE Continued Listing Standards

Quantitative Requirements	Standard
Pricing Standards:	
Average closing price over 30-consecutive-trading-day period of listed company's security	$1.00
Financial Standards:	
(a) For companies that listed under the earnings standards:	
Average global market capitalization over 30-consecutive-trading-day period	$75 million
AND	
Total shareholders' equity	$75 million
OR	
Average global market capitalization over 30-consecutive-trading-day period	$25 million
(b) For companies that listed under the pure valuation with cash flow standard:	
Average global market capitalization over 30-consecutive-trading-day period	$250 million
AND	
Total revenues for the most recent 12 months	$20 million
OR	
Average global market capitalization over 30-consecutive-trading-day period	$75 million

NYSE Continued Listing Standards

Quantitative Requirements	Standard
(c) For companies that listed under the pure valuation standard:	
Average global market capitalization over 30-consecutive-trading-day period	$375 million
AND	
Total revenues for the most recent fiscal year.....	$15 million
OR	
Average global market capitalization over 30-consecutive-trading-day period	$100 million
Distribution Standards:	
Public float	600,000 shares
Shareholders (including beneficial owners of stock held by NYSE members)	400
Shareholders (including beneficial owners of stock held by NYSE members) when average monthly trading volume (for past 12 months) falls below 100,000 shares.....	1,200

Qualitative Requirements	Standard
Continued compliance with NYSE corporate governance standards	See below
Absence of certain changes in a company's ongoing corporate status (e.g., sale or intent to cease, for any reason, use of substantial portion of operating assets; intent to file for bankruptcy or liquidation).....	Discuss with NYSE as applicable

NYSE Corporate Governance Standards

NYSE has established corporate governance standards for its listed companies. These governance standards are aimed at bolstering public confidence in NYSE companies, promoting prompt public disclosure of material events and enhancing corporate ethics and democracy. Companies must comply with these corporate governance standards as an ongoing condition to NYSE listing. Many Nasdaq companies follow the principal NYSE standards (or at least some of them), as we describe them here, as part of corporate governance "best practices."

A Majority of Directors Must Be Independent

A majority of the Board members of a NYSE company must qualify as "independent directors." In addition, all members of the three core Board Committees (Audit, Compensation and Nominating and Governance) must be "independent directors." For a director to qualify as "independent" under NYSE standards, a company's Board must affirmatively determine that the director has "no material relationship with the listed company" (including any parent or subsidiary in a consolidated group). The Board must consider the materiality of a director's direct and indirect relationships, as a partner, shareholder or officer of an organization with links to the company. A material relationship can come in many forms, including commercial, industrial, banking, consulting, legal, accounting, charitable or familial. (However, significant stock ownership by itself is not necessarily a material relationship.)

A company will need to disclose its independent directors and any relationships those directors have with the company (or if no proxy statement is filed, in its Form 10-K). A Board may determine categories of relationships it does not find material to assist it in making independence determinations (as long as these categories do not conflict with NYSE's bright line "independence" disqualifiers discussed below. If the Board makes categorical determinations, it will describe them in the proxy statement. The proxy statement could then simply disclose that a director's relationships fall within the categorical determinations, without detailing those relationships. However, if a Board determines that a relationship fails to fall into the Board's categorical determinations but that the director is nevertheless independent, then the company must describe the

relationship and disclose the basis for the Board's determination that the relationship does not affect the director's independence in the proxy statement.

Practical Tip:
Adopt Categories of Relationships Not Deemed Material

Most Boards of NYSE companies should seriously consider adopting and disclosing categories of Director relationships not deemed material to assist in making independence determinations. This will allow a Board to limit its detailed, often time-consuming, independence determinations to those relationships that fall outside the defined categories. In most cases, the company will only need to confirm that an independent director's relationships fall within the defined categories, eliminating lengthy descriptions of relationships with directors that often do not provide investors with meaningful information. A Board should periodically review and update its categorical determinations.

What's "Independence"? NYSE Describes "What's Not"

A director who has any of the following relationships is not independent:

- *Employment Relationship.* A director who is or was an employee within the last three years, or has an immediate family member who is or was an executive officer of the company within the last three years, will not be independent. Employment as an interim Chairman, CEO or other executive officer does not necessarily disqualify the director from being considered independent following that employment.
- *Compensation in Excess of $100,000.* A director who has, or whose immediate family member has, received more than $100,000 in any 12-month period within the last three years of direct compensation from the company, other than Board and Committee fees and pension or other deferred compensation for prior service (provided

the compensation is not contingent on continued service), will not be independent. Compensation that a director receives for past service as an interim Chairman, CEO or other executive officer and compensation that an immediate family member receives for service as a non-executive officer employee of the company *do not necessarily* disqualify the director from being considered independent.

- *Relationships with the Company's Internal or External Auditor.* Any of these auditor relationships will make a director not independent: (a) being a current partner or employee of the company's internal or external auditor; (b) having an immediate family member who is a current partner of the company's internal or external auditor or is a current employee of those auditors who participates or participated in its audit, assurance or tax compliance (but not tax planning) practice; or (c) having been, or having an immediate family member who was, a partner or employee of the company's internal or external auditor personally working on the company's audit within the past three years.
- *Interlocking Directorate.* A director will not be independent if the director or an immediate family member is or was employed within the last three years as an executive officer of another company (including non-profit), at the same time that a current executive of the company served on the other company's Compensation Committee.
- *Significant Business Relationship.* A director will not be independent if the director is a current employee, or an immediate family member is a current executive officer, of another company that made payments to or received payments from the NYSE company that exceeded, in any of the past three fiscal years, the greater of $1 million or 2% of the other employer's consolidated gross revenues.

Trap for the Unwary: Watch Those Charitable Contributions!

Charitable organizations generally are not considered "companies" for purposes of the "significant business relationship" disqualifier. However, your company must disclose in its annual proxy statement any contributions made by the company to any charitable organization in which an independent director serves as an executive officer if, within the previous three years, contributions in any single fiscal year exceeded the greater of $1 million or 2% of the charitable organization's consolidated gross revenues. Remember that your Board must consider any contribution to charitable organizations among the relationships it evaluates as part of its overall director independence determination. As a result, many NYSE companies determine at least some director relationships with charitable organizations as categories of relationships not deemed material.

Executive Sessions for Non-Management Directors

NYSE companies will schedule "regular" executive sessions in which non-management directors meet without management participation. "Non-management directors" exclude company officers, but may include other directors who may not be independent because of a material relationship. If the group of "non-management directors" includes any non-independent directors, then the independent non-management directors should meet separately at least once a year.

The non-management directors will want to either appoint a single presiding non-management director for all executive sessions or rotate the presiding position pursuant to a set procedure. (Companies generally seem to name the Lead Director or an independent Chair as the Presiding Director.) The annual proxy statement will name the Presiding Director or the procedure by which the Presiding Director is selected for executive sessions, as well as a method for interested parties to communicate directly with the Pre-

siding Director or with the non-management directors as a group. (We provide practical tips for organizing executive sessions in Chapter 8.)

Audit Committee

Composition and Independence. NYSE standards require that an Audit Committee consist of at least three independent directors. Audit Committee members must meet two overlapping independence standards, one established by Sarbanes-Oxley, the other by NYSE:

- *Sarbanes-Oxley* – An Audit Committee member may not receive any payment from the company other than for Board or Committee service or be an "affiliated person" of the company or any subsidiary. (We discuss these Sarbanes-Oxley independence requirements in detail in Chapter 8.)
- *NYSE Criteria* – If an Audit Committee member is determined to be an independent director under NYSE rules, and meets the Sarbanes-Oxley criteria for Audit Committee independence, the member will meet NYSE requirements for Audit Committee independence.

Audit Committee Financial Literacy and Financial Expertise. Each member of the Audit Committee must be, or within a reasonable period of time following appointment must become, "financially literate." At least one member must have "accounting or related financial management expertise". Each NYSE company's Board can set its own standards for financial literacy and financial expertise. The Board can presume that a person who meets the SEC's "audit committee financial expert" standards has the requisite accounting and financial expertise to meet NYSE standards. (We discuss the "audit committee financial expert" standard in Chapter 8.)

Audit Committee Must Adopt Written Charter. A NYSE company will have a written charter that addresses:

- *Purpose.* The core role of an Audit Committee is to help the Board fulfill its duty of overseeing management's financial operations and reporting. It reports on this role in the Audit Committee report in the annual proxy

statement. The Audit Committee's oversight functions cover:

- The integrity of the company's financial statements;
- The company's legal and regulatory compliance;
- The independent auditor's qualifications and independence; and
- The performance of both the internal audit function and the external auditor.

- *Duties and Responsibilities*. These include, among others (some of which are discussed in Chapter 8):
  - *Review of the Independent Auditor:* Annual review of the auditor's performance (including that of the lead partner and the need for rotation of auditor personnel), qualifications, independence, and internal quality control procedures.
  - *Review of Financial Statements and Earnings Releases:* Reviewing and meeting to discuss quarterly and annual financial statements with management and the independent auditor, including MD&A. Review and discuss earnings releases or guidance to analysts and rating agencies. (NYSE does not require specific pre-release review, instead permitting general guidance regarding releases. However, most Audit Committees, or key members, do preview earnings releases and guidance.)
  - *Oversight of Risk Exposure Policies:* Discussing the company's process for setting policies to govern risk assessment and management, including guidelines, policies and major financial risk exposure.
  - *Holding Executive Sessions:* Holding separate and periodic meetings with management, the internal auditor and the independent auditor.
  - *Review of the Audit Process:* Reviewing audit problems or difficulties (and management's responses) with the independent auditor.
  - *Informing the Board:* Regularly reporting to the Board on financial statements, compliance with laws and regulations, external and internal auditors' performance, and internal audit procedures.

- *Annual Self-Evaluation.* The Audit Committee must annually assess its performance.

Practical Tip:
Audit Committees Should Plan on Scheduling Additional Meetings or Meet Later in the MD&A Review Process

To comply with NYSE standards, the Audit Committee must review and discuss a relatively advanced draft of the MD&A included in a company's periodic reports, instead of simply discussing the MD&A disclosure in general. Accordingly, Audit Committees will need to schedule meetings in order to review MD&A disclosure in a form in which it is close-to-ready to be filed with the SEC. These meetings can be telephonic or in person.

Internal Audit Function. NYSE requires each listed company to have an internal audit function. A company may outsource this function to a third party other than its independent auditor.

Board Must Evaluate Effectiveness of Director's Service on Multiple Audit Committees. Does a director serve on more than three public company Audit Committees? If so, the Board will need to decide (and disclose its decision in the annual proxy statement) whether these commitments impair a director's ability to serve as an effective Audit Committee member.

Compensation Committee

Each NYSE company must have a Compensation Committee composed solely of independent directors. Each Compensation Committee will have a written charter that addresses:

- *Purpose and Responsibilities*. In addition to preparing the Compensation Committee report for the annual proxy statement, each Compensation Committee must at least oversee:

- *CEO Goals, Performance and Compensation:* The Compensation Committee reviews and approves corporate goals and objectives relevant to the CEO's compensation, evaluates the CEO's performance in light of those goals and objectives, and determines and sets the CEO's compensation level based on its evaluation (either as a Committee or with other independent directors as directed by the Board); and
- *Non-CEO Executive Compensation:* The Compensaton Committee recommends to the Board non-CEO executive compensation, incentive-compensation plans and equity-based plans that are subject to Board approval. (We discuss other duties and responsibilities of the Compensation Committee in Chapter 8.)

- *Annual Self-Evaluation.* The Compensation Committee must annually assess its performance.

Nominating and Governance Committee

Each NYSE company must have a Nominating and Governance Committee composed solely of independent directors. The Nominating and Governance Committee must have a written charter that addresses:

- *Purpose and Responsibilities.* The Nominating and Governance Committee's principal function is to oversee corporate governance, including, at a minimum:
  - Identifying qualified director nominee candidates consistent with criteria approved by the Board;
  - Selecting, or recommending that the Board select, director nominees for the annual shareholders' meetings;
  - Developing and recommending to the Board a set of corporate governance guidelines; and
  - Watching over the evaluation of the Board and management. (We discuss other duties and responsibilities of the Nominating and Governance Committee in Chapter 8.)
- *Annual self-evaluation.* The Nominating and Governance Committee must annually assess its performance.

Practical Tip: A "Controlled Company" Is Exempt From Independence and Certain Committee Requirements

Is your company a "controlled company" – one where more than 50% of the voting power of the company's securities is held by an individual, group or another company? If so, you may choose to be exempted from NYSE requirements relating to:

- Board independence; and
- Independent Compensation and Nominating and Governance Committees.

If your company opts to use the "controlled company" exemption, you will need to describe your "controlled company" status and explain that you are using the controlled company exemption, in your annual proxy statement. A controlled company must continue to comply with NYSE's other corporate governance standards, including the requirements relating to an independent Audit Committee and regular executive sessions of non-management directors.

Corporate Governance Guidelines

The "Corporate Governance Guidelines" required of each NYSE company allow the Board and senior management to publicly set out the key tenets of their company's governance values. Prominently featured on the "Corporate Governance" page of NYSE companies' websites, the Guidelines should address:

- Director independence standards, qualifications, responsibilities and compensation;
- Director access to management and independent advisors;
- Director orientation and continuing education;
- Management succession (including selection and contingency policies); and
- Annual self-evaluation of the Board.

NYSE calls for website posting of a company's Corporate Governance Guidelines, Code of Business Conduct and Ethics and core Committee charters (including at least the Audit, Compensation and Nominating and Governance Committees). Companies use website posting both as a way to publicly set forth the "tone from the top" of the CEO and Board, and as a ready reference for employees, directors and shareholders. The annual proxy statement may also remind shareholders that this information is available on the website and, on shareholder request, in print.

Code of Business Conduct and Ethics

Paired with the Corporate Governance Guidelines is the NYSE-required Code of Business Conduct and Ethics – a practical set of ethical requirements for a NYSE company's officers, directors and employees. Only the Board or a Board Committee can waive violations of the code by directors or executive officers, and the company must promptly disclose any waivers to its shareholders.

A NYSE-compliant Code of Business Conduct and Ethics will, at a minimum, address:

- Conflicts of interest, corporate opportunities and fair dealing;
- Confidentiality and protection and proper use of company assets;
- Compliance with laws, rules and regulations (including insider trading laws); and
- Proactive reporting of any illegal or unethical behavior (with protections against retaliation).

In reviewing a Code of Business Conduct and Ethics, the Board should be careful to ensure that the drafters have provided for sufficiently practical and general compliance standards so that the Board or a Board Committee is not put in a position of regularly considering waivers.

Annual CEO Certification of Compliance With NYSE Corporate Governance Standards

A NYSE company's CEO will annually certify to NYSE that he or she is unaware of any violation of NYSE's corporate governance standards. The certification will detail any qualifications. On an ongoing basis, the CEO must promptly notify NYSE in writing if any executive officer of the company becomes aware of noncompliance with NYSE's corporate governance standards.

NYSE May Issue Public Reprimand Letters

NYSE may issue a public reprimand letter to a listed company that it determines has violated any NYSE listing standard. For companies that repeatedly or flagrantly violate NYSE standards, the reprimand could lead to suspension or delisting.

Practical Tip: "Welcome to the Big Board": Grace Periods for Newly Listed Companies

IPO Companies

A company listing with NYSE at the time of its IPO has 12 months from the date of listing to satisfy the requirement that a majority of its Board members be independent. And, a newly public NYSE company will be allowed to phase in its independent Audit, Compensation and Nominating and Governance Committees over a 12-month period (this phase-in period mirrors the timeline that IPO companies have to comply with the Sarbanes-Oxley mandated Audit Committee requirements):

- One member of each core Committee (Audit, Compensation and Nominating and Governance) must be independent generally at the completion of the IPO process;
- A majority of the members of the core Committees must be independent within 90 days of listing; and

Practical Tip: "Welcome to the Big Board": Grace Periods for Newly Listed Companies (Cont'd)

- All members of the core Committees must be independent within one year of listing.

As a practical matter, most companies completing an IPO will want to have a majority of independent directors and at least a substantially or fully independent Audit Committee around the time of the IPO in order to meet investors' expectations.

Transferring Companies

For a company transferring from another exchange or market to NYSE (for example, from Nasdaq to NYSE), NYSE has special rules governing the phase-in period of its corporate governance requirements. Generally, if the exchange or market from which a company is transferring did not have the same requirements as NYSE, the transferring company has one year from the date of transfer in which to comply with the applicable NYSE requirements. Generally, if the exchange or market from which the company is transferring had substantially similar requirements but also provided for a transition period for its new companies, and that period has not expired, then the transferring company will have that same remaining period to comply with the applicable NYSE requirements upon transfer to NYSE.

Shareholder Approval

NYSE requires shareholder approval of the following key corporate actions.

Stock Compensation Plans

Shareholders must approve all new equity-based compensation plans or arrangements, whether or not officers and directors can participate. Shareholders must also approve any "material revision" or amendment to existing plans.

NYSE's broad definition of material revision includes:

- Materially increasing the number of shares available under the plan, or expanding the types of awards available under it;
- Materially expanding the class of persons eligible to participate in the plan;
- Materially extending a plan's term;
- Materially changing the method of determining the exercise price of options under the plan; and
- Repricing stock options where a plan does not permit repricing, or changing a plan to permit repricing.

The limited number of exemptions from NYSE's shareholder approval requirements include: dividend reinvestment or other plans offered to all shareholders, awards in connection with mergers and acquisitions, 401(k) and stock purchase plans or similar tax-qualified and parallel non-qualified plans, and equity grants made as a material inducement to a person being newly hired.

If a grant, plan or amendment is exempt from NYSE's shareholder approval requirements, the Compensation Committee (or a majority of the independent directors) will need to approve the grant, plan or amendment. In addition, the company must notify NYSE in writing of use of an exemption and, for any hiring inducement grant, issue a press release to disclose the grant.

20% Stock Issuance

Shareholders must approve a new issuance of common stock that would equal or exceed 20% of the outstanding common stock or 20% of the outstanding voting power before the new issuance. A public offering, even if over 20%, generally does not require shareholder approval, nor does a private sale of common stock for cash at a price at or above the common stock's book and market value.

Insider Issuances

NYSE recommends, but unlike Nasdaq does not mandate, that the Audit Committee (or a comparable Committee) review related party transactions. However, NYSE generally requires shareholder approval prior to the issuance of stock or securities convertible into common stock of over one percent of pre-issuance shares or voting power, to:

- Directors, officers or substantial securities holders, or people closely related to these insiders; or
- These insiders' subsidiaries or affiliates, or entities in which these insiders hold substantial direct or indirect interests.

Change of Control Transactions

NYSE generally requires shareholder approval prior to issuances of securities that would result in a change of control of the company.

Additional NYSE Standards

Other critical NYSE standards include:

- *Annual Shareholders'Meeting; Proxy Statements.* NYSE companies must hold an annual shareholders' meeting during each fiscal year, and solicit proxies and provide proxy statements for all shareholders' meetings.
- S*taggered Board of Directors.* A staggered Board may be divided into up to three classes, each class with approximately the same number of directors and serving approximately equal terms of no more than three years. (We discuss staggered Boards in Chapter 8.)
- *Quorums.* Generally, a quorum requires a majority of outstanding shares for any meeting of shareholders. Nevertheless, NYSE may permit quorum provisions of less than a majority of outstanding shares of common stock if the company agrees to make general proxy solicitations for shareholders' meetings.

Communicate! – NYSE Notices and Forms

A NYSE company's investor relations officer or corporate secretary should maintain close contact with the company's NYSE representative. At a minimum, the company will need to notify and provide supporting documentation to NYSE prior to or at the time of a number of corporate actions in addition to those already mentioned, including:

- Listing of additional shares or a new class of securities;
- Cash dividends or distributions, or stock splits or stock dividends;
- Corporate name or trading symbol change;
- The failure to pay interest on a listed security; or
- A change in auditor, transfer agent or registrar.

Disclosure of Material News

In making the disclosure decisions discussed in Chapter 3, a NYSE company must factor in the NYSE requirement calling for prompt release to the public of any material news that might affect the market for its securities. This obligation exists side by side with those imposed by the SEC and securities laws, and results in an affirmative disclosure obligation for NYSE companies that may not otherwise exist.

Material news includes information that might reasonably be expected to have an impact – favorable or unfavorable – on the market of a company's securities and information that might affect the value of the company's securities or influence an investor's decision to trade in the company's securities. Material news items may include earnings announcements, dividend declarations, mergers and acquisitions, tender offers, major management changes and significant new products. Chapter 3 provides a more detailed list of factors that will help in deciding when news merits public release.

Exceptions to Public Disclosure

NYSE permits a listed company to refrain from announcing even material news if it is necessary and possible for the company to maintain its confidentiality, while still keeping all investors on

equal footing and allowing no unfair information advantage. However, the company must take extreme care to keep the information confidential, and to remind persons who possess the information of their obligation to refrain from trading on insider information.

If deciding not to disclose material news, a company's investor relations officer and general counsel's office should closely monitor the price and trading patterns in its securities and be prepared to make a public announcement if it becomes clear that the information has leaked to outsiders. If NYSE detects unusual or suspicious trading activity in a company's securities, NYSE may contact the company, require that the company make the information public immediately, and possibly halt trading in the company's securities until the public has time to absorb the information.

Practical Tip:
Rumors – How to Respond?

When seeking to maintain the confidentiality of material news, perhaps the greatest threat is a rumor that indicates that the market is aware of the confidential information. In the event of unusual market activity or rumors indicating that investors already are aware of impending company events – for example, a possible acquisition – your company may be required to make a clear public announcement regarding the state of negotiations or the development of corporate plans relating to the rumored information. This may be required even if the Board has not yet considered the matter.

If rumors arise, you should first seek to confirm that the rumor did not originate with the company and, subject to conversations with NYSE, and if considered appropriate, issue the sort of release that we discuss in Chapter 3, i.e., the company's policy is not to comment on transactional rumors. If the rumors are false, you may need to issue a press release publicly denying or clarifying the false or inaccurate rumors. It is critical, of course, that you not deny negotiations that are in fact occurring, and that the statement be otherwise truthful and comply with anti-fraud laws.

Procedures for Public Disclosure

NYSE outlines these steps for releasing material news or responding to rumors to the public:

- If the release is made shortly before the opening or during market hours, NYSE encourages companies to telephone the company's NYSE representative at least ten minutes prior to providing the release to the media;
- Broadly disseminate the news, with releases to Dow Jones & Company, Inc., Reuters Economic Services, Bloomberg Business News, The Associated Press and United Press International, and to newspapers in New York and cities where the company is headquartered or has major facilities;
- Prepare an internal question and answer script, with someone at the company ready to respond to questions about the material news; and
- Promptly send any press release that may significantly impact trading to the company's NYSE representative.

Trading Halts

NYSE requires advance notice of disclosures in part to determine whether the material news justifies a trading halt in the company's securities. Companies can generally avoid trading halts by fully disseminating the disclosure to the public before 8:00 a.m. or after 6:30 p.m. Eastern Time.

Whenever NYSE decides to halt trading due to pending material news, it will make an announcement to the market that trading will be halted as material news is pending. Once the company releases the news, NYSE will monitor the situation and commence trading pursuant to its normal trading procedures. If the pending news is not released, NYSE will monitor the situation and may reopen trading (often within 30 minutes of the trading halt) and signal that there is material news still pending.

Chapter 10

To Market, To Market: Nasdaq Listing Standards

Deciding to list on the Nasdaq National Market brings with it the agreement to adhere to listing rules designed to achieve a strong standard of corporate governance, but a standard that is more flexible, and accommodating to the needs of less mature companies, than that of NYSE. For example, Nasdaq provides an "exceptional and limited circumstances" exception permitting a non-independent director to serve on the Audit, Compensation or Nominating Committee. Larger or more mature Nasdaq companies will want to be familiar with and consider complying with NYSE governance standards, as well as the expectations of Institutional Shareholder Services and other monitors of governance standards.

This Chapter presents an overview of Nasdaq's initial and continued quantitative listing standards and corporate governance standards. Nasdaq's requirements often mirror those imposed by the SEC, but are in fact independent obligations. Nasdaq listed companies will need to satisfy both sets of requirements.

Listing Requirements

Nasdaq imposes both quantitative (financial and public float) and qualitative (corporate governance) listing requirements on its listed companies.

Quantitative Listing Requirements

Initial Listing Requirements

A company electing to list its securities with Nasdaq must comply with one of three relatively modest alternative quantitative listing requirements, including a minimum public float (shares held by noninsiders) of 1.1 million shares, and a public float market value of $8 to $20 million. (We describe these three alternatives in Appendix 5.)

Continued Listing Requirements

Nasdaq requires that listed companies continue to maintain a minimum closing bid price of $1.00 per share and meet public float criteria in order to remain listed. The failure to meet these quantitative standards over a specified period of time may trigger a delisting procedure and the removal of a company's securities from the Nasdaq market.

Nasdaq Continued Listing Standards

Requirements	Standard 1	Standard 2
Minimum closing bid price ..... (standard must be met at least once every 30 consecutive business days)	$1.00	$1.00
Shareholder's equity	$10 million	N/A
Market capitalization ..... (standard must be met at least once every 10 consecutive trading days) *OR BOTH:* **Total assets** ..... AND: **Total revenue**	N/A	$50 million or both: $50 million and $50 million
Public float ..... (shares outstanding less any shares held by officers, directors, or beneficial owners of 10% or more)	750,000 shares	1.1 million shares
Market value of public float ..... (standard must be met at least once every 30 consecutive business days)	$5 million	$15 million
Round lot shareholders ..... (100-share block holders)	400	400
Market makers	2	4
Continued compliance with corporate governance standards	See below	See below

Nasdaq Corporate Governance Standards

Nasdaq corporate governance standards parallel NYSE in many respects, but provide greater flexibility for the less mature company. Many Nasdaq companies find that their institutional investors still expect a high standard of corporate governance, looking with disfavor, for example, on companies that use the

"exceptional and limited circumstances" exception to include a related party director on an otherwise independent Compensation Committee.

A Majority of Independent Directors

A majority of the Board members of a Nasdaq company must be "independent." The Board itself will annually determine independence – that directors do not have a relationship with the company that would interfere with their exercise of independent judgment – and list the independent directors in the annual proxy statement. A Nasdaq director is not independent if he or she has one or more of the following relationships:

- *Employment Relationship.* A director will not be independent if she has been employed by the company (or a parent or subsidiary) within the past three years, or had an immediate family member (including, for example, a sister-in-law) employed as an executive officer within the past three years.
- *Compensation Over $60,000.* A director will not be independent if she or an immediate family member has received over $60,000 in compensation from the company (or a parent or subsidiary) other than compensation for Board or Committee service in any 12-month period within the past three years. Independence will not be jeopardized by earnings on the company's securities, benefits under tax-qualified retirement plans or nondiscretionary compensation, compensation paid to a family member who is a non-executive employee, specified payments from financial institutions and certain specific loans. (Audit Committee members have a stricter noncompensation standard that we discuss later in this Chapter.)
- *Relationships With the Auditor.* A director will not be independent if she or an immediate family member is a current partner of the company's independent auditor, or was a partner or employee of the company's independent auditor and worked on the company's audit at any time during the past three years.
- *Interlocking Directorate.* A director will not be independent if she or an immediate family member is a

current executive officer of another company where, at any time during the past three years, an executive officer of the Nasdaq company has served on the other company's Compensation Committee.

- *Significant Business Relationship (Including Non-Profits).* A director will not be independent if the director is a current partner, executive officer or controlling shareholder of an entity, profit or non-profit, to which the company made, or from which the company received, payments in the current or any of the past three fiscal years that exceed 5% of the recipient's consolidated gross revenues or $200,000, whichever is more, other than payments arising solely from investments in the listed company's securities or payments under nondiscretionary charitable contribution matching programs. This rule also covers immediate family members who are current partners, executive officers or controlling shareholders of the other entity.

Nasdaq provides a cure period for failure to comply with the independent majority requirement if one director ceases to be independent for reasons beyond the company's reasonable control or in the case of a single vacancy on the Board. The cure period ends on the earlier of the company's next annual shareholders' meeting or the first anniversary of the event that caused the noncompliance. The company must notify Nasdaq immediately upon learning of the noncompliance.

Mandatory Executive Sessions of Independent Directors

Independent directors will meet "regularly" in executive sessions, without management or other directors present. Nasdaq contemplates at least two executive sessions each year. (We discuss executive sessions in further detail in Chapter 8.)

Audit Committee

Composition. Each Nasdaq company must have an Audit Committee consisting of at least three directors, all of whom must be independent. All Audit Committee members must be "financially literate" and at least one member must be "financially sophisticated." (We discuss these requirements below.) Directors who have participated in the preparation of the financial statements of the company or any current subsidiary of the company during the past three years cannot serve on the Audit Committee.

Heightened Independence Requirements for Audit Committee Members. In addition to Nasdaq's general independence requirements discussed above, Audit Committee members will also satisfy the Sarbanes-Oxley Audit Committee independence requirements. Under these "Rule 10A-3" requirements, Audit Committee members may not:

- Receive any payment from the company other than for Board or Committee service; or
- Be an "affiliated person" of the company or any subsidiary. (We discuss these Sarbanes-Oxley independence requirements in Chapter 8.)

"Exceptional and Limited Circumstances" Exception to Audit Committee Independence Requirements. A director who does not satisfy Nasdaq's general independence standards for directors, but who does satisfy the Sarbanes-Oxley Audit Committee independence requirements, and who is not a current officer or employee, or an immediate family member of a company employee, can serve on the Audit Committee for up to two years.

The company must disclose the nature of the director's relationship, and the reasons for the Board's determination that the director's service on the Committee is in the best interests of the company and its shareholders, in the company's annual proxy statement. Only one director may be appointed under this exception and he or she may not serve as the Audit Committee chair.

Trap for the Unwary: Use "Exceptional and Limited Circumstances" Exception From Independence With Great Care

Nasdaq permits a director who is not independent under Nasdaq criteria to serve on an Audit Committee for up to two years under its "exceptional and limited circumstances" exception, but Boards should be aware of two important limits to this exception's usefulness.

First, separate and apart from Nasdaq, Sarbanes-Oxley requires all public company Audit Committee members to be "independent" under the Sarbanes-Oxley definition. As we detail in Chapter 8, Sarbanes-Oxley has only two simple criteria for independence: no compensation from the company whatsoever other than for Board service, and no "affiliate" status, i.e., a director who controls, is controlled by, or is in common control with the listed company (or an officer or director of that affiliate).

Second, take the temperature of your shareholders before using this exception. Many institutional investors look with great disfavor on non-independent Audit Committee members. They may let you know that they will vote against those directors or against an entire Board slate that uses the exception without very good reason.

Companies Can "Cure" Inadvertent Noncompliance With Audit Committee Composition Requirements. A one-year cure period is available if a company fails to comply with the Audit Committee composition requirements because of a single Board vacancy, or for reasons outside the director's reasonable control. The company must notify Nasdaq immediately upon learning of the noncompliance. Nasdaq will excuse only a single noncomplying Committee member from meeting the Nasdaq independence requirements, and the Director must at all times meet Sarbanes-Oxley's Audit Committee independence requirements.

Financial Literacy and Sophistication. Audit Committee members must be able to read and understand fundamental financial statements, including balance sheets and income and cash flow statements, at the time of their appointment. In addition, at least one member of the Audit Committee must have "financial sophistication." Although Nasdaq did not expressly adopt the SEC's "audit committee financial expert" definition, any director who meets that definition will meet Nasdaq's "financial sophistication" standard. (We discuss the SEC's "audit committee financial expert" standard in Chapter 8.) Financial sophistication may result from past employment experience in finance or accounting, requisite professional certification in accounting or from other comparable experience or background, including being or having been a chief executive officer, chief financial officer or other senior official with financial oversight responsibilities.

Audit Committee Charter. A written Audit Committee charter will detail the responsibilities and authority of the Committee, including those established in the SEC's Audit Committee rule – Rule 10A-3. These will call for a Charter that requires the Audit Committee to:

- *Oversee Outside Auditor.* Be directly responsible for the appointment, compensation and oversight of the outside auditors.
- P*re-approve Outside Audit Services.* Pre-approve all permissible non-audit services provided by the company's accountants.
- *Set Procedures for Financial Whistleblower Complaints.* Establish procedures for the receipt, retention and treatment of complaints to the company regarding accounting, internal accounting controls or auditing matters, and for the confidential, anonymous submission by employees of accounting or auditing concerns.
- *Retain Advisors.* Be authorized to engage, and determine funding for, independent legal counsel and other advisors. (We discuss other common duties of the Audit Committee in Chapter 8.)

Audit Committee Approves Related Party Transactions

One critical "best practice" which Nasdaq adopted and that goes beyond NYSE requirements is that a Nasdaq company's Audit Committee, or a comparable body of independent directors, must review and approve all related party transactions. Nasdaq defines related party transactions, in order to be consistent with proxy disclosure, to be those described in Item 404 of SEC Regulation S-K. These include:

- Transactions to which the company or a subsidiary will be a party that involve over $60,000 and in which any director or nominee, executive officer, 5% or more shareholder, or any family member of the foregoing has or will have a direct or indirect material interest;
- Specified business relationships between the company and a director or nominee that have existed within the past fiscal year; and
- Indebtedness to the company or a subsidiary exceeding $60,000 by a director, nominee or any family member, related entities, or specified estates of those persons.

Compensation Committee (or Compensation Decisions by Independent Directors)

An independent Compensation Committee or a majority of the independent directors must determine, or recommend to the Board for determination, compensation for the CEO and other executive officers. The CEO may not be present during voting or deliberations concerning his or her compensation. Under the "exceptional and limited circumstances" exception discussed below, one non-independent director can serve for two years on the independent Compensation Committee.

Practical Tip: Institutional Shareholders and Practicality Call for A Compensation Committee

Although Nasdaq permits a Board to forgo a Compensation Committee and instead have a majority of the independent directors approve compensation for the CEO and other executive officers, institutional shareholders will generally expect an independent Compensation Committee. In addition, the need under the Internal Revenue Code to have independent directors approve certain equity compensation plans and option or share grants makes a Compensation Committee far more practical than having the independent directors act as a group on compensation.

Nominating Committee (or Nominations by Independent Directors)

The third core independent Board Committee of a Nasdaq company is the Nominating Committee. As with the Compensation Committee, the Board may forgo the Nominating Committee and choose instead to act by a majority of independent directors. The Nominating Committee (or majority of independent directors) will select, or recommend to the Board for selection, all director nominations, except for those Board "seats" where a third party has the contractual or other right to nominate a director. The Board may use the "exceptional and limited circumstances" exception discussed below for service by one non-independent director.

A Nasdaq company with a Nominating Committee will need to have its Board adopt a formal written charter. If instead the Board acts by having a majority of independent directors make nomination decisions, then a comparable Board resolution should address the nomination process.

Companies subject to a pre-November 2003 agreement governing the nomination of directors that contains provisions inconsistent with the Nasdaq standards are not required to comply with these requirements until the agreement expires.

"Exceptional and Limited Circumstances" Exception to Compensation Committee and Nominating Committee Independence Requirements. The "exceptional and limited circumstances" exception is available if:

- The nonindependent director is not an officer or employee of the company or an immediate family member of an officer or employee;
- The Board determines that the nonindependent director's service on the Committee is in the best interests of the company and its shareholders;
- The company discloses in its annual proxy statement the nonindependent director's relationship to the company and the basis for the Board's determination; and
- The member appointed under this exception serves for less than two years.

Practical Tip:
Controlled Companies Are Exempt From Independence Requirements

Does an individual, group or other entity own more than 50% of the voting power of your company's securities? If so, your company may be a "controlled company" that need not have:

- A Board consisting of a majority of independent directors; or
- Independent Compensation and Nominating Committees (or independent directors making compensation and nomination decisions).

A controlled company must continue to comply with Nasdaq's requirement for an independent Audit Committee and other Audit Committee rules. And the independent directors must hold regular executive sessions. Otherwise, the burdens are reduced. A controlled company does disclose its controlled company status in its annual proxy statement, as well as explain the basis for that determination.

Code of Business Conduct

A core component of a Nasdaq listed company's good governance framework is to adopt and publicly disclose a Code of Conduct that covers all its directors, officers and employees. Nasdaq requires that the Code of Conduct be in compliance with the "code of ethics" that Section 406 of Sarbanes-Oxley requires. Item 406 of SEC Regulation S-K defines this code of ethics as written standards reasonably designed to deter wrongdoing and to promote honest and ethical conduct. The code of conduct must include enforcement mechanics, and the Board must approve any waivers from the code for directors or executive officers. Waivers are disclosed on Form 8-K within four business days.

Notification of Material Noncompliance With Nasdaq Corporate Governance Rules

A Nasdaq company must promptly notify Nasdaq if an executive officer of the company becomes aware of any material noncompliance by the company with Nasdaq's corporate governance standards.

Practical Tip:
Transition Periods for IPOs and Transfers

Is your company just going public, or is it transferring from another exchange? If so, you may have a grace period before being subject to some of Nasdaq's corporate governance standards.

IPO Companies. If your company is listing in connection with its initial public offering it will be allowed to phase in the Board composition requirements. For each of the three core Committees the company adopts, the company must have one independent member at listing, a majority of independent members within 90 days of listing and fully independent Committees within one year. (The "exceptional and limited circumstances" exception, giving one non-independent director up to two years of service, is at its most useful at the time of an IPO – in part because institutional shareholders

Practical Tip: Transition Periods for IPOs and Transfers (Cont'd)

may have more patience during the Board's transition to a truly independent Board.) Boards that choose not to form independent Compensation or Nominating Committees, and instead choose to rely on a majority of independent directors to discharge these responsibilities, will be required to meet the majority of independent members requirement within one year of listing.

Transferred Companies. For a company transferring from another exchange or market to Nasdaq (for example, from NYSE to Nasdaq), Nasdaq has special rules governing the phase-in period of its corporate governance requirements. Generally, if the exchange or market from which a company is transferring did not have the same requirements as Nasdaq, the transferring company has one year from the date of transfer in which to comply with the applicable Nasdaq requirements. If the exchange or market from which the company is transferring had substantially similar requirements, the company is afforded the balance of any grace period provided by the other exchange or market (other than for Audit Committee requirements, unless a transition period is available under the SEC's Rule 10A-3).

Shareholder Approval

Nasdaq requires shareholders to approve several key corporate actions. (Usually, "approve" means by a majority of the votes cast.)

Stock Compensation Plans. Nasdaq requires that shareholders approve both new equity-based compensation plans or arrangements, whether or not officers and directors can participate, and material amendments to existing plans.

Nasdaq defines a *material amendment* to include:

- Material increase in the number of shares available under the plan, other than increases to reflect reorganizations, stock splits, mergers, spin-offs and similar transactions;
- Material increase in the benefits available to plan participants;
- Material expansion of the class of persons eligible to participate in the plan;
- Any expansion in the types of awards provided under the plan;
- Material extension of a plan's term;
- Reduction in the price at which shares or stock options may be offered;
- The repricing of stock options, where the plan does not specifically permit the repricing; and
- Expansion of types of options or awards provided under the plan.

There are a variety of special purpose exemptions to the Nasdaq shareholder approval requirements. These include exemptions for warrants or rights offered generally to all shareholders (poison pills), stock purchase plans available on equal terms to all shareholders (dividend reinvestment plans), awards in connection with mergers and acquisitions, tax-qualified, nondiscriminatory employee benefit plans and parallel nonqualified plans (like 401(k) plans or other ERISA plans), and "hiring bonus" grants of options or stock as a material inducement to a person's initial employment with the company. Even though a plan is exempt from shareholder approval requirements, Nasdaq still requires that the Compensation Committee (or majority of independent directors) approve inducement grants and tax-qualified nondiscriminatory benefit and parallel nonqualified plans. In addition, the company must promptly disclose in a press release the material terms of an inducement grant made in reliance on the exception.

20% Stock Issuance (5% to Affiliates in an Acquisition)

Shareholders of Nasdaq companies have long been required to approve a major additional issuance of common stock. This is the provision that generally triggers a shareholder vote and proxy solicitation on significant stock-for-stock mergers.

20% Rule. Shareholders must approve any issuance (other than in a public offering) that may exceed 20% of the outstanding common stock or the outstanding voting power, if the issuance is priced below the greater of the stock's book or market value (sales by officers, directors and 5% shareholders will be combined with the company's issuance in determining whether the 20% threshold has been met). Nasdaq also requires shareholder approval for any acquisition that results in the issuance of common stock (or convertible securities) of 20% or more of either outstanding shares or voting power (this acquisition-related approval triggers a vote regardless of the price of the Nasdaq purchaser's common stock).

5% Affiliate Acquisition Rule. A Nasdaq acquirer must also seek shareholder approval of an acquisition that results in the issuance of over 5% (by number of shares or voting power) of outstanding common stock if a director, executive officer or 5% shareholder of the acquirer has a 5% (or those insiders together have a 10%) interest in the target.

Change of Control Transactions. Nasdaq requires shareholder approval for issuances or potential issuances of securities resulting in a change of control of the company.

Additional Corporate Governance Standards

Nasdaq companies comply with an array of additional governance standards. Three critical ones are:

- *Annual Shareholders' Meeting.* Nasdaq requires companies to hold an annual shareholders' meeting and to provide notice to Nasdaq of the meeting.
- *Quorums.* Nasdaq prohibits quorum provisions that require less than one third of all outstanding shares of common stock.

- *Solicitation of Proxies.* Nasdaq requires companies to solicit proxies, provide proxy statements for all meetings of shareholders and to provide copies of the proxy solicitation to Nasdaq.

Keeping Nasdaq Informed

Nasdaq asks that listed companies notify, and provide supporting documentation to, Nasdaq, and in some cases file a Listing of Additional Securities form, at or prior to these corporate actions:

- Establishing or materially amending, with shareholder approval if necessary, a stock option plan, purchase plan or other equity compensation arrangement pursuant to which stock may be acquired by officers, directors, employees or consultants without shareholder approval;
- Issuing securities that may potentially result in a change of control;
- Issuing common stock or securities convertible into common stock in connection with the acquisition of another company, in which any officer, director or substantial shareholder of the issuing company has a 5% or greater interest (or if such persons collectively hold a 10% or greater interest) in the target company or the consideration to be paid;
- Entering into a transaction that may result in the potential issuance of common stock (or securities convertible into common stock) greater than 10% of either the total shares outstanding or the voting power outstanding on a pre-transaction basis;
- Any change in number of outstanding shares greater than 5%;
- A change in the company's general character or nature of business, address of principal executive offices or corporate name; or
- A change in transfer agent or registrar.

Disclosure of Material News

Nasdaq, like NYSE, generally requires an issuer to promptly and publicly disclose any material news or information that might affect the market for its securities. This obligation exists side by side with SEC and securities law obligations, and results in an affirmative disclosure obligation – with a variety of exceptions – for a Nasdaq company.

Material news includes information that might influence an investor's decision to trade in the company's securities, or, in the SEC's view, that might reasonably be expected to have an impact – favorable or unfavorable – on the market for a company's securities, or affect the value of the company's securities. Categories of material news are very broad; generally, all significant events affecting the company, including its business, products, management, and finances, presumably merit prompt public disclosure.

Practical Tip:
What's Material News?

Nasdaq provides examples of material news, similar to the SEC's list of possibly material information that we set out in Chapter 3, that serves as a useful guide for determining whether news merits disclosure. Nasdaq companies notify Nasdaq's MarketWatch Department of the release of this material information:

- Financial disclosures, including quarterly and yearly earnings, earnings restatements, pre-announcements and earnings guidance;
- Corporate reorganizations, changes of control and acquisitions, including mergers, tender offers, asset transactions and bankruptcies or receiverships;
- New products or discoveries, or developments regarding customers or suppliers;
- Senior management changes of a material nature;
- Resignation or termination of independent auditors, or withdrawal of a previously issued audit report;

Practical Tip:
What's Material News? (Cont'd)

- Events regarding the company's securities, for example, defaults on senior securities, calls of securities for redemption, repurchase plans, stock splits or changes in dividends, changes to the rights of security holders or public or private sales of additional securities;
- Significant legal or regulatory developments; and
- Any event requiring the filing of a Form 8-K.

Chapter 3 provides a list of other factors that may help your company determine when news merits disclosure.

Exceptions to Nasdaq's Disclosure Requirement

The exceptions to Nasdaq's disclosure requirement soften the general mandate to always promptly disclose material news. A company may delay public announcement of material news, if it is both necessary and possible for the company to maintain its confidentiality, and so long as no investor has an unfair information advantage. To take advantage of this, a Nasdaq company must keep the information confidential, and remind persons who possess the information of their obligation to refrain from trading on insider information.

The investor relations officer and other responsible officers of a Nasdaq company will also need to closely monitor the trading of its securities for unusual price or volume, and be prepared to make a public announcement if it becomes clear that the information has leaked. If Nasdaq detects unusual or suspicious trading activity in a company's securities, Nasdaq's MarketWatch Department may contact the company and require that it promptly and publicly disclose the information. In this case, Nasdaq may require a trading halt in the company's securities until the public has time to absorb the information.

Companies Must Publicly Announce Going Concern Qualifications

Nasdaq requires a listed company to publicly disclose through a press release any going concern qualification included in an auditor's opinion. The disclosure must be made within seven days of the filing of the SEC report that contained the auditor's opinion. Prior to the release of the public announcement, the company must provide the text of the public announcement to the StockWatch section of Nasdaq's MarketWatch Department.

Practical Tip:
Rumors: Where There's Smoke – Don't Get Burned!

Your Nasdaq company needs to carefully guard confidential information to prevent rumors that originate from company sources from circulating. Nasdaq specifies that if unusual market activity or rumors indicate that investors are aware of impending events, the issuer must make a clear public announcement regarding the state of negotiations or the development of corporate plans in the rumored area. This disclosure is required even if your Board has not yet taken up the matter for consideration.

If the rumors are false, the company may need to issue a press release publicly denying or clarifying the false or inaccurate rumor. This statement must obviously be truthful and not omit material information necessary to prevent the disclosure from being misleading.

Because a premature public announcement, triggered by rumors, can jeopardize proposed plans, careful monitoring of confidential information, and of rumor, can protect a critical corporate initiative.

Procedures for Public Disclosure

Nasdaq permits its companies to disclose material information through any Regulation FD-compliant method. These methods include press release and Form 8-K, as well as conference call, press

conference and Webcast, provided that the public is given adequate notice (generally by press release) and access. (We provide practical tips for making Regulation FD-compliant disclosures in Chapter 3.)

Nasdaq requires a listed company to notify Nasdaq's MarketWatch Department prior to the release of material information included in its list of material events (see the list in the "What's Material News?" Practical Tip earlier in this Chapter). For a press release or Form 8-K, companies should provide prior notice of the press release announcing the logistics of the future disclosure and a descriptive summary of the information to be announced. Nasdaq encourages companies to provide prior notice of material news disclosures, even if not mandated, whenever the company believes, based on its knowledge of the significance of the information, that a temporary halt in trading may be appropriate.

Trading Halts

Nasdaq requires advance notice of disclosures in part in order to determine whether the material news justifies a trading halt in the company's securities. A Nasdaq company can generally avoid a trading halt by broadly issuing the disclosure to the public before 8:00 a.m. or after 6:30 p.m., Eastern time.

When an issuer makes a significant announcement during trading hours, the exchange may require a trading halt to allow investors to gain equal access to information, to fully digest the news and to understand its impact. A trading halt also alerts the market that material news has been released. Nasdaq determines when a trading halt is necessary and how long it should last, usually permitting trading to resume within 30 minutes after news is fully disseminated.

Chapter 11

Corporate Structural Defenses to Takeovers

Going public is often the ultimate goal of a private company. But while an IPO can provide capital for expansion and growth, and some liquidity for shareholders, the public markets also provide third parties an opportunity to acquire control of the company. Vulnerability to unsolicited and sometimes hostile attempts to acquire a company, or to influence its actions, can mark the beginning of the end for management and its long-term goals for the company.

The techniques used to acquire control of a company range from friendly acquisitions negotiated with management and principal shareholders to hostile takeover attempts. Some of these techniques subject shareholders of the target company to various forms of coercion designed to influence them to accept the takeover proposal. Hostile takeovers can be particularly stressful because they are often accompanied by coercive tactics. For example, in the "two-tier" or "front-end loaded" tender offer, the tender offeror makes a cash offer to a target company's shareholders for less than all of the outstanding shares of the company. This creates an incentive to those shareholders to tender their shares for cash in the first stage of the tender offer in order to avoid being forced to accept a lesser amount of cash or different consideration later.

Although there are many steps a public company can take to defeat a takeover attempt after it has begun, it may be prudent for a Board to prepare for coercive takeover efforts before they occur.

Why Adopt Corporate Structural Defenses?

A Board of Directors oversees the development of a company's business goals and implementation of a strategy to achieve these goals. To protect the company's ability to accomplish these objectives, the Board may want to equip the company to withstand a coercive takeover effort. In particular, the Board may select and adopt appropriate corporate structural defenses. These defenses are generally implemented by amendments to a company's certificate or articles of incorporation or bylaws. They will not prevent a well-financed takeover that is in the best interest of shareholders, but will provide a target company's Board with time to:

- Evaluate an offer;
- Communicate with shareholders;
- Negotiate with a potential buyer to preserve the company's long-term objectives and/or achieve the best available price for the company's shareholders; and
- Otherwise maximize shareholder value.

While our discussion uses concepts from Delaware law, similar defenses are permitted by most other states.

Practical Tip: An Ounce of Protection

The Board should consider structural takeover defenses well before there is a takeover attempt. It is important to consider these options in a reasoned fashion, rather than in the heat of a takeover battle. Implementing some defenses may require considerable lead time (for instance, shareholder approval may be required). Structural defenses put in place after a takeover attempt has been initiated will, if challenged in court, be subjected to significantly closer judicial scrutiny than those established prior to a takeover attempt.

Why Not Adopt Structural Defenses?

Institutional shareholders often object to corporate structural defenses because they view these defenses as intrenching existing management and denying shareholders the benefit of potentially valuable offers for corporate control. Institutional Shareholder Services (ISS) and other institutions have urged:

- The elimination of staggered Boards;
- Election of directors by majority, rather than plurality, vote; and
- Elimination of shareholder rights plans and requirement that adoption of such plans be approved by shareholders.

Staggered Board of Directors

A staggered Board of Directors, which is discussed in Chapter 8, may serve as an impediment to some takeover attempts. Under Delaware law, shareholders may remove directors of a company with a staggered Board only for cause. If a company has three classes of directors, then, in the absence of cause, shareholders can replace no more than one-third of the directors in any one year.

Because staggered terms prevent hostile acquirors from taking control of the company by replacing the entire Board at one time, the existence of a staggered Board may deter certain types of takeover tactics, such as proxy fights and tender offers for less than all of a company's shares. A staggered Board alone will not usually deter an "any-and-all" cash tender offer – an offer made to all the shareholders to buy all their shares at the same price – since most Board members will not oppose an offeror that has acquired a majority of the company's shares. The use of a staggered Board, combined with a shareholder rights plan and a strong state anti-takeover statute, however, can delay substantially an any-and-all cash tender offer, until the acquiror can obtain majority control of the Board.

Supermajority Removal Provisions

If a company chooses not to implement a staggered Board, it may still wish to limit shareholders' ability to remove members of the Board. For example, the company may amend its certificate or

articles of incorporation so that the percentage vote of the shareholders required for removal of a director is increased from a simple majority to 75% or 80%.

Trap for the Unwary:
Don't Go Overboard

> If the Board itself wishes to remove a poorly performing director before his or her term has expired, a staggered Board could make removal extremely difficult.

Filling Vacancies on the Board

Another structural defense that can be employed in the absence of a staggered Board is an amendment to the company's bylaws to tighten the requirements for filling Board vacancies. For example, a company could provide that a vacancy may be filled:

- Only by the Board; and
- Only for the period remaining in the term of the departing director.

This makes it more difficult for a dissident shareholder to replace a departing director with its own nominee.

Shareholder Rights (Poison Pill) Plans

A shareholder rights plan, or poison pill, can be a powerful structural tool to drive acquirors to negotiate with a target company's Board. This gives the Board a chance to obtain the best value for a company, in the event of an acquisition. When adopting a typical rights plan, the Board will declare a special dividend of one right per share of common stock. Differences exist, but most rights plans have common principal features:

- If a bidder acquires a set percentage, usually ranging between 10% and 20% of the company's stock (the Board sets the trigger threshold), the rights allow common shareholders, except the bidder, to purchase shares of a new series of common or preferred stock of the company at a discount. This is called a "flip-in" provision.

- If, after a bidder acquires in excess of the trigger threshold, the company merges or sells more than 50% of its assets, the rights allow common shareholders to purchase shares of the bidder at a discount. This is called a "flip-over" provision.
- The Board can redeem the rights at a nominal cost, or waive the application of the plan to a favored bidder, before any bidder crosses the trigger threshold, thereby allowing a friendly transaction.
- The Board can exchange each right, except rights held by the bidder, for a specified percentage of the securities issuable on exercise of the rights after a bidder crosses the trigger threshold. Exchange may be easier than requiring exercise of the rights, and it also generally requires fewer shares.

A Board may adopt a rights plan without shareholder approval so long as the company has sufficient authorized and unissued shares available (and, in the case of each preferred stock plan, the certificate or articles of incorporation authorize blank check preferred stock).

In combination, the various features of rights plans have proven to be effective in defending against takeover attempts and as a deterrent to inadequate offers. However, rights plans are not designed to, and will not, deter all hostile takeover attempts. Specifically, a rights plan will not prevent a successful proxy contest for control of a company's Board, nor does it override the fiduciary obligations of the Board to consider a fairly priced, any-and-all cash tender offer for the company's shares. A rights plan will, however, encourage a potential bidder to negotiate with the company's Board as an alternative to triggering the rights and thereby diluting the interest of the bidder in the target company and substantially increasing the cost of a takeover to the bidder.

Practical Tip:
Let Time Be Your Friend

The best time to institute many structural defenses, such as a staggered Board, is prior to going public. It is less common, though not unknown, for companies to implement shareholder rights plans prior to their IPOs. Advantages of pre-IPO adoption include:

- A Board can thoughtfully implement the takeover measures well in advance of any immediate threat; and
- The company can avoid the problems and uncertainty that tend to arise when seeking shareholder approval as a public company.

However, there are disadvantages that cause other companies to hold off:

- Buyers frown on a protection-laden IPO;
- The threat of takeover may seem remote in an optimistic IPO environment; and
- Control or venture capital shareholders are seeking liquidity and may welcome takeover interest.

State Statutory Antitakeover Provisions

Delaware, the most common domicile of public companies, like virtually every other state, has adopted an antitakeover statute. State antitakeover statutes are generally based on either a control share, business combination or fair price model.

- *Control Share Statutes* prohibit an acquiror from voting shares of a target company's stock after crossing specified ownership percentage thresholds. The acquiror may proceed if it obtains the approval of the target company's shareholders to cross each threshold.
- *Business Combination Statutes* prohibit the target company from entering into specified significant business transactions – mergers, sales of assets and other change of control transactions – with an acquiror, for a three to

five year period after the acquiror crosses a specified ownership percentage threshold, unless the acquiror obtains the approval of the target company's Board of Directors prior to acquiring its ownership interest.

- *Fair Price Statutes* protect shareholders from the coercive effects of two-tier tender offers by requiring approval of a second-stage merger by a supermajority shareholder vote. Alternatives to the shareholder vote include having a disinterested Board approve the transaction or having the price paid in the merger be at least equal to the highest price, and for the same consideration, paid in the first-stage tender offer.

Delaware Section 203: A Business Combination Statute

Section 203 of the Delaware General Corporation law is a business combination statute. Section 203 limits any investor that acquires 15% or more of a company's voting stock (thereby becoming an interested shareholder) from engaging in certain business combinations with the issuer for a period of three years following the date on which the investor became an interested shareholder, unless:

- The company's Board has approved, before the acquiror becomes an interested shareholder, either the business combination or the transaction that resulted in the investor's becoming an interested shareholder;
- Upon consummation of the transaction that made the investor an interested shareholder, the interested shareholder owned at least 85% of the voting stock outstanding at the time the interested shareholder began the transaction that resulted in its becoming an interested shareholder (excluding shares owned by persons who are both directors and officers, and shares held in employee stock plans that do not provide plan participants with the opportunity to tender shares on a confidential basis); or
- The business combination is approved by the Board and authorized by the affirmative vote of at least 66-2/3% of the outstanding voting stock not owned by the interested shareholder (at a meeting, and not by written consent).

Section 203 defines a business combination broadly to include:

- Any merger or sale, or other disposition of 10% or more of the assets of a company, with or to an interested shareholder;
- Transactions resulting in the issuance or transfer to the interested shareholder of any stock of the company or its subsidiaries;
- Certain transactions that would result in increasing the proportionate share of the stock of a company or its subsidiaries owned by the interested shareholder; and
- Receipt by the interested shareholder of the benefit (except proportionately as a shareholder) of any loans, advances, guarantees, pledges or other financial benefits.

A Delaware company may opt out of Section 203:

- If the company's original certificate of incorporation contains a provision expressly electing not to be governed by Section 203; or
- If the company's shareholders approve an amendment to its certificate of incorporation or bylaws expressly electing not to be governed by Section 203. This amendment must be approved by a majority of the outstanding shares entitled to vote, and it is not effective until 12 months after adoption. An opt-out amendment will not apply to any business combination with an investor that became an interested shareholder prior to its adoption.

Practical Tip:
Waive the Statute? Yes – But Use Care

In a friendly acquisition, the buyer will request the company's Board to waive the application of any state antitakeover statutes that could prevent or delay the transaction. To satisfy their duty of care, before granting such a waiver, the directors should:

- Ask management and legal counsel to brief the Board on the application of the statute; and
- Ask about and understand all possible impacts of the waiver.

Authorized Common and Blank Check Preferred Stock

Common Stock

A public company should ensure that it always has an adequate number of authorized shares of common stock, taking into account both outstanding shares and the number of shares issuable upon conversion or exercise of outstanding or anticipated preferred stock, stock options and warrants. The company should maintain sufficient authorized, but unissued and unreserved, shares for:

- Current and future stock incentive plans;
- Potential stock splits and dividends;
- Strategic acquisitions; and
- Equity financings.

Preferred Stock

The company's certificate or articles of incorporation may authorize blank check preferred stock – a specified number of shares of authorized but undesignated preferred stock. Authorizing blank check preferred stock gives the Board the authority, without the necessity to seek prior shareholder approval, to designate one or more series of preferred stock out of the undesignated shares and to establish the rights, preferences and privileges of each series.

Blank check preferred stock, together with a reserve of authorized but unissued shares of common stock, will provide the Board flexibility in the following ways:

- The shares may be sold to a friendly party;
- The shares may be used as consideration for a defensive reorganization or acquisition;
- The shares may be used to grant a friendly party a lockup option to acquire shares; and
- The shares may be used to implement a shareholder rights plan.

Trap for the Unwary: NYSE or Nasdaq May Require Shareholder Approval of 20% Stock Issuances

Even with sufficient authorized common and/or preferred stock, under NYSE or Nasdaq rules, certain large stock issuances may still require shareholder approval. For example, Nasdaq requires shareholder approval of the issuance of common stock (or securities convertible into common stock) equal to 20% of the outstanding common stock or 20% of the voting power prior to the issuance for less than book or market value of the stock. (We discuss this and NYSE's similar requirement in detail in Chapters 9 and 10.)

Limitations on Shareholders' Meetings and Voting Requirements

Limitations on shareholders' meetings and other shareholder action can slow the efforts of an acquiror to appeal directly to shareholders without negotiating with a target company's Board. For example, if shareholders can act only at annual meetings, an unfriendly third party would be unable to acquire control of the company by soliciting written consents to remove directors and elect a new Board.

Limitations on the Right to Call Special Shareholders' Meetings

Appropriately limiting the power of shareholders to call special shareholders' meetings can help defend against coercive takeover attempts. Delaware law provides that only the Board and persons authorized in the company's certificate of incorporation or bylaws may call a special meeting of shareholders. For example, unless the company's certificate of incorporation or bylaws authorize the calling of a special meeting upon written request of holders of a certain percentage of the company's stock, the shareholders have no such right. In other states, a certain percentage of shareholders by default have the right to call a special shareholders' meeting, but the certificate or articles of incorporation of the company may increase the default percentage and, in some cases, entirely eliminate this right. Limiting the right of shareholders to call special meetings can ensure additional time to negotiate by preventing a would-be acquiror from electing a class of directors or gaining control of the Board until the company's next annual shareholders' meeting.

Advance Notice Bylaw Provisions

Advance notice bylaw provisions provide that shareholders seeking to bring business before, or to nominate directors for election at, any shareholders' meeting must provide written notice of such action within a specified number of days (usually 60 to 90) in advance of the meeting. Since only business contained in the meeting notice may be conducted at special shareholders' meetings, these bylaw provisions can delay the efforts of coercive acquirors and prevent surprises at shareholders' meetings.

Elimination of Shareholder Action by Written Consent

Under Delaware law, unless otherwise provided in a company's certificate of incorporation, any action required or permitted to be taken by shareholders may be taken by written consent, without a meeting or shareholder vote. A valid consent sets forth the action to be taken and is signed by the holders of shares of outstanding stock having the requisite number of votes that would be necessary to authorize the action at a meeting of shareholders. The certificate of incorporation may prohibit shareholder action by written consent. Such a prohibition has the effect of giving all the

shareholders the opportunity to discuss a proposed action at a shareholders' meeting, and of preventing the holder or holders of a majority of the voting stock of the company from taking preemptive, unilateral action without a meeting.

Supermajority Vote on Merger or Sale of Assets

Delaware law requires shareholder approval for any merger or sale of substantially all of the assets of a company. A Delaware company's certificate of incorporation or bylaws may provide for a supermajority provision requiring the approval of a greater number of shares than a simple majority (generally companies choose a percentage between 60% and 80%). A typical provision requires the affirmative vote of 66-2/3% of the shareholders for any merger or sale of substantially all of the company's assets if, at the time of the vote, the company has a controlling shareholder (i.e., a shareholder holding a substantial block of stock, such as 10%). Such a provision requires a potential acquiror to obtain a specified number of shares if it is to be sure of completing the acquisition.

In deciding whether to adopt a supermajority requirement for a merger or sale of substantially all of a company's assets, it is important for a Board to consider:

- Too high a standard can allow minority holders to block favorable acquisitions and other transactions.
- If a company is listed on an exchange, it may be subject to additional restrictions or listing requirements. For example, NYSE disapproves of any proposal that results in either discrimination against an existing substantial shareholder or discouragement of anyone seeking to make a substantial investment.

Practical Tip: Create an Escape from Supermajority Requirements

Supermajority vote provisions should include an "out" – an exception calling off the supermajority vote requirement under certain circumstances. For example, the bylaws could provide for either (a) a supermajority vote or (b) the bare majority required by statute if the transaction is approved by a majority of directors serving before the controlling shareholder acquired its controlling stake in the company.

Another common exception comes into play in two-tier tender offers. A company's bylaws may provide for the elimination of the supermajority vote requirement in a two-tier tender offer if the acquiror consents to purchase, at a fair price determined by a specified calculation, the shares remaining after the initial stage of the tender offer. This so-called "fair price" provision is designed to discourage only coercive, front-end loaded, two-tier tender offers. Two-tier tender offers, common in the 1970s and 1980s, occur much less frequently now due in part to the implementation of fair price provisions.

Supermajority Vote on Amendments to Certificate of Incorporation

Under Delaware law, amendments to the certificate of incorporation of a company must be approved by at least a majority of the outstanding shares. A company's certificate of incorporation, however, may require supermajority voting on some amendments. Requiring a supermajority vote to approve certain amendments to the certificate and bylaws, also known as "lock-in" provisions, forces a hostile acquiror to control a greater number of shares in order to amend the certificate of incorporation and bylaws to eliminate the company's corporate structural defense provisions. However, supermajority voting requirements reduce a company's flexibility to make other desirable changes to its certificate of incorporation. As a result, a company may choose to retain a majority approval requirement for amendments to most of the provisions of

its certificate of incorporation, and to require a two-thirds supermajority approval only for amendments to those particular provisions that provide takeover protection, such as provisions dealing with:

- A classified Board;
- Removal of a director for cause;
- The right of shareholders to call special meetings; and
- Supermajority voting provisions for business combinations.

A company may also retain flexibility by providing that the supermajority approval is not required if the amendment is approved by a majority of directors serving before a controlling shareholder acquired its controlling stake in the company.

Trap for the Unwary:
Marketing and Disclosure Impact

Every time a public company solicits shareholder approval of amendments to its certificate or articles of incorporation (for example, to increase the authorized number of shares), it must describe its corporate structural defense provisions in a proxy statement for the shareholders' meeting. Too formidable an array of structural defense measures may suggest to shareholders and prospective investors that the company adamantly opposes a change-of-control. Institutional investors may prefer the short-term returns engendered by hostile takeovers, and will vote against many corporate structural defense provisions. For this reason:

- Don't adopt every possible measure of protection;
- Choose only those best designed to maximize shareholder value; and
- Tailor protections to the company's situation and to its perceived vulnerability to takeover attempts.

Other Actions: Change-of-Control or "Golden Parachute" Agreements

Change-of-control or golden parachute agreements are an employee benefit with protective overtones. These arrangements, which can be stand-alone agreements or severance provisions included in employment agreements, provide key executives some economic certainty by triggering a cash payment (or vesting of stock options, restricted stock or other noncash benefits) on such change-of-control events as a merger, sale of assets or stock, or change of the constituency of the Board. "Single trigger" agreements result in a severance payment becoming due on the occurrence of a change-of-control alone. The more common "double trigger" agreements result in a severance payment only if the triggering event is coupled with a significant change in job status or compensation (for example, termination of employment or decrease in salary or responsibilities). Change-of-control agreements can enable the Board to retain key management during and after a takeover attempt.

Best Protections

Corporate structural defenses are not absolute deterrents. Instead, they are designed to give directors and management time to consider the merits of an offer as well as leverage to negotiate that offer and counteract the coercive tactics that sometimes characterize takeover contests.

Some of the strongest protections against an unfriendly takeover are not special provisions in a company's charter documents, but are, in this order:

- A significant block of stock held by friendly shareholders;
- A high stock price and price/earnings ratio;
- Strong state antitakeover statutes (protections under Delaware law are among the best available); and
- A shareholder rights plan.

Chapter 12

Follow-On, Secondary and Shelf Registrations

Each offering of securities to the public requires the issuer to file a registration statement. However, shelf registrations can ease this burden somewhat by allowing one 1933 Act registration statement to serve several separate transactions.

Registration: A Fact of Public Company Life

The SEC has adopted a variety of 1933 Act registration forms that require differing levels of disclosure depending on the type of transaction to be registered and the 1934 Act reporting history of the registrant. The most commonly used forms are:

- *Forms S-1 and S-3* – used for financing transactions for a company and public resale of a company's securities by its selling shareholders.
- F*orm S-4* – used for acquisition transactions, such as mergers, in which a purchaser's securities will be issued to a target company's shareholders.
- *Form S-8* – used for issuance of a company's securities under employee benefit plans, such as stock option or employee stock purchase plans.

Follow-On and Secondary Offerings on Forms S-1 and S-3

Following its IPO, a company may access the public markets to raise capital through additional offerings of debt or equity securities. These additional public offerings are sometimes referred to as "follow-on" offerings, as they follow the IPO. A follow-on offering made directly by the company is referred to as a "primary offering," to

distinguish it from a registered offering of securities to be offered and sold by selling shareholders, which is referred to as a "secondary offering."

In a secondary offering, selling shareholders, not the registrant, receive the proceeds from the offering. These offerings provide immediate liquidity to the selling shareholders. For example, the selling shareholders may hold restricted securities purchased from the company in a pre-IPO private transaction, which cannot be easily or quickly resold except through a registered public offering. In another situation, both the company and a shareholder who holds a sizable block of shares may choose an underwritten public secondary offering as an orderly and efficient means of liquidating the shareholder's position.

Primary and secondary offerings are registered on one of two forms: Form S-1 or S-3. Both these forms require the same description of the transaction, including a description of the securities offered, the plan of distribution and risk factors relating to the offering. Where the forms differ is in the level of disclosure about itself that the registrant must provide in the prospectus: Form S-3 allows the company to incorporate information by reference to its previous and future 1934 Act reports (Forms 10-K, 10-Q and 8-K). This disclosure includes, among other items, information regarding the company's business, properties and pending legal proceedings, financial information, and management descriptions. Pursuant to new SEC rules, Form S-1 allows for "backward" incorporation by reference to previously filed 1934 Act reports in some circumstances, but does not allow for incorporation by reference of 1934 Act reports filed after the effective date of the registration statement.

Registrants naturally prefer the form that allows for the most flexiblity as to how and when information is provided, including maximum use of incorporation by reference. However, not all companies are eligible to use, or to realize all the potential benefits of, all the registration forms. Eligibility will depend on the company's 1934 Act reporting history, the number and value of its outstanding securities, and the type of transaction being registered.

Breaking News: SEC Adopts Major Securities Offering Reforms

In 2005, the SEC approved rules that significantly modified the registration, communications and offering processes under the 1933 Act. These rules provide companies with varying degrees of flexibility in conducting securities offerings depending on their membership in one of four primary issuer categories based on their reporting history under the 1934 Act and their equity market capitalization or fixed income issuance history.

- *Well-Known Seasoned Issuers (WKSIs).* WKSIs generally must:
  - meet the eligibility requirements of Form S-3, including being current and timely in 1934 Act reports for at least one year (we discuss these requirements in detail later in this Chapter);
  - have either $700 million of public float or have issued $1 billion of non-convertible securities, other than common equity, in registered primary offerings for cash, excluding exchange offers, in the prior three years (public float refers to the aggregate worldwide market value of the voting and nonvoting common equity held by nonaffiliates of the company); and
  - not be an "ineligible issuer" – generally, companies that are not current in filing 1934 Act reports, blank check companies, shell companies, penny stock issuers, some limited partnerships, and companies that have filed for bankruptcy, have been subject of refusal or stop orders or violated the antifraud provisions of the federal securities laws during the previous three years.
- *Seasoned Issuers.* Seasoned issuers are 1934 Act reporting companies that meet the eligibility requirements of Form S-3 for a primary offering and have a public float of at least $75 million.

Breaking News: SEC Adopts Major Securities Offering Reforms (Cont'd)

- *Unseasoned Issuers*. Unseasoned issuers are 1934 Act reporting companies that are not "seasoned" issuers.
- *Non-Reporting Issuers.* Non-reporting issuers are companies not *required* to file 1934 Act reports (regardless of whether they file those reports voluntarily).

WKSIs benefit the most from the securities offering reforms, qualifying for a variety of simplified securities registration procedures, some of which we discuss below. Consult with your counsel to determine which issuer category your company falls into and how this designation impacts your company's securities offering process.

Registration on Form S-1

Form S-1 is the most comprehensive of the registration statements, and is the default form to be used by any company that does not qualify to use Form S-3. The Form S-1 prospectus requires complete registrant- and transaction-oriented information. If the company is current in its reporting under the 1934 Act and has filed at least one annual report, it may be eligible to incorporate previously filed 1934 Act reports by reference. Form S-1 does not permit "forward-looking" incorporation by reference of 1934 Act reports – those filed after the effective date of the registration statement. Most companies use Form S-1 only once – for their IPOs. However, a company that conducts offerings less than a year after its IPO will use Form S-1, due to its limited 1934 Act reporting history. In addition, Unseasoned and Non-Reporting Issuers will use this form to conduct primary offerings of common stock.

Registration on Form S-3

Form S-3 is the most cost-effective and efficient way to register follow-on and secondary offerings, as it requires the least amount of registrant-oriented disclosure in the prospectus. Information on Form S-3 is incorporated by reference to the company's previously filed 1934 Act reports. In addition, unlike Form S-1, Form S-3 also incorporates by reference all future 1934 Act reports filed by the company. In this way, a registration on Form S-3 can remain updated over time, a feature that is useful in a shelf registration (discussed below).

Practical Tip:
Marketing Considerations May Trump Brevity

> Although an issuer may be eligible to use Form S-3, and may extensively incorporate information by reference, the resulting prospectus may be too brief to be useful to underwriters of a follow-on offering. For marketing reasons, underwriters may request that the company set forth much of the information that otherwise could be incorporated by reference in the prospectus made available to prospective investors.

While Form S-3 is the most efficient 1933 Act registration statement from a disclosure perspective, it is also the most stringent in terms of eligibility requirements. To use Form S-3, the registrant must satisfy both registrant and transaction requirements.

Registrant Requirements. To qualify for use of Form S-3, the registrant must have been required to be a 1934 Act reporting company for at least 12 months and must have timely filed all 1934 Act reports required to be filed during the 12 months preceding the date of the registration statement. In addition, since the end of the fiscal year covered by its most recent Form 10-K, the company must not have failed to pay any dividend or sinking fund installment on preferred stock, or defaulted on any material debt or long-term lease. WKSIs and Seasoned Issuers will meet these requirements, but Unseasoned and Non-Reporting Issuers generally will not.

Transaction requirements. Registrants that meet the registrant requirements may use Form S-3 only in offerings that satisfy the applicable Form S-3 transaction requirements.

Public Float Required For Follow-on Offerings of Common Stock. A registrant that has a public float of at least $75 million may use Form S-3 to register any type of debt or equity security that is offered for cash. This is the most significant transaction requirement, as it permits an issuer to conduct a follow-on (or primary) offering of common stock. Registrants who do not meet the public float requirement may not register a follow-on offering of common stock on Form S-3, although they may register other more limited transactions on this form if they meet the registrant requirements. (We discuss these other transactions immediately below.)

Transactions That Do Not Require a Minimum Public Float. The public float requirement does not apply to, and Form S-3 is available to register:

- Secondary offerings, provided the class of securities registered is listed on a national securities exchange or market (such as NYSE or Nasdaq);
- Primary offerings of nonconvertible investment-grade securities;
- Securities to be offered upon the exercise of outstanding rights under a dividend or interest reinvestment plan, or upon the conversion or exercise of outstanding convertible securities, including options and warrants; and
- Offerings of investment-grade asset-backed securities.

Shelf Registrations

Sometimes a company may wish to sell securities to the public at an undetermined future date to take advantage of favorable market conditions when they occur. A company may also have shareholders that wish to resell restricted securities (for example, securities issued in a private placement) in the public markets over a period of time. Usually these types of offerings are accomplished through the use of a shelf registration. A shelf registration allows a company to register securities for future use or to register the sale or resale of securities on a continuous basis.

Common Types of Shelf Registrations

Resale Shelf. A resale shelf registration is used to register the resale to the public of securities issued in a private placement. For example, when a venture fund invests in a privately held company, the company usually agrees at the time of the investment to file for the venture fund one or more shelf registration statements on Form S-3 after the company has gone public. This promise will provide liquidity for the venture fund's investment.

Resale shelf registrations are also used when a public company issues securities in an acquisition of a private company. For instance, when acquiring a privately held company, a public company may issue restricted shares to the shareholders of the target company. Often, the shareholders of the target company will require the acquiror to register the shares they received in the acquisition by filing a shelf registration statement on Form S-3 soon after the closing of the acquisition. (A public company that contemplates using its stock to acquire companies in the future may also file an acquisition shelf on Form S-4 to simplify this type of registration as described later in this Chapter.)

A company also files a resale shelf registration statement in connection with PIPE (Private Investment in Public Equity) offerings. In a typical PIPE offering, a public company agrees to sell shares of its common stock to institutional investors in a private placement, usually at a discount to the market price, with the closing of the purchase and sale being conditioned on notification from the SEC that a Form S-3 shelf registration statement covering the resale of those shares is effective. In other PIPE offerings, the S-3 shelf registration statement will be filed shortly after the completion of the purchase and sale of a company's securities. In either case, the benefit to the company of a PIPE offering is that the company is able to obtain the proceeds of the sale much faster than it otherwise would if it were to do a follow-on public offering. A resale shelf registration statement can be prepared in less time than a registration statement for a follow-on offering, and is less likely to be reviewed by the SEC.

A resale shelf registration statement will generally be kept open (meaning that the prospectus will be kept up to date and shareholders will be allowed to sell under the registration statement) for a certain period of time, usually between six months and two years. This allows holders of restricted securities to have some control over the timing of their resales. Two years after issuance is often the outside time period, because after that point shares will usually be fully resaleable under Rule 144. (We discuss Rule 144 in Chapter 4.)

Practical Tip:
Your Company Has Heightened Disclosure Obligations When Using a Resale Shelf

With an effective resale shelf registration statement, your company has a heightened obligation to disclose material information and to update regularly information disclosed in prior filings. Because sales are being made pursuant to the resale shelf over an extended period of time, your company (and the officers who signed the registration statement and its directors) may be liable to purchasers of the shares under Rule 10b-5 if the information contained in the resale shelf prospectus contains disclosure that is inaccurate or misleading, or omits material information. Accordingly, during the period in which the resale shelf registration statement is effective, your company must continually monitor and update the information in the prospectus to ensure that the information is accurate and complete. Since the prospectus is automatically updated through incorporation by reference of subsequently filed 1934 Act reports, officers should maintain a heightened awareness of any nonpublic developments and, where material, disclose such developments on a Form 8-K.

Universal Shelf. A universal shelf registration statement is a registration statement on Form S-3 that registers a variety of securities that the company may wish to sell in the future. A typical universal shelf registration statement will include common stock, preferred stock, debt securities and convertible subordinated debt securities. Sometimes a universal shelf will also include more exotic securities, such as depositary shares, foreign currency exchange warrants and stock index warrants. In this type of registration statement, the company specifies the aggregate dollar amount of all the securities it intends to offer, rather than specifying the dollar amount of each type of debt security or the number of shares of each type of equity security it is registering. (As discussed below, a WKSI may be able to register securities by specific types or classes without indicating any dollar amount.)

Acquisition Shelf. An acquisition shelf provides for the issuance of equity securities as consideration in future acquisitions of privately held businesses. Unlike resale shelf and universal shelf registration statements that are filed on Form S-3, an acquisition shelf registration statement is filed on Form S-4. (We discuss acquisition shelfs in greater detail later in this Chapter.)

Requirements of Resale Shelf and Universal Shelf Registration Statements

Resale shelf and universal shelf registration statements are typically filed on Form S-3. Form S-3 allows for the incorporation by reference into the registration statement and prospectus of information contained in documents previously filed with the SEC, such as the company's most recent Forms 10-K, 10-Q and 8-K. Reports filed by the company with the SEC after the shelf registration statement becomes effective are automatically incorporated into the filed Form S-3. In this way, if the company complies with its periodic reporting obligations in a timely and comprehensive manner, its prospectus for the Form S-3 offering will remain current. Under new SEC rules, a shelf registration statement can be used for three years, and any unsold securities and related SEC fees from an existing registration statement can be carried over to a new shelf registration statement.

Resale Shelf. The prospectus of a resale shelf registration statement tends to be very short – sometimes as few as 10 pages in length. It typically includes a section listing the company's SEC filings and incorporating them by reference, a section on risk factors, a list of the selling shareholders (including the name, address, and number of securities a holder plans to sell), and a section that outlines the manner in which the securities are to be distributed. A selling shareholder will deliver a copy of the resale shelf prospectus to purchasers at the time it sells the securities.

Universal Shelf. A universal shelf registration statement consists of a base prospectus that is part of the initially filed registration statement on Form S-3 and a prospectus supplement that is filed when there is a takedown (a sale) of securities from the shelf. The base prospectus has typically included a section listing the documents incorporated by reference, a section on risk factors, the plan of distribution, a short description of the intended use of the proceeds from a sale of the securities, and a description of each type of security that is being registered on the shelf.

The base prospectus does not contain detailed information on the terms of the sale of the registered securities. These will appear in the prospectus supplement, which is filed with the SEC at the time the securities are taken down and sold. For some offerings, the prospectus supplement will only contain the basic terms of the securities being sold. For instance, a prospectus supplement filed in connection with a takedown of medium-term notes might contain only the aggregate principal amount of the notes to be sold in the offering, the public offering price, any discounts and commissions, a detailed description of the notes and a description of the plan of distribution. By contrast, an underwritten follow-on offering of equity securities may contain additional information that the underwriters would deem useful in marketing the offering, such as a description of the company's business, MD&A, capitalization and information on the company's principal shareholders. Under the SEC's 2005 securities offering reforms, new practices are likely to develop in the next few years with regard to the forms in which information is included in universal shelf registration statements and related prospectuses, with, for example, more required disclosure incorporated through Form 8-Ks.

When a takedown from the shelf occurs, the universal shelf issuer delivers a final prospectus containing both the prospectus supplement and the base prospectus to purchasers of the securities or an appropriate notice of the sale under an effective registration statement.

Unique Flexibility for WKSIs

WKSIs are entitled to additional flexibility in using shelf registration statements. WKSIs may file shelf registration statements on Form S-3 that are automatically effective upon filing. These shelf registration statements are not subject to review and comment by the SEC prior to their use, which means that an offering under one of these registration statements can begin immediately after it is filed with the SEC.

In the base prospectus included in the registration statement, a WKSI does not have to:

- specify the amount of securities to be offered,
- allocate the registered securities between primary and secondary shares,
- describe the securities (other than the name or class of securities), or
- outline the plan of distribution.

A WKSI can essentially make unlimited sales off its shelf registration statement and provide the required information omitted from the base prospectus in a prospectus supplement used at the time of the offering. If the WKSI chooses, it can file the required disclosure at the time of the offering in 1934 Act reports, like a Form 8-K or Form 10-Q, and incorporate the information by reference into a registration statement. A WKSI can also pay SEC registration fees on a "pay-as-you-go" basis, rather than at the time of initial filing.

A WKSI's ability to use the automatic shelf registration statement to register specific types of securities depends on how the company qualifies as a WKSI:

- *$700 million public float.* A company that qualifies as a WKSI based on public float ($700 million or more) is eligible to conduct an offering for any kind of security on an automatically effective shelf registration statement.
- *$1 billion of non-convertible securities.* A company that qualifies as a WKSI based on the aggregate value of issuances of its non-convertible securities (other than common equity) in registered offerings for cash during the three previous years ($1 billion or more) may use the automatic shelf registration statement to register investment-grade, non-convertible securities (other than common equity). In addition, if the value of the company's common equity held by non-affiliates is at least $75 million, it may register any other security using an automatically effective shelf registration statement.

A company's status as a WKSI is determined at the date of the initial filing of the registration statement and at the time of the filing of each amendment to the registration statement, as well as annually as part of its Form 10-K filing.

Form S-4: Mergers and Acquisitions

Form S-4 is designed to register securities to be issued in merger and acquisition transactions: reclassifications, mergers, consolidations or transfers of assets that involve an offer and sale of securities to the shareholders of the target company. (These are called Rule 145 transactions.) Shareholders make an investment decision by voting on a plan of merger, consolidation or sale of assets under which they will receive securities of the acquiring company. The offer is generally made in the form of a combined proxy statement/prospectus. These transactional solicitations must be registered under the 1933 Act unless an exemption from registration is available.

Form S-4 is unique in that it is a single document that satisfies both the 1933 Act registration requirements and the 1934 Act proxy solicitation and information requirements. The core disclosure document in a Form S-4 serves as the proxy or information statement of the target company soliciting shareholder approval of the transaction and the prospectus of the acquiring company offering its securities in consideration of the transaction.

A Form S-4, like all 1933 Act registration statements, becomes publicly available when filed. Preliminary proxy statements also are public upon filing. In limited circumstances described in Rule 14a-6 under the 1934 Act, confidential treatment of preliminary proxy materials is available to issuers whose public communications regarding the transaction are limited to the minimal information found in a tombstone advertisement.

Form S-4 allows a Form S-3 eligible acquiror and its target company to incorporate by reference information about their respective companies from their 1933 Act and 1934 Act filings. A Form S-4 proxy statement/prospectus that incorporates by reference must be sent to shareholders at least 20 business days prior to the date of the shareholders' meeting or, if no shareholder vote is required, 20 business days prior to the date of the closing.

Form S-4 requires extensive disclosure of the terms of the transaction, including discussion about the background and reasons for the transaction and any fairness opinions provided by financial advisors, as well as a comparison of the rights of shareholders of the two companies.

Practical Tip:
"Dear Diary..."

The "Background of Merger" section is the heart of the disclosure of any merger proposal a public company submits to its shareholders. During your negotiations, designate a team member to keep a brief but accurate timeline of critical dates of meetings, telephone calls, and other interactions between the target company and the potential acquiror. This can provide the outline of the Form S-4 mandated "Background of Merger" section.

Shareholders of the acquired company who receive securities in a transaction registered on a Form S-4 can generally resell their securities immediately after the closing of the transaction. For affiliates, however, Rule 145(d) under the 1933 Act adds some limitations:

- If the selling shareholder was an affiliate of the acquired company, but does not become an affiliate of the purchaser, then the seller can resell immediately after the closing, but will be subject, for one year after closing, to the volume, manner of sale and related limitations of Rule 144. After one year, the shares can be resold free of the volume and manner of sale limitations, and after two years, all remaining Rule 144 limitations fall away.
- If the seller was an affiliate of the acquired company and becomes an affiliate of the issuer, the seller can rely on Rule 145(d) to resell securities received in the transaction, but is subject to all the resale limitations of Rule 144. (We discuss Rule 144 in Chapter 4.)

Although Rule 145 by its terms does not apply to registered exchange offers, the SEC Staff has taken the position that the resale limitations of Rule 145(d) apply to securities received by affiliates in an exchange offer.

Form S-4 can also serve double duty as a Form S-3-like resale shelf registration statement allowing target company shareholders (for example, those subject to resale limitations under Rule 145) to resell their shares freely. To do so, the issuer must include Form S-3 type reoffering information in the registration statement.

The Acquisition Shelf

One of the major motivations for a rapidly expanding private business to become a public company is to be able to use its stock as currency for acquisitions. The Form S-4 acquisition shelf registration statement is a flexible and underused corporate finance vehicle designed for a series of stock-for-stock acquisitions of privately held target companies by a public company. An acquisition shelf is particularly useful at times when the initial public offering window is closed to private companies. At those times, stock-for-stock acquisitions by public purchasers represent an attractive exit to shareholders of private target companies who have discovered that a public offering will not provide them near-term liquidity.

The closer a purchaser's securities are to cash equivalents (for example, freely tradeable shares of a large-capitalization public company), the higher the value the target company's shareholders will attribute to the shares. Shares of a public company that are issued in a private placement without registration rights may be valued at a discount of 40 percent or more below their normal public trading price. The three methods to place readily resaleable shares into the hands of a private target company's shareholders are:

- A stand-alone registration on Form S-4;
- A private placement, followed by a resale shelf on Form S-3, used to register the sale of stock by the selling shareholder; and
- An acquisition shelf.

The acquisition shelf was recognized in a series of no-action letters (Service Corp. (1985) and later letters) in which the SEC authorized the use of this vehicle for stock-for-stock acquisitions of private companies that could otherwise be effected under a private placement exemption from registration. (The acquisition shelf also may be used more broadly, but its highest and best use is for transactions in which the private placement exemption would be available.) The acquisition shelf process has requirements which, while detailed and requiring close compliance, are quite practical for a well-organized public company:

- Prior to initiating discussions with a potential target company's shareholders, the issuer files a Form S-4 shelf registration statement with the SEC.
- The registration statement will not describe a particular transaction, but will be available for any of a broad range of private-company acquisitions.
- The acquisitions may be effected by merger, consolidation, acquisition of assets or share-for-share exchange (whether or not technically permitted by the Form S-4 instructions or Rule 145(a)).

Practical Tip: An Acquisition Shelf Checklist

To use an acquisition shelf, confirm that your company fits the optimal profile:

- A Form S-3 eligible issuer;
- Considering acquisition of one or more private companies (including subsidiaries or assets of a public company); and
- Likely to use stock as a significant portion of the consideration.

Deliver the acquisition shelf prospectus (which need not describe the acquisition itself) to the target company's shareholders:

- To insiders, when negotiations begin; and
- To other shareholders, at least 20 business days in advance of any shareholder vote or closing of the acquisition.

Some issuers, to ensure delivery of all material information, also deliver to the target company's shareholders copies of all the documents incorporated by reference into the prospectus. The target company usually simultaneously delivers to its shareholders an information statement that describes the terms of the transaction and other relevant information.

If an acquisition, or a series of smaller deals, is material for financial statement purposes, then the purchasing company will file a current report on Form 8-K or a post-effective amendment to the shelf Form S-4 containing full Regulation S-X required financial statements.

Affiliates of the target company will have restrictions on resale as "Rule 145(d)" persons. Those who become affiliates of the purchaser will become subject to Rule 144 for their resales. (We discuss Rule 144 in Chapter 4.)

Benefits of the Acquisition Shelf

The acquisition shelf has a number of benefits including the following:

- Because shares issued under an acquisition shelf Form S-4 are registered, those shares are freely tradeable by shareholders of the target company (although resales by affiliates of the target company are subject to Rule 145(d) restrictions).
- The shelf registration statement prospectus can be used immediately once the registration statement is effective, allowing the registrant to close a private company acquisition quickly.
- The shelf needs to be updated only if there is a material change in the plan of how shares will be distributed as described in the prospectus, or in other information included in the prospectus and not incorporated by reference.

Downsides to the Acquisition Shelf

Some companies will view as downsides that:

- Any acquisition shelf filing will signal the company's acquisition appetite to competitors and the market; and
- Some analysts and shareholders may view the registered shares negatively as "overhang."

Registration on Form S-8

Form S-8 is available for 1934 Act reporting companies to register securities offered to employees pursuant to an employee benefit plan. The requirements for the use of Form S-8 are much simpler than those of other registration forms. Like Form S-3, Form S-8 allows a company to incorporate by reference all the current and future 1934 Act reports filed by the company. Unlike Form S-3, however, Form S-8 does not require the company to file a prospectus with the SEC, but merely to provide employees with a prospectus containing specified information, including a description of the material terms and tax consequences of the benefit plan. Form S-8 is effective immediately upon filing.

Registrant Requirements

To be eligible to use Form S-8, the registrant must be a reporting company and must have filed all reports required to be filed during the preceding 12-month period (or shorter period that the company has been a registrant). For example, a company going public typically files a Form S-8 to become effective immediately after the effectiveness of the 1933 Act registration statement for the IPO.

Transaction Requirements

A reporting company can use Form S-8 to register securities offered to its employees pursuant to any written option, purchase, savings, bonus appreciation, profit-sharing, thrift, incentive, pension or similar plan, or a written compensation contract, including an individually negotiated agreement.

Practical Tip:
Beware of Restricted Stock

> A company may register shares underlying employee stock options at any time before the options are exercised, either before or after the options are granted. However, for restricted stock (stock subject to forfeiture restrictions that lapse over time), the Form S-8 must be effective before the company grants and issues the restricted stock.

Definition of Employee

The term "employee" includes consultants and advisors, other than those who render services in connection with an offer or sale of securities in a capital-raising transaction.

Practical Tip:
No Entities

In general, Form S-8 is available only to register securities offered to natural persons who qualify as employees and is not available for securities to be issued to entities.

Transferable Options

In 1999, the SEC amended Form S-8 to make it available for the exercise of employee stock options by an employee's family member who has acquired the options from the employee through a gift or a domestic relations order. Form S-8 is also available for family members of consultants, advisors and others who are deemed employees for purposes of Form S-8.

Chapter 13

Securities and Corporate Governance Litigation

Beause a public company is more visible and has more shareholders than a private company, it faces more litigation risks. Shareholders may bring federal securities class actions for alleged disclosure violations, or class and derivative actions asserting corporate governance claims. And a public company's regulators may bring:

- SEC enforcements actions,
- Criminal prosecutions, and
- NYSE and Nasdaq investigations and delisting proceedings.

A well-prepared management team and Board can conduct business as a public company in a way that reduces the risk of these claims and provides maximum protection to directors and officers for any claims that may arise.

Liability Under the 1934 Act — Section 10(b) and Rule 10b-5

Section 10(b) of the 1934 Act and related Rule 10b-5 provide the most common basis for private claims under the federal securities laws. Rule 10b-5 makes it unlawful for a person, in connection with the purchase or sale of a security:

- to make any untrue statement of a material fact; or
- to omit to state a material fact necessary in order to make a statement made, in light of the circumstances under which it was made, not misleading.

In practical terms, a company or individual risks a lawsuit for violating Rule 10b-5 by making an intentional or reckless misrepresentation or omission of fact that influences the price of the company's stock.

Rule 10b-5 applies to virtually any statement by a company, officer or director, including statements in periodic reports, press releases and analyst calls. Purchasers or sellers of stock can sue even if they did not see, hear or rely on the alleged misstatement. These purchasers can allege that they relied on the integrity of the market price of the stock to reflect all available material information and, therefore, can claim to be damaged. Rule 10b-5 imposes liability even where a company or person was not a party to a securities transaction, such as when an investor buys stock in a market transaction.

Although liability under Rule 10b-5 is broad, there are important limitations. A company or person is not liable for mere negligence. Instead, Rule 10b-5 imposes liability only on a defendant who acts with "scienter," which means with knowledge that a statement is false or with reckless disregard of whether the statement was false. In addition, a defendant is liable only for economic losses caused by the alleged misrepresentation or omission. In light of these limitations, defendants often assert a multi-pronged defense to claims under Rule 10b-5, arguing that:

- a statement was not false or misleading;
- the defendants did not know of or recklessly disregard the falsity of any statement; and
- the alleged misrepresentations and omissions did not cause the economic losses claimed by the plaintiffs.

Practical Tip: When You Talk, Says 10b-5: It's Quality, Not Quantity

Rule 10b-5 generally requires that a company speak truthfully when it speaks, but Rule 10b-5 does not impose an affirmative duty to disclose all material information about the company's business. For example, a company may have no obligation to disclose its development of a new product. However, if it chooses to discuss a new development, it must discuss the development accurately and completely.

Liability Under the 1933 Act — Sections 11 and 12(a)(2)

Sections 11 and 12(a)(2) of the 1933 Act impose liability for misstatements made in connection with a registered offering of securities. Sections 11 and 12(a)(2) often overlap, but they are not identical. They have different elements and provide for the recovery of different types of damages. Although Sections 11 and 12(a)(2) are limited to misstatements and omissions in registration statements and prospectuses, they allow a shareholder more easily to establish a claim. Therefore, they provide a powerful incentive to issuers and their agents to ensure the accuracy of statements in registration statements and prospectuses.

Section 11 — Liability for Misrepresentations in a Registration Statement

Section 11 of the 1933 Act permits shareholders to recover damages for misstatements or omissions of material facts in a registration statement – including the prospectus. Shareholders bear a relatively light burden under Section 11. With limited exceptions, Section 11 does not require a plaintiff to prove that he or she relied on the alleged misstatement, nor that the defendant acted with scienter (the 10b-5 requirement of knowledge or reckless disregard that a statement was false). A plaintiff generally must prove only that:

- The registration statement or prospectus misrepresented or omitted a material fact at the time it became effective;
- The plaintiff bought securities traceable to the registration statement; and

- The plaintiff suffered damages (typically a loss due to a decline in the price of a security).

A shareholder may bring a Section 11 claim against, among others:

- an issuer,
- any director of the issuer at the time of the offering, or
- any person who signed the registration statement.

Other Section 11 targets include any person who controls these primary defendants, as well as underwriters and accountants. Directors and officers of the issuer (but not the issuer) and some other defendants may assert an affirmative defense of reasonable care. In addition, all defendants may have available as affirmative defenses that:

- the misstatement or omission, if it occurred, did not cause the plaintiff's damages; and
- the plaintiff knew the truth when he or she bought the securities.

Section 12(a)(2) — Seller's Liability

Section 12(a)(2) of the 1933 Act provides shareholders with a right to sue for a misstatement or omission of material fact in a prospectus or oral communication used to offer or sell securities to the public. Any investor who purchases a security in a public offering can assert a Section 12(a)(2) claim against any person who offers or sells the security. Section 12(a)(2) applies only to sales of securities in a public offering, not to trading in the secondary market or to private sales of securities. Within those parameters, Section 12(a)(2) imposes relatively few requirements on a plaintiff. A plaintiff need not prove reliance, scienter or that the misstatement or omission caused the purchase. In order to recover, a plaintiff must prove only that:

- The defendant offered or sold securities:
- By the use of any means of interstate commerce (such as an interstate mailing or telephone call);
- Through a prospectus or oral communication;
- Which included a misstatement or omission of material fact; and

- The plaintiff was ignorant of the truth.

A successful plaintiff who still holds the security is entitled to rescission and may recover the consideration paid for the security, minus any income. Where the plaintiff has sold the security, the plaintiff may recover rescissionary damages, generally the difference between the purchase price and the resale price, plus interest, and minus any income or return of capital on the security.

A defendant may assert an affirmative defense of reasonable care. In addition, a defendant may have available the defenses of causation and plaintiff knowledge that we describe as available under Section 11.

Special Situations Under the 1933 Act and the 1934 Act

Forward-Looking Statements

Forward-looking statements, such as forecasts of earnings or revenues, have historically often served as the basis for private claims under the 1933 Act and the 1934 Act. In order to encourage forward-looking statements, Congress created, in the Private Securities Litigation Reform Act of 1995 (1995 Reform Act), a "safe harbor" defense to liability for forward-looking statements, that protects against claims under both the 1934 Act's Rule 10b-5 and the 1933 Act.

Under this safe harbor, a forward-looking statement cannot be the basis of liability if the company:

- Properly identifies it as a forward-looking statement and
- The statement is accompanied by "meaningful cautionary" statements that identify important factors that could cause actual results to differ materially from those in the forward-looking statement.

A company does not need to identify all important factors, or even the factor that ultimately causes actual results to differ from those forecast in the forward-looking statement, as long as it issues the best cautionary statements possible in the circumstances. (We provide practical guidance on this safe harbor in in Chapter 3.)

Liability for Endorsing Third-Party Statements

A company or person may be liable for statements made by stock analysts or other third parties if that company or person:

- Provided the third party with false or misleading information;
- Expressly or impliedly adopted the third-party statements as their own (the test is whether the defendant has so entangled itself with the third-party statements that the statements are, in effect, attributable to the defendant); or
- Endorses or adopts that statement after publication of the misleading or false statement, for example by distributing it to the public.

Practical Tip: How to Avoid Liability for Endorsing an Analyst's Report

Your company can take three basic steps to minimize liability for statements in a stock analyst's report:

- Enforce your company's policy of neither endorsing nor adopting the statements made by analysts;
- Do not link your website to analysts' reports or otherwise distribute them to shareholders or other members of the public; and
- Comply with Regulation FD. (We explain how in Chapter 3.)

Duty to Correct and Duty to Update

A company has a duty to correct a material statement of historical fact that the company discovers to have been untrue when made. The company must correct the prior statement within a reasonable time after learning that the original statement of historical fact was not true. There is no general duty to update statements that were true when made.

Frequently the passage of time and events cause a forward-looking statement, although reasonable at the time it is made, to become outdated or, if viewed as a current statement, to be materially misleading. Because it may be difficult to determine when a prior statement, in view of current developments, can become materially misleading, the best practice is to identify statements as accurate only on and as of the date they were made, and to specifically disclaim any intention or obligation to update them. This may not be possible, and the company is more likely to have to update a prior forward-looking statement that involved a central and significant issue about the company's business.

Shareholder Class Actions

Plaintiffs often assert private claims under the 1933 Act and the 1934 Act as "shareholder class actions." A shareholder class action is a lawsuit brought by a purchaser or seller, or a relatively small group of purchasers or sellers, on behalf of all investors who purchased or sold securities during a specified period of time known as a "class period." Plaintiffs and their lawyers often file shareholder class actions when a negative announcement by a company triggers a drop in the company's stock price.

A shareholder class action typically begins with one or a series of complaints; these soon are consolidated into one complaint. The issuer and other defendants often move to dismiss the complaint on the basis that the complaint fails to allege facts that meet applicable legal standards. If the court grants the motion, the court dismisses the case either:

- "With prejudice," meaning the case is over (subject to possible appeal); or
- "Without prejudice," meaning the plaintiffs have a chance to correct the defects in the complaint.

If the court denies the motion, the case proceeds to the discovery phase. Because most securities lawsuits cover an extended period of time and multiple aspects of a company's operations and financial condition, discovery can be extensive, costly and time-consuming. Once the plaintiff obtains access to extensive internal records of the company, the theory of what was not properly disclosed often changes and expands.

Practical Tip:
Named in a Shareholder Class Action?
Here's What to Do

As soon as a plaintiff names you or your company in a shareholder class action, you should promptly take these four basic steps:

- Consult your insurance broker and arrange to give timely notice to your D&O liability insurance carriers.
- Research and retain outside legal counsel experienced in securities litigation. Choose qualified counsel with good practical judgment who fit with your company. Because discovery in these cases can be unusually burdensome, it is helpful if your legal counsel knows the company well. You may be working closely with these lawyers for an extended period of time, and you should feel comfortable with them and confident in their abilities.
- Work with legal counsel to preserve documents as required by the 1995 Reform Act. Counsel will identify which documents should be retained and by whom. Preserve both paper documents and electronic records.
- Develop strategies and goals for handling the lawsuit. The first step in nearly all securities lawsuits is to move to dismiss the complaint. But plan beyond the motion to dismiss because the case may begin to move quickly if the court denies the motion to dismiss.

Securities Litigation After Sarbanes-Oxley

Sarbanes-Oxley has had only a modest impact on private securities class actions. The statute has, however, contributed to an increase in enforcement activity by the SEC and other government officials and had a significant effect on how companies respond to reports of wrongdoing.

CEO/CFO Certifications

Sarbanes-Oxley requires a CEO and CFO to certify their company's periodic reports. The certification requirement itself does not appreciably increase the potential liability of a CEO or CFO in securities class actions. However, the SEC has used the certifications in enforcement proceedings or litigation. Private plaintiffs have used the certifications to focus the claims more directly on the CEO and CFO or to suggest that, based on those officers' required review of the periodic report, they knew, or were reckless in not knowing, that the periodic report contained material misrepresentations or omissions. (We discuss practical tips for establishing procedures for complying with the certification requirements in Chapter 2.)

Extension of Statute of Limitations

Sarbanes-Oxley extends the statute of limitations for private securities lawsuits which assert fraud, deceit, manipulation, or a contrivance in contravention of a regulatory requirement. Claims subject to the statute of limitations must be brought not later than the earlier of:

- Two years after discovery of the violation (up from one year before Sarbanes-Oxley); or
- Five years after the occurrence of the violation (up from three years before Sarbanes-Oxley).

Most courts have held that the extended statute of limitations is not retroactive and does not revive claims that expired before July 30, 2002, when Sarbanes-Oxley took effect.

Retention and Destruction of Documents

Accountants are now required to retain a broad range of documents relating to audits or reviews of a company's financial statements, including audit and review work papers, for seven years from the end of the fiscal period in which the audit or review was conducted. An auditor must retain these materials whether they "support" or are "inconsistent" with the auditor's final conclusions. In addition, Sarbanes-Oxley imposes criminal liability on any

person – not only an auditor – who "corruptly" alters, destroys, mutilates, or conceals a document or other record with the intent to impair its integrity or availability for use "in an official proceeding."

Practical Tip:
Creating a Document Management Policy Post Sarbanes-Oxley

To protect the company and its employees, a Company's document management policy should include the following elements.

- A document creation policy that encourages professionalism in written communications, prohibits the use of profane language, unfounded gossip or speculation and encourages face-to-face discussion to resolve issues. You don't have to manage a misleading or unduly embarassing document that is never created.
- A document retention policy that identifies documents that should be retained, the retention period for different classes of documents, and the procedures to follow. Consult with tax, regulatory affairs, legal and other personnel to determine the right length of each category. Retained documents should include both important business records and documents necessary to meet government requirements.
- A document destruction policy that sets out procedures for destroying those documents that do not need to be retained, such as personal correspondence, non-essential emails, drafts of documents and records that have passed their retention dates.

Practical Tip: Creating a Document Management Policy Post Sarbanes-Oxley (Cont'd)

- Clear standards for suspending document destruction practices and preserving records, along with clear responsibilities for compliance. Relevant documents should be preserved whenever litigation, an investigation or other "official proceeding" has commenced or becomes reasonably foreseeable. Destroying relevant documents under those circumstances – or under any other circumstance that might suggest an intent to make the documents unavailable in the lawsuit, investigation or other official proceeding – may subject the company and its employees to sanctions for spoliation of evidence or even criminal charges for obstruction of justice. There is no bright line test, so err on the side of caution.

Standards of Professional Conduct for Attorneys

The SEC's "up-the-ladder reporting" rules require attorneys to report evidence of material violations of state or federal law to a company's senior management. If senior management does not respond appropriately, the reporting attorney is required to report the violation to a committee of independent directors or to the full Board. Since 2003, the SEC has been considering a proposed rule expanding these "up-the-ladder" procedures to require an attorney to withdraw from representation of a company if senior management or the Board does not respond appropriately to the reported violation. The company or the attorney could be required to notify the SEC about the withdrawal.

Securities Debts Survive Bankruptcy

One of the more obscure provisions of Sarbanes-Oxley amends the Bankruptcy Code to provide that some debts arising from claims under federal or state securities law and common law securities fraud are not dischargeable in bankruptcy.

"Whistle-blower" Protection

Sarbanes-Oxley provides protection from retaliation for employees, agents, and contractors who lawfully provide information or otherwise assist investigations being conducted by a federal regulatory or law enforcement agency, a congressional member or committee, or any supervisor of the employee. The protection extends to employees who participate in proceedings alleging violations of selected federal statutes and regulations.

SEC, Justice, State Regulators Are Active

Regulators have enforced the securities laws more vigorously in recent years. The SEC has brought more enforcement actions and has sought more serious sanctions, including director and officer bars and harsher penalties. The SEC has also increased its scrutiny of gatekeepers and third parties who aid and abet alleged violations of the securities laws. The Department of Justice has likewise been more active, bringing hundreds of criminal cases for alleged corporate frauds.

Sarbanes-Oxley has contributed to these developments by providing more resources to the SEC and giving the SEC expanded powers. Sarbanes-Oxley, for instance, gives the SEC greater authority to bar individuals from serving as officers or directors of public companies, permits the SEC to recover profits earned by certain insiders in the case of an accounting restatement and allows the SEC to obtain a freeze order barring an issuer from making certain extraordinary payments during the pendency of an SEC investigation. Sarbanes-Oxley has also facilitated more vigorous criminal prosecutions by increasing penalties and creating new crimes.

Practical Tip:
Create and Monitor an Effective Compliance Program

Companies will generally be liable for crimes committed by employees in connection with their employment. In determining whether to charge a company for the wrongdoing of an employee, prosecutors and regulators often ask: Did the company have an effective compliance program to detect and prevent violations of law? To protect the company, establish a compliance program that:

- Includes written standards and procedures.
- Establishes clear responsibilities for overseeing and operating the compliance program.
- Ensures that corporate authority is responsibly delegated.
- Provides appropriate training at all levels, including the board of directors and senior management.
- Monitors, audits, evaluates and promotes the reporting of potential and actual violations, including a confidential or anonymous reporting mechanism.
- Holds employees accountable for violations of policy or law.
- When a possible violation occurs, takes prompt and reasonable steps to remedy or, as appropriate, report the violation.

Corporate Governance Litigation

In addition to claims under the federal securities laws, directors and officers of a public company may also face claims in connection with the corporate governance issues discussed in Chapters 8, 9 and 10. Corporate governance litigation often involves alleged conflicts of interest. (We discuss ways to manage conflict of interest situations responsibly in Chapter 8.)

Change of Control Situations

Change of control transactions are especially fraught with potential conflicts of interest for directors and are a common source of litigation, whether brought by frustrated potential acquirors or by shareholders dissatisfied with a transaction. For example, shareholder plaintiffs often allege that directors have approved a merger or other change of control transaction in order to entrench themselves, to obtain benefits for themselves or to benefit a favored shareholder. The duty of the Board in a change of control situation is fairly clear - at least in theory:

- The Board must act in the best interests of the company and all of its shareholders.
- If the Board decides to sell the company, it generally must take reasonable steps to obtain the best available price and cannot unduly favor a lower-valued transaction.

Directors' actions in the face of a takeover threat are subject to enhanced scrutiny. The business judgment rule protects only those actions that have successfully passed this stringent test. Using one of the four methods described in Chapter 8 for dealing with conflicts of interest in a change of control situation can address conflict issues and protect the directors from liability.

The sale of a company will generally trigger dissenters' rights provisions in the governing corporate statute. Careful compliance with these provisions can result in preemption of shareholder claims for monetary relief, in favor of the statutory appraisal process. (The statutory dissent process will not preempt claims for injunctive relief or claims for fraud, misrepresentation or other serious impropriety.)

Derivative Lawsuits

Many corporate governance claims are asserted in derivative lawsuits. In a derivative lawsuit, a shareholder sues on behalf of the company, seeking relief for alleged claims the company owns but has failed to bring itself. A derivative plaintiff cannot recover damages personally; instead, any damages or injunctive relief inure solely to the benefit of the company. Typically, derivative claims

include alleged breaches of fiduciary duty by officers, directors or major shareholders, as well as claims against third parties who are alleged to have harmed the company.

Derivative plaintiffs generally must comply with strict procedural requirements:

- The plaintiff must be a shareholder at the time of the alleged wrong and remain a shareholder throughout the litigation;
- The plaintiff must be an adequate representative of the company's other shareholders;
- The company usually must be made a party to the litigation, generally as a nominal defendant; and
- Before bringing suit, the plaintiff must make a demand upon the Board that the company take steps to assert the claim.

A court will permit the plaintiff to proceed without a demand upon the Board if the plaintiff can establish that demand would be futile by showing a reasonable doubt that

- The directors are disinterested and independent, and
- The challenged transaction was the product of a valid exercise of business judgment.

A company may assume control of derivative litigation by appointing a Special Litigation Committee of the Board to investigate the claims asserted by a derivative plaintiff and determine whether pursuing the claims is in the best interests of the company. A Special Litigation Committee will have the power to terminate, settle or pursue the litigation, and may decide to permit the existing plaintiff to continue the suit. The Board should appoint disinterested independent directors to a Special Litigation Committee, and give it full authority to accomplish its investigation and to implement its decisions. Courts often grant motions to stay derivative suits, including all discovery, pending the outcome of Special Litigation Committee investigations. Any Committee decision to terminate the litigation will be subject to judicial review, and a party challenging the Special Litigation Committee's decision is entitled to limited discovery into the independence and good faith of the Committee's investigation.

Practical Tip: The Lonely Life of the One-Member Special Committee

A Special Litigation Committee (or any other special Board Committee) must be composed of directors who are disinterested and independent. In some states, a minimum of two directors may be required; in Delaware and other states, a Committee may be composed of only one director. However, in the words of one court, "[i]f a single member committee is to be used, the member should, like Caesar's wife, be above reproach." As a practical matter, the independence of a single member Committee may come under more rigorous scrutiny than would otherwise be applied to individual members of a larger Committee.

For this reason and others discussed elsewhere in this Public Company Handbook, a public company's Board is best composed of at least three independent directors.

Once a derivative action is commenced, the parties will need court approval to settle or dismiss it. In most derivative cases, notice of a settlement must be provided to the shareholders, and the court will convene a hearing to determine whether the settlement is fair and adequate. Attorneys' fees may be awarded to plaintiff's counsel – either out of the proceeds of the settlement or from the issuer itself – if the court determines that counsel's efforts conferred a substantial monetary or non-monetary benefit upon the company.

Regulatory Investigations and Enforcement

SEC

Each year the SEC brings hundreds of civil enforcement actions against companies and individuals that are alleged to have violated the federal securities laws. These actions include claims for:

- Insider trading;
- Accounting fraud;
- Disclosure violations; and
- Aiding and abetting violations.

The SEC will often seek immediate injunctive relief against defendants to prohibit the acts and practices that violate the law or SEC rules; the SEC may also seek disgorgement, monetary penalties and other sanctions against the alleged wrongdoers. While the SEC does not have the authority to pursue criminal actions, it may refer matters to the Department of Justice for criminal investigation and prosecution.

The SEC often pursues initial investigations through an informal inquiry, interviewing potential witnesses and examining brokerage records or trading data in order to determine whether further investigation is warranted. Following the preliminary investigation, if the SEC issues a formal order of investigation, the division staff may compel witnesses by subpoena to testify and produce books, records and other relevant documents to assist the SEC in its investigation. The SEC can authorize its staff to file a case in federal court or to bring an administrative action against some individuals and companies.

NYSE/Nasdaq

In addition to the SEC's civil enforcement authority, both NYSE and Nasdaq can exercise their discretionary authority to enforce organization rules. NYSE and Nasdaq require each listed company to comply with the rules of their respective exchanges, federal securities laws and rules and regulations promulgated by the SEC. Companies face delisting or harsh penalties for failing to comply.

Both NYSE and Nasdaq maintain ongoing surveillance on trading and information disseminated by listed companies. Moreover, both NYSE and Nasdaq can require issuers to furnish information to their staffs. NYSE or Nasdaq inquiries may be triggered by any number of events. For example, if there has been unusual trading in a company's stock prior to a material announcement, the exchange may make an informal inquiry for information about the background leading up to the announcement and the persons knowledgeable about these events. The most dramatic tools available to either NYSE or Nasdaq are the ability to suspend trading in a security or to delist a security. Violations of the terms of the listing agreement or the rules of NYSE or Nasdaq are sufficient grounds for delisting. In addition, many SEC investigations are initiated as a result of information obtained from NYSE or Nasdaq.

Chapter 14

Tiring of the Public Eye? Delisting, Deregistration and Going Private

At some point in their corporate life cycles, many companies delist, deregister or go private and cease making periodic filings with the SEC.

Delisting and Deregistration

Exchange Delisting (Section 12(b))

A public company registered under Section 12(b) of the 1934 Act can delist its securities voluntarily by application in accordance with the rules of its exchange. However, as long as the company has 300 or more shareholders, it will remain subject to the 1934 Act under Section 12(g) (companies of a certain size).

Size Criteria Delisting (Section 12(g))

A company can voluntarily terminate its registration of securities under Section 12(g) of the 1934 Act, by filing a Form 15 certifying that either:

- The registered class of securities is held of record by fewer than 300 persons; or
- The registered class of securities is held of record by fewer than 500 persons and the total assets of the company have not exceeded $10 million on the last day of each of the company's three most recent fiscal years.

The company's duty to file periodic reports is immediately suspended upon filing the Form 15, and its registration under the 1934 Act terminates 90 days after filing. The suspension will terminate if the company crosses the Section 12(g) size thresholds as of the end of any future fiscal year.

Suspension After Filing 1933 Act Registration (Section 15(d))

In rare instances, a company registers its securities with the public and has reporting obligations under Section 15(d) of the 1934 Act, but neither lists with an exchange nor meets the Section 12(g) size criteria. Under these circumstances, the company's periodic reporting obligations are automatically suspended for a fiscal year if at the beginning of that year the registered securities are held of record by less than 300 persons. A company must file a Form 15 with the SEC as a notice of the automatic suspension within 30 days after the beginning of the fiscal year in which the suspension is effective.

A company cannot usually suspend its Section 15(d) periodic reporting requirements in the same year that it initially registers its securities under the 1933 Act. Accordingly, a company cannot complete an IPO and immediately escape the periodic reporting requirements of Section 15(d). Instead, at least in the first fiscal year of its IPO, it must file periodic reports with the SEC.

Going Private Transactions: Flying Below the Radar

In a going private transaction, a significant shareholder group (often insiders) offers to purchase all or most of the company's equity securities held by the general public. The company then files a Form 15 to deregister under the 1934 Act and will no longer have its stock publicly traded.

The Board of Directors of a public company may determine that a going private transaction is in the best interest of shareholders and the company for a number of reasons:

- *Small Float for Orphan Company.* A company with a small public float and little or no analyst coverage sometimes is unable to realize the benefits of being a public company. Stock prices for these types of companies, sometimes

referred to as orphan public companies, may be undervalued and shareholders may have limited liquidity.

- *No Third-Party Purchasers.* The company may have sought and failed to find a third-party purchaser to maximize shareholder value.
- *Weary Outside Shareholders.* Outside shareholders may be prepared to liquidate their investment, while significant shareholders and management may not be ready to sell.
- *Liquidity.* A going private transaction will provide public shareholders with an opportunity to sell their shares at a premium to recent market prices.
- *Elimination of 1934 Act Reporting Obligations.* Going private relieves a company of the expenses and burdens of preparing and filing 1934 Act reports with the SEC, and complying with proxy requirements and stock exchange or market rules.

There are downsides to going private, including:

- *Cost, Decreased Liquidity and Loss of Public Profile.* Future cost savings may be offset by other considerations, such as:
  - The cost to complete the going private transaction;
  - Decreased liquidity for remaining shareholders;
  - A potentially heavy debt burden (if the transaction is financed); and
  - A loss of public profile or prestige compared to status as a public company.
- *Conflicts of Interest.* Going private transactions raise special concerns because the proponent typically has a conflict of interest. The proponent is frequently represented on the company's Board of Directors and has a fiduciary duty to the other shareholders, while it is in the proponent's personal financial interest to pay the minimum purchase price for the company.

The Process of Going Private

A going private transaction may take many forms, but the ultimate result is that the proponent acquires all or most of the outstanding stock, and the selling shareholders receive cash, redeemable preferred stock or debentures for their shares. The two most common transaction types are a self tender or proxy solicitation to propose a merger.

Self Tender. A company self tender offer that buys out the general public will leave the proponent shareholder group holding a majority of the company's outstanding equity. The self tender is followed by a second-step merger transaction in which all shareholders other than the proponent are squeezed out.

Friendly Merger/Proxy Solicitation. Alternatively, the company can solicit shareholder proxies to merge the target company with an insider or an aquiror controlled by a third party. As with a self tender, the proponent group will be left with a majority of the shares, and selling shareholders will receive cash or other consideration.

If any of the Board members has a conflict of interest in the transaction, the company's Board will often appoint a Special Committee of independent directors to review the proposal, negotiate with the proponent, and make recommendations to the full Board. The Special Committee may retain independent counsel and a financial advisor to evaluate the proposed transaction and opine on the fairness of the transaction. (We discuss how to manage conflicts of interest in Chapter 8.) If the Board is unable to cleanse a conflict of interest, the transaction will be subject to entire fairness review, which includes demonstrating fair dealing and a fair price.

Rule 13e-3

Rule 13e-3 under the 1934 Act governs going private transactions and imposes significant disclosure requirements on a public company going private. Among other items, the company must disclose in the proxy statement or tender offer document filed with the SEC:

- The purpose of the transaction;
- Alternatives considered and reasons for their rejection;

- Reasons for the structure of the transaction and for undertaking it at this time;
- Why the issuer believes the transaction is fair;
- A discussion of the analysis underlying a financial advisor's fairness opinion;
- Firm offers made by any third party for the company during the past two years; and
- Extensive financial information.

Practical Tip:
Key Players in a Going Private Transaction

Special Committee. A going private transaction often involves a conflict of interest between an insider proponent that may control the company and the other shareholders. The Board will want to ensure that a Special Committee is selected and granted broad authority. The Special Committee will have the ability to choose its own financial, legal and accounting advisors, and will become the voice of the Board in the transaction. The first significant act of the Special Committee is to choose its outside advisor.

Financial Advisor. The financial advisor will advise the Special Committee on the financial structure of the transaction and on strategic alternatives to the transaction. The Special Committee will also request that the financial advisor deliver a fairness opinion to the Special Committee. A fairness opinion is a statement by the financial advisor that the consideration or financial terms of the going private transaction are fair, from a financial point of view, to the company and its shareholders. Obtaining a fairness opinion is an important step in establishing that the Board has satisfied its fiduciary duty of care.

Practical Tip: Key Players in a Going Private Transaction (Cont'd)

Information Agent. Even before the going private transaction begins, an information agent, typically, a proxy solicitation or consulting firm, will provide an analysis of the company's shareholder base and, based on that, help give strategic advice on the structure of the transaction. Following the commencement of the offer, the information agent will handle the distribution of tender offer documentation (if the transaction is structured as a self tender) and will field telephone calls from shareholders with questions about the offer or procedures for tendering their shares.

Dealer Manager. The dealer manager (typically an investment banking firm retained by the company) will solicit tenders or consents and communicate generally regarding the transaction with brokers, dealers, commercial banks and trust companies. In smaller deals, the information agent plays this role.

Depositary. In a self tender transaction, the depositary, typically a company's transfer agent, receives tenders of shares and provides daily updates to the company on the number of shares tendered.

Outside Counsel. Outside counsel will prepare the transaction documents and handle filings and communications with the SEC. It will also advise the Board (and Special Committee if the Special Committee does not retain separate counsel) on the legal aspects of the transaction and on the fiduciary duties of the directors. The Special Committee may wish to retain independent counsel.

APPENDIX 1
Key Sarbanes-Oxley and Corporate Governance Disclosure Items

Disclosure Item	Location	Source/Rule
SARBANES-OXLEY/SEC		
Disclose whether the company has a Code of Ethics for its CEO and senior financial officers, or if not, explain why not.	10-K (may be incorporated from Proxy Statement) Code of Ethics must be posted on website or filed as an exhibit to the 10-K, or instructions must be provided in the 10-K as to how to receive a copy free of charge	Sarbanes-Oxley § 406 SEC Regulation S-K Item 406
Disclose waivers or changes to Code of Ethics for CEO and senior financial officers.	8-K (within 4 business days) or website (but only if website address and intention of website disclosure clearly noted in most recent 10-K)	Sarbanes-Oxley § 406 SEC Regulation S-K Item 406
Disclose information regarding the process by which shareholders may communicate with the board, and, if no process exists, explain why not. If a company has a process for communication: • describe how shareholders can communicate with the board (and if applicable, individual directors); and • if all shareholder communications are not sent directly to board members, describe the process for determining which communications will be delivered to board members.	Proxy Statement (information may also be posted on website and referenced in the Proxy Statement)	Schedule 14A Item 7(h)
Disclose policy regarding Board members' attendance at annual meeting and the number of directors who attended the prior year's annual meeting.	Proxy Statement (information may also be posted on website and referenced in the Proxy Statement)	Schedule 14A Item 7(h)

Disclosure Item	Location	Source/Rule
Disclose whether the members of the nominating committee are independent within the meaning of the applicable SRO's listing standards (if any directors are not independent, disclose the nature of the relationship and the reasons for any determination to appoint a non-independent director to the nominating committee).	Proxy Statement (nominating committee charter may also be posted on website and referenced in the Proxy Statement; otherwise must be attached as an exhibit to the Proxy Statement at least once every three years)	Schedule 14A Item 7(d)(2)(ii)
Disclose information about the director nomination process, including: • the "minimum qualifications" for a nominee to be recommended by the nominating committee, including "any specific qualities or skills" necessary for a nominee; • whether the company has a policy (including the material terms of the policy) regarding consideration of shareholder-recommended board candidates and, if not, why not, as well as whether the nominating committee will consider shareholder-recommended candidates and, if so, the procedures for recommending them; • a description of the process for identifying and evaluating potential nominees to the board, including shareholder-recommended candidates.	Proxy Statement	Schedule 14A Item 7(d)(2)(ii)

Disclosure Item	Location	Source/Rule
(if shareholder-recommended candidates are evaluated on a different basis from other candidates a company must disclose and explain the differences); and • disclose the name of a candidate and the recommending shareholder (and whether the company nominated the candidate) if such shareholder holds 5% or greater of company securities and has held such position for at least a year and has recommended the director candidate at least 120 calendar days prior the anniversary of the mailing date of the prior year's Proxy Statement.		
Describe any material changes to the procedures by which security holders may recommend nominees to the company's board where those changes were implemented after the last provided disclosure about the director nomination process in the Proxy Statement.	10-K (if change occurred in 4th quarter) (may be incorporated from Proxy Statement); 10-Q (for all other quarters where the change occurred)	SEC Regulation S-K Item 401(j)
Disclose whether the company has a separately standing audit committee and the names of members on the audit committee (if no committee exists disclose that the entire board is acting as the audit committee).	Proxy Statement; 10-K (may be incorporated from Proxy Statement)	SEC Regulation S-K Item 401(i)
Disclose whether the members of the audit committee are independent (if any directors are not independent disclose the nature of the relationship and the reasons for any determination to appoint a non-independent director to the audit committee). If the company does not have a separately designated audit committee, or committee performing similar functions, provide the disclosure with respect to all members of the board.	Proxy Statement	Schedule 14A Item 7(d)(3)

Disclosure Item	Location	Source/Rule
Disclose whether the audit committee has a financial expert (including the name of the person) and if not, why not.	10-K (may be incorporated from Proxy Statement)	SEC Regulation S-K Item 401(h)
To the extent not already disclosed per the requirements above, disclose whether the company has standing audit, nominating and compensation committees (or other committees performing similar functions) and briefly describe the functions performed by each committee. Also, identify each committee member and state the number of committee meetings held by each committee during the last fiscal year.	Proxy Statement	Schedule 14A Item 7(d)(1)
Post on website Section 16 "Insider" Reports: Forms 3, 4, and 5.	Website (post filed forms)	Sarbanes-Oxley § 403 1934 Act Rule 16a-3(k)
Disclose website address and whether periodic and current reports (10-Ks, 10-Qs and 8-Ks) are posted on website (if a company does not post reports on its website it must disclose the reasons why not and whether it will provide electronic or paper copies upon request).	10-K (business section)	Sarbanes-Oxley § 403 SEC Regulation S-K Item 101(e)
Whenever one or more non-GAAP financial measures are included in a filing made with the SEC a company must include the following: • the most directly comparable GAAP information; • reconciliation of the non-GAAP information to the GAAP information; and • management rationale and purposes for use of the non-GAAP information.	SEC filing that includes non-GAAP financial measures	Sarbanes-Oxley §§ 401(b), 409 SEC Regulation S-K Item 10

Disclosure Item	Location	Source/Rule
If any release (orally or telephonically or by webcast, broadcast or similar means) includes non-GAAP information, disclose the most directly comparable GAAP information and a reconciliation of the non-GAAP information to the GAAP information.	Website (if provided on the website at the time the non-GAAP information is made public and the website location is made public during the presentation)	Sarbanes-Oxley §§ 401(b), 409 SEC Regulation G (Rule 100)
File CEO and CFO certifications of fair representation of material facts and development, maintenance and review of disclosure controls and procedures and internal control over financial reporting.	10-K; 10-Q (certifications filed as exhibits)	Sarbanes-Oxley § 302 SEC Regulation S-K Item 601
Furnish CEO and CFO certifications of accuracy, compliance and fair representation in all material respects of financial condition and results of operations.	10-K; 10-Q (certifications furnished as exhibits)	Sarbanes-Oxley § 906 SEC Regulation S-K Item 601
Disclose conclusions of principal executive and financial officers regarding effectiveness of the company's disclosure controls and procedures as of the period covered by the report.	10-K; 10-Q	SEC Regulation S-K Item 307
Disclose management report on internal control over financial reporting.	10-K Deadlines for compliance: • accelerated filers (generally companies with a market capitalization in excess of $75 million) are first required to comply for fiscal years ending on or after November 15, 2004 • non-accelerated filers and foreign private issuers are first required to comply for fiscal years ending on or after July 15, 2007	Sarbanes-Oxley § 404 SEC Regulation S-K Item 308(a)

Disclosure Item	Location	Source/Rule
Disclose independent auditor's report on management's report on internal control over financial reporting.	10-K Deadlines same as for management reports under SEC Regulation S-K Item 308(a) immediately above	Sarbanes-Oxley § 404 SEC Regulation S-K Item 308(b)
Provide tabular disclosure of contractual obligations for future payments.	10-K MD&A; 10-Q (describe material changes outside the ordinary course of business to the table provided in the 10-K)	Sarbanes-Oxley § 401 SEC Regulation S-K Item 303
Disclose any material off-balance sheet transactions.	10-K MD&A; 10-Q MD&A	Sarbanes-Oxley § 401 SEC Regulation S-K Item 303
NYSE Listing Standards		
Disclose Corporate Governance Guidelines.	Website (post printable version)	NYSE § 303A.09
Disclose charters of most important board committees (including at least the audit, and for most companies, compensation and nominating committees).	Website (post printable versions)	NYSE § 303A.09
Disclose Code of Business Conduct and Ethics for directors, officers and employees, and disclose any waiver for directors and executive officers.	Website (post printable version of code) Waivers may be disclosed via press release, Website or Form 8-K	NYSE § 303A.10
Disclose the names of independent directors and the basis for the board's independence determination (including if the board has adopted any categorical independence standards and whether any directors fit into those standards). If a board determines that a director who fails to meet the board's categorical independence standards is nevertheless independent it must specifically explain its rationale.	Proxy Statement (or 10-K if the company does not file a Proxy Statement)	NYSE § 303A.02

Disclosure Item	Location	Source/Rule
Disclose contributions from the company to any tax exempt organization for which an independent director serves as executive officer if within the preceding three years such contributions exceeded the greater of $1 million or 2% of the tax exempt organization's consolidated gross revenues.	Proxy Statement (or 10-K if the company does not file a Proxy Statement)	NYSE § 303A.02
Disclose the name of the director who presides over all executive sessions of the non-management directors or the procedure by which a presiding director is selected for each executive session.	Proxy Statement (or 10-K if the company does not file a Proxy Statement)	NYSE § 303A.03
Disclose the method for third parties to communicate directly with the presiding director of executive sessions of non-management directors or with non-management directors as a group.	Proxy Statement (or 10-K if the company does not file a Proxy Statement)	NYSE § 303A.03
Disclose any board determinations allowing an audit committee member to simultaneously serve on three or more audit committee boards.	Proxy Statement (or 10-K if the company does not file a Proxy Statement)	NYSE § 303A.07
Provide a CEO certification that the company is not aware of any violation of NYSE corporate governance listing requirements.	NYSE; Annual Report to Shareholders (or 10-K if the company does not prepare an Annual Report to Shareholders), if applicable.	NYSE § 303A.12
Provide prompt notification after an executive officer of the company becomes aware of noncompliance by the company with any applicable provisions of NYSE's corporate governance standards.	NYSE	NYSE § 303A.12

Disclosure Item	Location	Source/Rule
NASDAQ Listing Standards		
Disclose Code of Conduct for directors, officers and employees, which must comply with the SEC definition of code of ethics contained in SEC Regulation S-K Item 406.	Nasdaq requirement is to make publicly available Code of Conduct must be posted on website or filed as an exhibit to the 10-K, or instructions must be provided in the 10-K as to how to receive a copy free of charge	NASDAQ § 4350(n)
Disclose waivers to the Code of Conduct for directors or executive officers.	8-K (within 4 business days)	NASDAQ § 4350(n)
Disclose the names of directors the board has determined to be independent.	Proxy Statement (or 10-K if the company does not file a Proxy Statement)	NASDAQ §§ 4200, 4350(c)(1)
If a non-independent director is appointed to the compensation committee under the "exceptional and limited circumstances" exception, disclose the nature of the relationship and the reasons for the determination to appoint the non-independent director.	Proxy Statement (or 10-K if the company does not file a Proxy Statement)	NASDAQ § 4350(c)(3)
If a non-independent director is appointed to the nominating/corporate governance committee under the "exceptional and limited circumstances" exception, disclose the nature of the relationship and the reasons for the determination to appoint the non-independent director.	Proxy Statement (or 10-K if the company does not file a Proxy Statement)	NASDAQ § 4350(c)(4)
Provide prompt notification after an executive officer of the company becomes aware of any material noncompliance by the company with NASDAQ corporate governance standards.	NASDAQ	NASDAQ § 4350(m)

Disclosure Item	Location	Source/Rule
Disclose receipt of an audit opinion that contains a going concern qualification (disclosure to be made no later than seven calendar days following the filing of such audit opinion in a public filing with the SEC).	Press Release (prior to such release the text must be provided to the StockWatch section of NASDAQ's MarketWatch Department)	NASDAQ § 4350(b)(1)(B)

APPENDIX 2

ANNUAL 1934 ACT REPORTING CALENDAR (SEC Reporting and Annual Shareholders' Meeting)

The following sample form of Annual 1934 Act Reporting Calendar for SEC Reporting and Annual Shareholders' Meeting purposes provides a starting point for creating your company's checklist and timetable for the tasks associated with SEC periodic reporting obligations and the annual shareholders' meeting. Tailor the Calendar to your company to reflect your company's specific requirements and timing. Work closely with your company's internal reporting teams (legal, finance, investor relations, human resources, etc.), Disclosure Practices Committee, outside legal counsel and independent auditors to assure compliance with each of: (a) the 1934 Act requirements and other federal securities law requirements; (b) state law requirements (the Calendar assumes a company incorporated in Delaware); (c) the company's charter, bylaws, reporting and governance policies, and Board committee charters; and (d) applicable NYSE or Nasdaq listing standards. For simplicity, the Calendar assumes that your company is a large accelerated filer with a December 31 fiscal year-end and a May 15th annual meeting date, and that no proposal to be considered at the annual meeting will require the filing of a preliminary proxy statement with the SEC.

Date*	Item	Responsibility
December 1	Insider trading "blackout" period begins *(Sometimes begins at start of last month of quarter, or two weeks prior to quarter end, although timing will depend on Company policy)*	*Company*
	Send reminder to officers and directors to give prior notice to and obtain preclearance from Company with respect to securities transactions to be made during next month *(Form 4s must be filed with SEC within two business days after the transaction requiring reporting on Form 4 is executed)*	*Company*
December 1 – 6	Coordinate with Auditors regarding Q4 and year-end audit	*Company/Auditors*

** Dates will change depending on the calendar year. Generally, if the last filing day relating to an SEC filing requirement falls on a weekend or holiday, then the last filing day relating to such filing shall extend to the next business day.*

Date*	Item	Responsibility
December 1 – 9	Meetings of internal reporting teams, including meeting of Disclosure Practices Committee regarding, among other things: planning for Q4 and year-end earnings release; 10-K and proxy season reporting; disclosure/materiality issues relating to public disclosures; review of disclosure controls and procedures and internal control over financial reporting; and CEO/CFO certifications for 10-K	*Company*
December 1 – 10	Schedule appropriate meetings for actions to be taken by Audit, Compensation, Governance/Nominating, and other Board Committees, and Disclosure Practices and other management Committees, for upcoming year, including reporting season	*Company*
December 5 – 9	Determine whether Company or any intermediaries will use SEC "householding" rules regarding delivery of annual meeting materials	*Company/Legal Counsel*
December 5 – 16	Review FD policy and provide training sessions for applicable personnel	*Company*
December 19 – 23	Determine if preliminary proxy statement will be required. If so, revise schedule accordingly, including accelerating initial filing of proxy statement	*Company/Legal Counsel*
December 23 – 26	Determine if paper and envelopes should be ordered for proxy materials and annual report to shareholders *(Particularly if a large printing of a glossy annual report to shareholders will be required)*	*Company*
	Determine whether a proxy solicitor will be used	*Company*
	Select printer(s) for proxy materials, 10-K and annual report to shareholders (as well as determine if annual report to shareholders will have special graphics or photography)	*Company*
December 26 – 30	Distribute D&O Questionnaires (including Audit Committee financial expert/independence materials) relating to annual proxy statement, 10-K and Form 5s	*Company/Legal Counsel*
December 31	**End of Q4 and reporting year**	

Date*	**Item**	**Responsibility**
January 1	Send reminder to officers and directors to give prior notice to and obtain preclearance from Company with respect to securities transactions to be made during next month *(Form 4s must be filed with SEC within two business days after the transaction requiring reporting on Form 4 is executed*)	*Company*
January 2 – 4	Planning meeting to review and update business section, MD&A and risk factors in 10-K	*Company/Legal Counsel /Auditors*
	Determine location, time and date of annual meeting	*Company*
January 3 – 10	Begin closing books and compiling information for financial statements and notes for Q4 and year-end; continue coordinating with Auditors regarding Q4 and year-end audit; draft financial statements and notes for Q4 and year-end; draft Q4 earnings release	*Company/Auditors*
January 5 – 23	Draft 10-K, including financial statements and notes	*Company*
January 7 – 14 *(assuming previous year's definitive annual proxy materials were sent out between March 28 and April 4)*	Final date Company may file with SEC no-action requests regarding Rule 14a-8 of the 1934 Act shareholder proposals to be included in annual proxy statement *(Rule 14a-8 of the 1934 Act requires filing no-action requests no later than 80 calendar days prior to filing of definitive proxy materials with SEC)*	*Company/Legal Counsel*
January 9 – 11	Notify insiders that insider trading window opens for Q1 on January 27 *(Generally notify insiders two/three weeks before quarterly earnings release, although timing will depend on Company policy)*	*Company*
January 10 – 24	Prepare first draft of annual proxy statement, proxy card and notice	*Company*
	Prepare first draft of Audit Committee Report *(Circulate to Audit Committee for review and revision at next Audit Committee meeting)*	*Company*
	Prepare first draft of Compensation Committee Report *(Circulate to Compensation Committee for review and revision at next Compensation Committee meeting)*	*Company*

Date*	Item	Responsibility
	Determine drafter of performance graph for proxy statement, as necessary *(Often outside consultant will draft the performance graph with assistance from investor relations department)*	*Company*
January 11	D&O Questionnaires and information relating to Form 5s due at Company	*Company*
January 11 – 16 *(based on third week after end of quarter earnings release)*	Auditors review Q4 and year-end financial statements; Auditors confirm numbers for Q4 earnings release	*Auditors*
	Draft and distribute Q4 earnings release to Legal Counsel for review	*Company*
January 16 *(pursuant to Rule 14a-4(c) of the 1934 Act and assuming Company's bylaws' advance notice provision provides that shareholder nominations and other proposals must be made no earlier than 120 days prior to the annual meeting date and no later than 90 days prior to the annual meeting date.* *Note: Company's bylaws may provide for different period)*	First date for receipt of shareholder nominations for director and other shareholder proposals to be referenced in annual proxy statement (if timely) pursuant to Rule 14a-4(c) of the 1934 Act and Company's bylaws, and that may be brought before annual meeting	*Company/Legal Counsel*
January 16 – 17	**Disclosure Practices Committee Meeting** regarding issues relating to Q4 earnings release and year-end financial results, disclosure controls and procedures and internal control over financial reporting, and conducting Q&A with business unit managers and other employees, relating to 10-K, and CEO/CFO certifications	*Company*
January 18	Distribute Board and Committee materials for January 23-24 meetings, including Q4 earnings release and Q4 and year-end financial results	*Company*

Date*	Item	Responsibility
January 23 – 24	**Governance/Nominating Committee Meeting/Conference Call** regarding review and recommendation of slate of director nominees (and may review director independence depending on Company's review policies)	*Company*
	Audit Committee Meeting regarding: • Review Q4 and year-end financial results, including Q4 earnings release • Review Auditors' relationship with the Company, including the lead partner's performance • Review Auditors' annual report on its internal quality control procedures, including any issues raised through its internal review, and the assessment of Auditors' independence· • Appoint independent Auditors (including review and applicable preapproval and approval of services and fees and such policies) • Review Disclosure Practices Committee report relating to Q4 and year-end financial results • Review financial expertise and independence of Audit Committee members • Review Auditors' report on all critical accounting policies and practices; alternative GAAP-compliant accounting treatments available for material items, including impact of different treatments; and any material written communications between Auditors and management, including the management letter *(Meeting should be prior to Q4 earnings release with ample time following meeting for legal and accounting review of any revisions to release)*	*Company*
	Board Meeting approving, among other things: • Annual meeting date and record date • Business to be transacted at the annual meeting • Inspectors of election with power of substitution • Independence determinations of directors • Officers to vote proxies with full power of substitution • Authorization for the preparation and distribution to shareholders of a notice of meeting, proxy card, proxy statement, annual report to shareholders, 10-K, and other materials as may be appropriate • Determination of slate of director nominees and recommendation of slate to shareholders (including any shareholder nominations) *(Notify applicable exchange/market of annual meeting and record dates per exchange/market requirements)*	*Company*

Date*	Item	Responsibility
January 24	Distribute complete 10-K and proxy statement and related materials to Legal Counsel and Auditors for initial review	*Company*
	Release Q4 and year-end numbers in earnings release; conference call regarding Q4 and year-end financial results *(Make applicable financial information available on website and applicable report filing with SEC. Send required number of copies of earnings release materials to applicable exchange/market)*	*Company*
January 27	Insider trading window opens for Q1 *(Often begins on second or third business day following quarterly earnings release, although timing will depend on Company policy)*	*Company*
January 30	Initial comments due back to Company from Legal Counsel and Auditors on complete 10-K and proxy statement and related materials, including Compensation Committee and Audit Committee Reports	*Legal Counsel/Auditors*
February 1	Send reminder to officers and directors to give prior notice to and obtain preclearance from Company with respect to securities transactions to be made during next month *(Form 4s must be filed with SEC within two business days after the transaction requiring reporting on Form 4 is executed)*	*Company*
February 1 – 6	Senior management initial review of 10-K and proxy statement and related materials *(Start tracking all changes)*	*Company*
February 1 – 7	Prepare Board resolutions relating to annual meeting and reporting actions (that were not done at January meeting) for February 23-24 Board meeting, together with related Committee resolutions	*Company/Legal Counsel*
February 6 – 10	Revise 10-K and proxy statement and related materials, including Compensation Committee and Audit Committee Reports	*Company*
February 10	Distribute revised 10-K and proxy statement and related materials per management's review to Legal Counsel and Auditors for review	*Company*
February 12 – 14	Request a listing of participants and an omnibus proxy from depositories holding securities of Company in common nominee name	*Company*

Date*	Item	Responsibility
February 14	Comments due back to Company from Legal Counsel and Auditors on 10-K and proxy statement and related materials, including Compensation Committee and Audit Committee Reports	*Legal Counsel/Auditors*
	Form 5s due at SEC regarding securities transactions made in prior reporting year relating to securities transactions not disclosed in Form 4 filings for prior reporting year *(Required to be filed with SEC on or before the 45th day following the end of the reporting year)*	*Company/Legal Counsel*
	Deadline for applicable and eligible shareholders to file reports or amendments on Schedule 13G *(Required to be filed with SEC on or before the 45th day following the end of the reporting year)*	*Shareholders*
	Send notice to transfer agent, proxy solicitor and printer as to: • Proxy solicitation timetable • Record date • Annual meeting date • Proxy statement and related materials • Name and address of financial printer • Request for shareholder lists as of the record date • Instructions as to ordering and printing of mailing and return envelopes and proxy cards • Confirmation of availability of post office box for return of proxies, if applicable • Confirmation of quantities to be printed and mailed • Material request cards to be sent to brokers	*Company*
February 14 – 16	Communicate with banks, brokers, depositories, ADP, proxy agents and transfer agent, informing them of record date and the annual meeting date and whether or not they will be requested to forward proxy solicitation materials to customers; enclose a materials request card *(SEC regulations require that these communications be done at least 20 business days prior to the record date)*	*Company*

Date*	Item	Responsibility
February 15 *(pursuant to Rule 14a-4(c) of the 1934 Act and assuming Company's bylaws' advance notice provision provides that shareholder nominations and other proposals must be made no earlier than 120 days prior to the annual meeting date and no later than 90 days prior to the annual meeting date. Note: Company's bylaws may provide for different period)*	Final date for receipt of shareholder nominations for director or other shareholder proposals to be referenced in annual proxy statement (if timely) pursuant to Rule 14a-4(c) of the 1934 Act and Company's bylaws, and that may be brought before annual meeting	*Company*
February 15 – 16	**Disclosure Practices Committee Meeting** regarding review of and issues relating to 10-K and proxy statement and disclosure controls and procedures and internal control over financial reporting, and conducting follow-up Q&A with business unit managers and other employees, relating to 10-K and proxy statement, and CEO/CFO certifications	*Company*
February 16	Hold diligence session regarding CEO/CFO certifications for 10-K and management's report on internal control over financial reporting to, among other things, review Disclosure Practices Committee report and review disclosure controls and procedures and internal control over financial reporting	*Company*
February 17	Distribute proxy materials (at least information incorporated by reference into 10-K) and substantially final draft of 10-K and annual report to shareholders (and in case of Board and Committees, other relevant Board and Committee materials) to Board, Committees, key senior management, Legal Counsel and Auditors for review	*Company/Legal Counsel /Auditors*
	Send 10-K to printer	*Company/Printer*
February 21 – 27	Finalize 10-K	*Company/Legal Counsel /Auditors*
February 22 – 23	Obtain CEO and CFO certifications and applicable subcertifications for 10-K	*Company*

Date*	Item	Responsibility
February 23 – 24	**Governance/Nominating Committee Meeting** to: • Recommend Committees membership • Review Committee charter and recommend any charter changes to Board • Review Board and Committees compensation for recommendation to Board	*Company*
	Compensation Committee Meeting to: • Approve Compensation Committee Report for inclusion in the annual proxy statement • Review Committee charter and recommend any charter changes to Board	*Company*
	Audit Committee Meeting to: • Review final audited financial statements with the Company and Auditors, and recommend audited financial statements for inclusion in 10-K, and review other applicable parts of 10-K, including MD&A • Review and approve Audit Committee Report for proxy statement • Review Auditors' and management's reports and discuss issues relating to disclosure and internal control over financial reporting • Review Committee charter and recommend any charter changes to Board • Recommend financial expert(s) • Review audit fees to be listed in the proxy statement • Review Auditors' report on all critical accounting policies and practices; alternative GAAP-compliant accounting treatments available for material items, including impact of different treatments; and any material written communications between Auditors and management, including the management letter	*Company*

Date*	Item	Responsibility
	Board Meeting to, among other things, and as necessary: • Approve proxy materials, annual report to shareholders and 10-K in substantially the form presented to Board • Appoint Committee members • Approve Board and Committee compensation • Appoint financial expert(s) • Review Audit Committee and Compensation Committee Reports for proxy statement • Approve any changes to Committee charters • Approve other actions relating to annual meeting, Board and Committees and annual reporting, not previously approved • Review any reports from Audit Committee, including any reports regarding financial reporting and internal control over financial reporting	*Company*
	Obtain signature pages and powers of attorney from Board members for 10-K	*Company*
February 27 – 28	Obtain executed report for audited financial statements and consents from Auditors for filing as an exhibit to 10-K, including Auditors' attestation report on management's report on internal control over financial reporting	*Company/Auditors*
February 27 – March 6	Company must provide shareholders whose Rule 14a-8 shareholder proposals will be accompanied by a Board Opposition Statement in annual proxy statement, a copy of the Board Opposition Statement *(Generally must be sent to applicable shareholders 30 calendar days prior to distribution of definitive annual proxy materials)*	*Company/Legal Counsel*
February 28 – March 1	File 10-K with SEC *(Beginning with fiscal years ending on or after December 15, 2006, SEC regulations will require that large accelerated filers file 10-K with SEC via EDGAR within 60 days of end of reporting year. See Chapter 2 of The Public Company Handbook)*	*Company*
March 1	Insider trading "blackout" period begins for Q1 *(Sometimes begins at start of last month of quarter, or two weeks prior to quarter end, although timing will depend on Company policy)*	*Company*

Date*	Item	Responsibility
	Send reminder to officers and directors to give prior notice to and obtain preclearance from Company with respect to securities transactions to be made during next month *(Form 4s must be filed with SEC within two business days after the transaction requiring reporting on Form 4 is executed)*	*Company*
March 6 – 8	Assign annual meeting responsibilities for: • Hosts (to direct seating, distribute and collect ballots) • Welcoming Committee (officers assigned to greet shareholders and guests) • Arbiters (legal or corporate secretary's staff who will handle difficult questions or complicated situations with regard to admission to the meeting) • Meeting transcript *(Arrange for services of a court reporter or other means for preparation of a meeting transcript, if desirable)* • Coordinating physical layout, security and audio/visual arrangements	*Company*
March 6 – 16	Finalize annual proxy statement and related materials	*Company/Legal Counsel /Auditors*
March 10	If Company has not already done so, notify applicable exchange/market of annual meeting date and record date pursuant to applicable exchange/market requirements *(Generally at least 10 business days prior to record date)*	*Company*
March 17 – 18	Send annual proxy statement and related materials, including proxy card, to printer; galleys reviewed in subsequent days	*Company/Legal Counsel /Printer*
	Send annual report to shareholders (or 10-K wrap) to printer *(This often may be done earlier depending on formatting/substance of annual report to shareholders)*	*Company/Printer*
March 18 – 24	Blueline of annual proxy statement and related materials, including proxy card, to be reviewed, and comments, sent to printer; finalize annual proxy statement and related materials, including proxy card	*Company/Legal Counsel*
	Blueline of complete annual report to shareholders delivered for review	*Company/Legal Counsel /Printer*
	Transfer agent ships preaddressed proxy cards to printer	*Company/Transfer Agent*
March 24 – 29	Printer sends printed annual proxy materials and annual report to shareholders to transfer agent	*Company/Printer/ Transfer Agent*

Date*	Item	Responsibility
March 26	**RECORD DATE** *(Depending on Company bylaws and state law, generally between 10 days and 60 days prior to the annual meeting date)*	*Company*
	Ask transfer agent to confirm number of voting shares and supply certified list of record date shareholders	*Company/Transfer Agent*
March 29 – April 5	File definitive proxy materials with, and send copies of annual report to shareholders to, SEC *(Copies of the definitive proxy statement, proxy card and any other solicitation materials must be filed with SEC via EDGAR no later than the date such materials are first sent to shareholders. Send required number of copies to applicable exchange/market)* *(Eight hard copies of the annual report to shareholders must be mailed to SEC no later than the date on which the report is first sent or given to shareholders or the date on which preliminary copies (or definitive copies, if preliminary filing was not required) of the proxy materials are filed with SEC pursuant to Rule 14a-6(a), whichever date is later. Send required number of copies to applicable exchange/market)*	*Company/Legal Counsel /Printer*
	Mail annual proxy statement and related materials, including proxy card, to all shareholders: each annual proxy statement must be accompanied or preceded by an annual report to shareholders, which needs to include audited financial statements *(Depending on state law and Company bylaws, generally, written notice of the annual meeting shall be given not less than 10 nor more than 60 days before the date of the meeting to each shareholder entitled to vote at such meeting. Mailing must occur at least 20 to 30 days before annual meeting to timely receive brokers' votes)*	*Company/Transfer Agent*
	Distribute proxy statement and annual report to option holders and other applicable benefit plan participants	*Company/Transfer Agent*
March 31	**End of Q1**	
April 1	Send reminder to officers and directors to give prior notice to and obtain preclearance from Company with respect to securities transactions to be made during next month *(Form 4s must be filed with SEC within two business days after the transaction requiring reporting on Form 4 is executed)*	*Company*

Date*	Item	Responsibility
April 3 – 7	Meetings of internal reporting teams regarding Q1 financial statements, 10-Q, disclosure controls and procedures and internal control over financial reporting, and CEO/CFO certifications for 10-Q	*Company*
April 7 – 19	Draft and review 10-Q, including financial statements and notes; coordinate with Auditors regarding financial statements	*Company/Auditors*
April 10 – 14	Complete annual meeting arrangements for preparation of: • Ballots • Programs • Agenda • Meeting script • Q&A book • Registration cards • Inspectors' reports	*Company/Legal Counsel*
April 12 – 14	Prepare and submit periodic reports on proxy returns to management; determine if another proxy mailing is required	*Company/Transfer Agent/Proxy Solicitor*
April 14 – 19	Draft Q1 earnings release	*Company*
April 19	Distribute 10-Q, including financial statements and notes, and Q1 earnings release, to Legal Counsel and Auditors	*Company*
April 19 – 24	Legal Counsel and Auditors review and provide comments on 10-Q and Q1 earnings release	*Legal Counsel/Auditors*
April 22 – 24	Notify insiders that insider trading window opens for Q2 on May 10 - 15 *(Generally notify insiders two/three weeks before quarterly earnings release, although timing will depend on Company policy)*	*Company*
April 22 – 26	Review annual meeting script, speeches, audio/visual requirements, microphone requirements, catering arrangements, displays, parking requirements, security, procedure for checking in shareholders, coordination with news media and analysts, and availability of tape recorder or public stenographer (as desired)	*Company/Legal Counsel*
April 25	Comments due back on 10-Q, including financial statements and notes, and Q1 earnings release from Legal Counsel and Auditors	*Legal Counsel/Auditors*
April 25 – May 1	If desirable, begin contacting by telephone those major shareholders who have not responded to proxy solicitation	*Company/Transfer Agent*

Date*	Item	Responsibility
	Confirm attendance of Legal Counsel and Auditors at annual meeting	*Company*
April 25 – May 2	Revise Q1 financial statements, 10-Q and Q1 earnings release	*Company/Legal Counsel /Auditors*
April 28	**Disclosure Practices Committee Meeting** regarding issues relating to Q1 earnings release, disclosure controls and procedures and internal control over financial reporting, and conducting Q&A with business unit managers and other employees, relating to 10-Q, and CEO/CFO certifications	*Company*
April 30	Deadline for filing proxy materials with the SEC if the 10-K incorporates information by reference from the proxy materials	*Company*
May 1	Send reminder to officers and directors to give prior notice to and obtain preclearance from Company with respect to securities transactions to be made during next month *(Form 4s must be filed with SEC within two business days after the transaction requiring reporting on Form 4 is executed)*	*Company*
May 2	Distribute Q1 financial statements, 10-Q, Q1 earnings release and other materials to Audit Committee	*Company*
May 3 – May 4	Hold CEO/CFO 10-Q certifications diligence session with Disclosure Practices Committee to review 10-Q, review disclosure controls and procedures and internal control over financial reporting; obtain CEO/CFO certifications and applicable sub-certifications for 10-Q	*Company*
	Prepare script and management for Q1 earnings release conference call	*Company*
May 4	Have shareholder list open for examination *(The officer (usually the corporate secretary) in charge of the stock ledger shall prepare and make available, at least 10 days before every annual meeting, a complete list of the shareholders entitled to vote at such meeting. Such list shall be open to examination by any shareholder at the meeting place and, during ordinary business hours, for at least 10 days prior to the meeting at corporate headquarters. It shall also be produced and kept at the time and place of the meeting during the whole time thereof. The specifics and availability will depend on Company bylaws and state law requirements)*	*Company/Transfer Agent*

Date*	Item	Responsibility
May 8	**Audit Committee Meeting/Conference Call** to: • Review Q1 financial results, including the earnings release • Review 10-Q • Review of Disclosure Practices Committee report relating to Q1 • Review Auditors' report on all critical accounting policies and practices; alternative GAAP-compliant accounting treatments available for material items, including impact of different treatments; and any material written communications between Auditors and management, including the management letter	*Company*
May 8 – 10	Release Q1 numbers in earnings release; conference call regarding Q1 financial results *(Make applicable financial information available on website and applicable report filing with SEC. Send required number of copies of press release materials to applicable exchange/market)*	*Company*
	File 10-Q for Q1 with SEC *(Assuming SEC regulations require that 10-Q be filed within 40 days of end of reporting quarter. See Chapter 2 of The Public Company Handbook)* *(Note: Reporting Calendar is scheduled so that quarterly earnings releases are released and 10-Qs are filed generally around the same time. Some companies will need to adjust Reporting Calendar if earnings release is released earlier)*	*Company*
May 10 – 15	Insider trading window opens for Q2 *(Often begins on second or third business day following quarterly earnings release, although timing will depend on Company policy)*	*Company*
May 13 - 14	Prepare and review meeting admission guidelines, "disruptive person" guidelines, proxy acceptance guidelines and any other applicable guidelines for annual meeting	*Company/Legal Counsel*
	Senior management briefing regarding annual meeting	*Company*
	Final revisions to management reports to be made at annual meeting and any accompanying presentations	*Company*
	Set up annual meeting headquarters at meeting site; rehearsals and final briefings	*Company*
May 14 – 16	**ANNUAL MEETING OF BOARD OF DIRECTORS AND COMMITTEE MEETINGS**	*Company*

Date*	Item	Responsibility
May 15	**ANNUAL MEETING OF SHAREHOLDERS** *(Notify applicable exchange/market of any changes in directors or executive officers as required)*	*Company*
May 17 – 24	If applicable, send to exchange/market any required certifications or affirmations consistent with applicable exchange/market rules (e.g., any CEO certification)	*Company*
June 1	Insider trading "blackout" period begins *(Sometimes begins at start of last month of quarter, or two weeks prior to quarter end, although timing will depend on Company policy)*	*Company*
	Send reminder to officers and directors to give prior notice to and obtain preclearance from Company with respect to securities transactions to be made during next month *(Form 4s must be filed with SEC within two business days after the transaction requiring reporting on Form 4 is executed)*	*Company*
June 30	**End of Q2**	
July 1	Send reminder to officers and directors to give prior notice to and obtain preclearance from Company with respect to securities transactions to be made during next month *(Form 4s must be filed with SEC within two business days after the transaction requiring reporting on Form 4 is executed)*	*Company*
July 1 – 7	Prepare final shareholder voting numbers in order to publish results of shareholder voting at the annual meeting in 10-Q for Q2	*Company*
	Evaluate company's stature as large accelerated/accelertated filer as of the last business day of Q2	*Company*
July 3 – 7	Meetings of internal reporting teams regarding Q2 financial statements, 10-Q, disclosure controls and procedures and internal control over financial reporting, and CEO/CFO certification for 10-Q	*Company*
July 7 – 19	Draft and review 10-Q, including financial statements and notes; coordinate with Auditors regarding financial statements	*Company/Auditors*
July 7 – 11	Confirm that the Company is an accelerated filer *(See Chapter 2 of The Public Company Handbook)*	*Company*

July 14 – 19	Draft Q2 earnings release	*Company*
Date*	**Item**	**Responsibility**
July 19	Distribute 10-Q, including financial statements and notes, and Q2 earnings release to Legal Counsel and Auditors	*Company*
July 19 – 24	Legal Counsel and Auditors review and provide comments on 10-Q and Q2 earnings release	*Legal Counsel/Auditors*
July 20	**Board Meeting**	*Company*
July 22 – 24	Notify insiders that insider trading window opens for Q3 on August 9 - 14 *(Generally notify insiders two/three weeks before quarterly earnings release, although timing will depend on Company policy)*	*Company*
July 25	Comments due back on 10-Q, including financial statements and notes, and Q2 earnings release from Legal Counsel and Auditors	*Legal Counsel/Auditors*
July 25 – August 1	Revise Q2 financial statements, 10-Q and Q2 earnings release	*Company/ Legal Counsel/Auditors*
July 28	**Disclosure Practices Committee Meeting** regarding issues relating to Q2 earnings release, disclosure controls and procedures and internal control over financial reporting, and conducting Q&A with business unit managers and other employees, relating to 10-Q, and CEO/CFO certifications	*Company*
August 1	Send reminder to officers and directors to give prior notice to and obtain preclearance from Company with respect to securities transactions to be made during next month *(Form 4s must be filed with SEC within two business days after the transaction requiring reporting on Form 4 is executed)*	*Company*
	Distribute Q2 financial statements, 10-Q, Q2 earnings release and other materials to Audit Committee	*Company*
August 2 - 3	Hold CEO/CFO 10-Q certifications diligence session with Disclosure Practices Committee to review 10-Q, review disclosure controls and procedures and internal control over financial reporting; obtain CEO/CFO certifications and applicable sub-certifications for 10-Q	*Company*
	Prepare script and management for Q2 earnings release conference call	*Company*

Date*	Item	Responsibility
August 7	**Audit Committee Meeting/Conference Call** to: • Review Q2 financial results, including the earnings release • Review 10-Q • Review Disclosure Practices Committee report relating to Q2 • Review Auditors' report on all critical accounting policies and practices; alternative GAAP-compliant accounting treatments available for material items, including impact of different treatments; and any material written communications between Auditors and management, including the management letter	*Company*
August 7 – 9	Release Q2 numbers in earnings release; conference call regarding Q2 financial results *(Make applicable financial information available on website and applicable report filing with SEC. Send required number of copies of press release materials to applicable exchange/market)*	*Company*
	File 10-Q for Q2 with SEC (including, if necessary, notice requirements regarding shareholder proposals for next year's proxy, and shareholder election results from annual meeting) *(Assuming SEC regulations require that 10-Q be filed within 40 days of end of reporting quarter. See Chapter 2 of The Public Company Handbook)* *(Note: Reporting Calendar is scheduled so that quarterly earnings releases are released and 10-Qs are filed generally around the same time. Some companies will need to adjust Reporting Calendar if earnings release is released earlier)*	*Company*
August 9 – 14	Insider trading window opens for Q3 *(Often begins on second or third business day following quarterly earnings release, although timing will depend on Company policy)*	*Company*
September 1	Insider trading "blackout" period begins *(Sometimes begins at start of last month of quarter, or two weeks prior to quarter end, although timing will depend on Company policy)*	*Company*
	Send reminder to officers and directors to give prior notice to and obtain preclearance from Company with respect to securities transactions to be made during next month *(Form 4s must be filed with SEC within two business days after the transaction requiring reporting on Form 4 is executed)*	*Company*

Date*	Item	Responsibility
September 20	**Board and Committee Meetings**	*Company*
September 30	**End of Q3**	
October 1	Send reminder to officers and directors to give prior notice to and obtain preclearance from Company with respect to securities transactions to be made during next month *(Form 4s must be filed with SEC within two business days after the transaction requiring reporting on Form 4 is executed)*	*Company*
October 2 – 6	Meetings of internal reporting teams regarding Q3 financial statements, 10-Q, disclosure controls and procedures and internal control over financial reporting, and CEO/CFO certification for 10-Q	*Company*
October 6 – 18	Draft and review 10-Q, including financial statements and notes; coordinate with Auditors regarding financial statements	*Company/Auditors*
October 13 – 18	Draft Q3 press release	*Company*
October 18	Distribute 10-Q, including financial statements and notes, and Q3 earnings release to Legal Counsel and Auditors	*Company*
October 18 – 23	Legal Counsel and Auditors review and provide comments on 10-Q and Q3 earnings release	*Legal Counsel/Auditors*
October 21 – 23	Notify insiders that insider trading window opens for Q4 on November 9 - 14 *(Generally notify insiders two/three weeks before quarterly earnings release, although timing will depend on Company policy)*	*Company*
October 24	Comments due back on 10-Q, including financial statements and notes, and Q3 earnings release from Legal Counsel and Auditors	*Legal Counsel/Auditors*
October 24 – 31	Revise Q3 financial statements, 10-Q and Q3 earnings release	*Company/Legal Counsel /Auditors*
October 27	**Disclosure Practices Committee Meeting** regarding issues relating to Q3 earnings release, disclosure controls and procedures and internal control over financial reporting, and conducting Q&A with business unit managers and other employees, relating to 10-Q, and CEO/CFO certifications	*Company*
October 31	Distribute Q3 financial statements, 10-Q and Q3 earnings release to Audit Committee	*Company*

Date*	Item	Responsibility
November 1	Send out time and responsibility schedule for next year's annual proxy statement and annual reporting season to management, Legal Counsel and Auditors	*Company*
	Send reminder to officers and directors to give prior notice to and obtain preclearance from Company with respect to securities transactions to be made during next month *(Form 4s must be filed with SEC within two business days after the transaction requiring reporting on Form 4 is executed)*	*Company*
November 1 - 2	Hold CEO/CFO 10-Q certifications diligence session with Disclosure Practices Committee to review 10-Q, review disclosure controls and procedures and internal control over financial reporting; obtain CEO/CFO certifications and applicable sub-certifications for 10-Q	*Company*
	Prepare script and management for Q3 earnings release conference call	*Company*
November 6	**Audit Committee Meeting/Conference Call** to: • Review Q3 financial results, including the earnings release • Review 10-Q • Review Disclosure Practices Committee report relating to Q3 • Review CEO/CFO reporting and disclosure philosophy and internal communications and reporting design to set "tone at the top" for preparation of the 10-K and financial statements • Review Auditors' report on all critical accounting policies and practices; alternative GAAP-compliant accounting treatments available for material items, including impact of different treatments; and any material written communications between Auditors and management, including the management letter	*Company*
November 6 – 9	Release Q3 numbers in earnings release; conference call regarding Q3 financial results *(Make applicable financial information available on website and applicable report filing with SEC. Send required number of copies of press release materials to applicable exchange/market)*	*Company*

Date*	**Item**	**Responsibility**
	File 10-Q for Q3 with SEC *(Assuming SEC regulations require that 10-Q be filed within 40 days of end of reporting quarter. See Chapter 2 of The Public Company Handbook)* *(Note: Reporting Calendar is scheduled so that quarterly earnings releases are released and 10-Qs are filed generally around the same time. Some companies will need to adjust Reporting Calendar if earnings release is released earlier)*	*Company*
November 9 – 14	Insider trading window opens for Q4 *(Often begins on second or third business day following quarterly earnings release, although timing will depend on Company policy)*	*Company*
November 14	**Board Meeting and Committee Meetings**	*Company*
November 29 – December 6 *(assuming previous year's definitive annual proxy materials were sent out between March 28 and April 4)*	Final date for receipt of Rule 14a-8 shareholder proposals to be included in annual meeting proxy statement for upcoming year *(Rule 14a-8 of the 1934 Act generally requires that shareholder proposals be received by Company at corporate headquarters no later than 120 days prior to the date of distribution of previous year's proxy materials if upcoming annual meeting is scheduled to be held within 30 days of previous year's annual meeting; if not, then the last day for 14a-8 shareholder proposals is a "reasonable" time before printing proxy materials for upcoming annual meeting)*	*Company*

APPENDIX 3
Form 8-K Reportable Events and Filing Deadlines

Reportable Event	Form 8-K Item	Filing Deadline	Notes/Comments
Entry into a Material Definitive Agreement (or a Material Amendment of a Material Definitive Agreement)*	Item 1.01	Within four business days	Generally, agreements required to be filed as exhibits to Form 10-K or 10-Q under Item 601 of Regulation S-K, including executive compensation agreements, will trigger Form 8-K disclosure. Companies are encouraged, but not required, to file copies of the agreements as exhibits to Form 8-K. If not filed with the Form 8-K, the agreements will be filed as exhibits to the company's next periodic report or registration statement.
Termination of a Material Definitive Agreement*	Item 1.02	Within four business days	No disclosure required if agreement terminates by expiration on its stated termination date or upon the parties' completion of their obligations under the agreement, or if the company believes in good faith that the agreement has not been terminated, unless the company has received notice of termination pursuant to agreement terms.
Bankruptcy or Receivership	Item 1.03	Within four business days	Triggered by appointment of a receiver in federal or state bankruptcy proceeding or by entry of an order confirming a plan of reorganization, arrangement or liquidation.
Completion of Acquisition or Disposition of Assets	Item 2.01	Within four business days	Report acquisition or disposition of a significant amount of assets other than in the ordinary course of business.
Results of Operations and Financial Condition	Item 2.02	Within four business days	Triggered by public announcement/release of material nonpublic information regarding financial results/condition for a completed fiscal year or quarter (other than in Form 10-Q or 10-K).

Reportable Event	Form 8-K Item	Filing Deadline	Notes/Comments
Creation of a Direct Financial Obligation or an Obligation Under an Off-Balance Sheet Arrangement*	Item 2.03	Within four business days	Triggered by: • Entering into an enforceable agreement under which a material direct financial obligation will arise or be created. If no agreement, then triggered by closing or settlement of the transaction under which the direct financial obligation arises or is created. • Becoming directly or contingently liable for an obligation that is material arising out of an off-balance sheet arrangement. If company or an affiliate is not party to the transaction or agreement creating a contingent obligation arising under the off-balance sheet arrangement, the Form 8-K report may be filed on the earlier of (a) the fourth business day after the contingent obligation is created or arises or (b) the day on which an executive officer becomes aware of the contingent obligation. A "direct financial obligation" is a long-term debt obligation, capital lease obligation, operating lease obligation, or short-term debt obligation arising other than in the ordinary course of business.
Triggering Events That Accelerate or Increase a Direct Financial Obligation or an Obligation Under an Off-Balance Sheet Arrangement*	Item 2.04	Within four business days	Triggered by the occurrence of an event of default, event of acceleration or similar "triggering" event that accelerates or increases a direct financial obligation or an obligation under an off-balance sheet arrangement with consequences material to the company.
Costs Associated with Exit or Disposal Activities*	Item 2.05	Within four business days	Triggered when the Board or an authorized officer commits the company to an exit or disposal plan, or otherwise disposes of a long-lived asset or terminates employees under a plan of termination, under which the company will incur a material write-off or restructuring charge.

Reportable Event	Form 8-K Item	Filing Deadline	Notes/Comments
Material Impairments*	Item 2.06	Within four business days	Triggered when the Board or an authorized officer concludes that a material charge for impairment to one or more assets, including impairments of securities or goodwill, is required under GAAP (except if conclusion is in connection with the preparation, review or audit of financial statements included in a timely filed periodic report).
Notice of Delisting or Failure to Satisfy a Continued Listing Rule or Standard; Transfer of Listing	Item 3.01	Within four business days	Triggered by: • Receipt of notice from NYSE, Nasdaq or other exchange of failure to satisfy continued listing standards, or that the exchange has taken delisting action; • Receipt of public reprimand letter or similar communication from NYSE, Nasdaq or other exchange that indicates the company has violated a continued listing standard; • Notice by the company to NYSE, Nasdaq or other exchange of any material noncompliance with a continued listing standard; or • Definitive Board or authorized officer action to withdraw listing from NYSE, Nasdaq or other exchange.
Unregistered Sales of Equity Securities	Item 3.02	Within four business days	Triggered by "sale," but only if the securities sold, in the aggregate since the company's last report under this Item or its last periodic report, constitute 1% or more of the number of shares outstanding (5% or more for small business issuers). "Sale" occurs when company enters into an enforceable agreement under which equity securities are to be sold. If there is no written agreement, "sale" occurs on date of closing or settlement of the sale. "Shares outstanding" include only actual shares outstanding (not convertible securities). Disclosure not required to be reported on Form 8-K - because of Form 8-K size threshold – will continue to be required to be reported in Forms 10-Q and 10-K.

Reportable Event	Form 8-K Item	Filing Deadline	Notes/Comments
Material Modification to Rights of Security Holders	Item 3.03	Within four business days	Triggered by material modification to instruments (like articles of incorporation) that define the rights of shareholders or other security holders, or by the issuance or modification of any other securities that has a material adverse impact on those rights. Duplicate disclosure not required in parallel Form 10-Q disclosure item.
Changes in Certifying Accountant	Item 4.01	Within four business days	Triggered by resignation or dismissal of accountant or its refusal to stand for reappointment and, as a separate reportable event, by the engagement of a new accountant.
Nonreliance on Previously Issued Financial Statements*	Item 4.02(a)	Within four business days	Triggered when the Board, a Board Committee or an authorized officer concludes that any previously issued financial statements no longer should be relied upon because of an error in those financial statements.
Nonreliance on Previously Issued Audit Report or Completed Interim Review	Item 4.02(b)	Within four business days	Triggered when company is advised by its independent accountant that the company should make disclosure or take action to prevent further reliance on a previously issued audit report or interim review related to previously issued financial statements.
Changes in Control	Item 5.01	Within four business days	Triggered when the Board, a Board Committee or an authorized officer has knowledge that a change in control of the company has occurred.
Departure of a Director as a Result of a Disagreement or Removal For Cause	Item 5.02(a)	Within four business days	If the director furnishes the company with any written correspondence concerning the circumstances surrounding the director's departure arising out of a disagreement, the company must file the correspondence as an exhibit to the Form 8-K. Company must also provide the Form 8-K disclosure to the director – not later than the day it is filed – and give the director an opportunity to furnish a letter stating whether the director agrees with the company's disclosures. If provided, the director's response letter must be filed as an exhibit by amendment to the previously filed Form 8-K within two business days of company receipt.

Reportable Event	Form 8-K Item	Filing Deadline	Notes/Comments
Any Other Departure of a Director or Any Departure of a Principal Officer	Item 5.02(b)	Within four business days	Triggered by notice of a decision to resign, retire or refuse to stand for re-election. Whether communications represent discussion or consideration, on the one hand, or notice of a decision, on the other, is a facts and circumstances determination. Principal officers include the company's principal executive officer, president, principal financial officer, principal accounting officer, principal operating officer, or any person performing similar functions.
Appointment of a New Principal Officer	Item 5.02(c)	Within four business days	Triggered on date of appointment or, if the company intends to make a public announcement of the appointment other than by means of a Form 8-K, on the day on which the company publicly announces the appointment.
Election of a New Director Other Than by Shareholder Vote	Item 5.02(d)	Within four business days	Triggered on date of election. Form 8-K is not required if the election is by vote of the shareholders at a meeting called for that purpose.
Amendments to the Company's Articles of Incorporation or Bylaws Other Than by Shareholder Vote	Item 5.03(a)	Within four business days	Form 8-K is not required if the amendments were adopted by the shareholders pursuant to a previously filed proxy statement.
Change in Fiscal Year Other Than by Shareholder Vote	Item 5.03(b)	Within four business days	Form 8-K is not required if the change is approved by a shareholder vote through the solicitation of proxies or is effected through an amendment to the company's articles of incorporation or bylaws.
Temporary Suspension of Trading Under Company's Employee Benefit Plans	Item 5.04	Within four business days	Triggered by receipt of notice from the plan administrator of a pension fund trading blackout period. If notice is not received, then triggered by a Regulation BTR notification from the company to an affected officer or director of a pension fund trading blackout period. (We discuss Regulation BTR in more detail in Chapter 4.)

Reportable Event	Form 8-K Item	Filing Deadline	Notes/Comments
Amendment to the Company's Code of Ethics or Waiver of a Provision of the Code of Ethics	Item 5.05	Within four business days	Form 8-K filing is not required if the company provides the required disclosure on its website within four business days, and the company disclosed in its most recently filed Form 10-K its website address and intention to provide disclosure in this manner. (A company need not disclose technical, administrative or other non-substantive amendments to its code of ethics.) A waiver must only be disclosed when it relates to a material departure from a provision of the Company's code of ethics.
Change in Shell Company Status	Item 5.06	Within four business days	If the company that was a shell company (other than a shell company related to a business combination) completed a transaction that effectively caused it to cease being a shell company, then the material terms of the transaction need to be disclosed under this Item.
Events Related to Asset-Backed Securities	Items 6.01 - 6.05	Within four business days	These Items require the reporting of various events applicable to asset-backed securities, including the filing of ABS informational and computational materials, change of servicer or trustee, change in credit enhancement or other external support, failure to make a required distribution, and significant change in the asset pool relating to an offering of asset-backed securities.
Regulation FD Disclosure	Item 7.01	Comply with Regulation FD timing requirements	This Item can be used to comply with Regulation FD disclosure requirements. (We discuss Regulation FD in detail in Chapter 3.) Disclosure under this Item is deemed to be "furnished" and not "filed."
Other Events	Item 8.01	No specific timing requirement	Voluntary disclosure of any events, with respect to information not otherwise required by Form 8-K, that the company deems of importance to shareholders. The company may file a report under this Item disclosing the nonpublic information required to be disclosed by Regulation FD. Unlike a filing under Item 7.01, disclosure under this Item is deemed to be "filed," not "furnished."

Reportable Event	Form 8-K Item	Filing Deadline	Notes/Comments
Financial Statements and Exhibits	Item 9.01	Financial statements required by Item 9.01 will be filed with initial Item 2.01 Form 8-K report (or by amendment not later than 71 calendar days after the date that initial Form 8-K is filed). Other required exhibits are filed as required by the relevant Form 8-K Item.	Requires filing of financial statements and pro forma financial information for business acquisitions required to be described under Item 2.01 of Form 8-K. Also calls for filing of other exhibits required by the relevant Form 8-K Item or Item 601 of Regulation S-K.

* These Items are subject to a limited safe harbor from public and private claims under Section 10(b) of the 1934 Act and Rule 10b-5 under the 1934 Act for a failure to timely file a Form 8-K. The safe harbor extends only until the due date of the next periodic report for the relevant period in which the Form 8-K was not timely filed. In addition, failure to timely file these Items will not impair eligibility to use short form registration statements on Form S-3, so long as the required 8-K is filed on or before the date of filing of the Form S-3. (We discuss these safe harbors in more detail in Chapter 2.)

APPENDIX 4

NYSE Initial Listing Requirements

This table substantially reproduces publicly available information posted by the NYSE at www.nyse.com

Distribution and Size Standards (must satisfy each of these three criteria)	Requirements
1. Shareholders	
Round-lot (generally 100 shares) holders, including beneficial owners of "street name" shares	2,000
OR:	
Total Shareholders	2,200
together with:	
Average Monthly Trading Volume (for the most recent six months)	100,000 shares
OR:	
Total Shareholders	500
together with:	
Average Monthly Trading Volume (for the most recent 12 months)	1,000,000 shares
2. Public Shares	1,100,000 shares
3. Market Value of Public Shares	
Public Companies	$100,000,000
IPOs, Spin-offs, Carve-outs	$60,000,000
If a company either has a significant concentration of stock or changing market forces have adversely impacted the public market value of a company that otherwise would qualify for NYSE listing, such that its public market value is no more than 10% below the minimum, the NYSE will consider shareholders' equity of $60 million or $100 million, as applicable, as an alternate measure of size.	

Financial Standards (must satisfy one of the following three criteria)	Requirements
1. Earnings	
Aggregate pretax earnings, adjusted for items listed in the NYSE Listed Company Manual (two most recent years must be a minimum of $2,000,000 and third year must be positive):	$10,000,000
OR:	
2. Valuation with Cash Flow	
For companies with not less than $500 million in global market capitalization and $100 million in revenues in the last 12 months:	
Aggregate operating cash flow for the last three years (each year must report positive amount).....	$25,000,000
Operating cash flow is net cash provided by operating activities excluding the changes in working capital or in operating assets and liabilities, as adjusted for items listed in the NYSE Listed Company Manual.	
OR:	
3. Global Market Capitalization	
Revenues for the Last Fiscal Year.....	$75,000,000
Average Global Market Capitalization.....	$750,000,000

APPENDIX 5

Nasdaq Initial Listing Requirements

This table substantially reproduces publicly available information posted by Nasdaq at www.nasdaq.com

Requirements	Standard 1	Standard 2	Standard 3
Shareholders' Equity	$15 million	$30 million	N/A
Market value of listed securities..... *OR BOTH:* (for latest fiscal year or for 2 of last 3 fiscal years) **Total assets**..... *AND* **Total revenue**.....	N/A	N/A	$75 million or both: $75 million and $75 million
Tax income from continuing operations..... (in latest fiscal year or 2 of last 3 fiscal years)	$1 million	N/A	N/A
Publicly held shares ..... (shares outstanding less any shares held by officers, directors, or beneficial owners of 10% or more)	1.1 million	1.1 million	1.1 million
Operating history.....	N/A	2 years	N/A
Market value of publicly held shares	$8 million	$18 million	$20 million
Minimum bid price	$5	$5	$5
Round-lot shareholders ..... (100-share block holders)	400	400	400
Market Makers	3	3	4
Compliance with corporate governance standards.....	Yes	Yes	Yes

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