Survey of Securities Regulation
L03.3040.001
NYU Law School
Professor Carlson
(Fall 2006)

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Convertible Securities, Warrants, Options; Securitization; American Depositary Receipts; Derivatives; Short Sales

(A Vastly Simplified Primer)

**Convertible Security.** Is a security of an issuer which is convertible or exchangeable, by its terms, for another underlying security, usually of the same issuer. For example, a note issued by a company which is convertible (through the surrender of the note) for common stock of the same company.

**Warrant or Option.** Is a security of an issuer which is exercisable for additional consideration for another underlying security, usually of the same issuer. For example, a warrant issued by a company which is exercisable (through the payment of cash) for common stock of the same company. (Note that a warrant or option involves the payment of additional, separate consideration, as compared to a convertible security, where the consideration is the surrender of the convertible security.)

**Guaranty.** Is a security or obligation of an issuer in which the guarantor guarantees the payments by another issuer of their obligations under the other issuer’s securities. For example, a guaranty by a parent company of the payment of the notes issued by a subsidiary of that parent company.

**Securitization.** Involves placing receivables (i.e., payment obligations from others) into an entity which, in turn, issues various securities. For example, a bank places a group of credit card receivables owed by consumers into a trust, and the trust issues notes to finance the purchase of those receivables.

**American Depositary Receipts (ADRs).** Is a security issued by a trust or other entity in the U.S. which represents ownership in a number of shares issued by a foreign company. For example, a British Telecom ADR is issued in the U.S. by a trust in which British Telecom shares are placed, and each British Telecom ADR represents a specified number of British Telecom shares.

**Derivatives.** Involves securities, contracts and instruments whose value is determined by reference to the performance and value of another security, index or measure. For example, a financial institution agrees to make various levels of payments to a customer based upon the level of interest rates or the future market value of a basket of securities.

**Puts.** Involve rights, at the holder’s option, to require someone else to purchase in the future a specified number of securities at a specified price. A put protects the holder against a drop in market values. For example, a holder pays some money to a financial institution, and obtains a right to require that institution to purchase at any time in the next year 100 shares of
IBM at $125 per share. So the value of the put increases as IBM stock falls. In this sense, a put can be viewed as a derivative, whose value is determined by reference to the value of IBM stock.

**Calls.** Involve rights, at the holder’s option, to require someone else to sell in the future a specified number of securities at a specified price. A call enables the holder to participate in a rise in market values. For example, a holder pays some money to a financial institution and obtains a right to purchase from that institution at anytime in the next year 100 shares of IBM at $125 per share. So the value of the call increases as IBM stock rises. In this sense, a call can be viewed as a derivative, whose value is determined by reference to the value of IBM stock.

**Short Sale.** Involves an arrangement where an investor borrows a specified number of shares of a company at a specified price per share, and in effect sells those shares in the public markets, and agrees to repay in the future the borrowing with the same number of shares. With a short sale, the investor is expecting a drop in market values, and that the investor will be able, in the future, to repurchase the shares at a lower price than the borrowing price per share, then use those cheaper shares to repay the loan, and profit from the spread. For example, an investor borrows 100 shares of IBM at $125 per share, and resells them for $125. His loan must be repaid with 100 shares of IBM. IBM’s share price then drops. The investor then repurchases 100 shares of IBM in the market at $110 per share and uses those cheaper shares to repay the loan, thus profiting from the $15 per share drop in market value. A short sale, like a put, grows in value as a company’s share price declines, and protects an investor against a drop in market value.
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RESCSSION OFFER

From September 2001 through June 2004, we granted under our 1998 Stock Plan, 2003 Stock Plan, 2003 Stock Plan (No. 2) and 2003 Stock Plan (No. 3) to residents of the United States options to purchase 37,079,623 shares of our common stock with a weighted average per share exercise price of $2.86, of which, 12,743,816 shares remain subject to outstanding options. As of June 2004, we issued 23,702,819 shares of our common stock upon the exercise of certain of these options, of which 23,240,668 shares remain outstanding, subject to our right to repurchase certain of these shares in limited circumstances. Options we granted during this period may not have been exempt from the registration or qualification requirements under the securities laws of some states. In addition, certain shares issued upon exercise of options granted during this period may not have been exempt from the registration or qualification requirements under Rule 701 under the Securities Act of 1933 and under those state securities laws that provide an exemption to the extent the requirements under Rule 701 are met. We became aware that we were approaching the numeric limitations prescribed by Rule 701 in September 2002 and thereafter determined that we could not continue to rely on being able to rely on Rule 701 to provide an exemption from the registration requirements of the Securities Act of 1933. In addition, continued compliance under Rule 701 would have required broad dissemination of detailed financial information regarding our business, which would have been strategically disadvantageous to our company. In evaluating how to issue stock upon exercise of outstanding options in light of these limitations, we determined we would utilize "private placement" exemptions provided by Section 4(2) of the Securities Act of 1933 in order to exempt these issuances from federal registration requirements notwithstanding the factual and legal uncertainties inherent in Section 4(2). These uncertainties arose because analyzing whether or not issuances of securities qualify for the exemptions afforded by Section 4(2) involves a number of subjective determinations including whether the number of offers constitutes a general solicitation, the financial sophistication of offerees and their access to information regarding the issuer, as well as whether the offering was designed to result in a distribution of shares to the general public. We considered various alternatives in determining to rely on the exemption provided by Section 4(2) despite its inherent uncertainties. We considered ceasing granting options and shares to service providers. However, we determined that this would be detrimental to our development, as equity compensation was an essential ingredient to building our company. We also considered becoming a reporting company for the purposes of federal securities laws. We determined that this too would be contrary to the best interests of our stockholders. We therefore concluded that relying on Section 4(2) despite its uncertainties was in the best interest of our security holders. Because of the uncertainty in relying on Section 4(2), the options we granted and the shares issued upon exercise of these options during this period may have been issued in violation of either federal or state securities laws, or both, and may be subject to rescission. In order to address this issue, we intend to make a rescission offer soon after the effective date of this offering to all holders of any outstanding options and shares who we believe may be entitled to rescission and, pursuant to this rescission offer, we will offer to repurchase such options and shares then outstanding from the holder. We will be making this rescission offer to 1,406 persons who are or were residents of Arkansas, California, Colorado, Connecticut, the District of Columbia, Georgia, Illinois, Maryland, Massachusetts, Michigan, Nevada, New Hampshire, New Jersey, New York, North Carolina, Pennsylvania, Texas, Virginia and Washington. If our rescission offer is accepted by all offerees, we could be required to make an aggregate payment to the holders of these options and shares of up to approximately $23.9 million, which includes statutory interest.

Our anticipated rescission offer will cover an aggregate of approximately 23,240,668 shares of common stock issued and outstanding under our 1998 Stock Plan, 2003 Stock Plan, 2003 Stock Plan (No. 2) and 2003 Stock Plan (No. 3), and options outstanding under these plans to purchase 3,592,248 shares of common stock. These securities represent all of the options we granted to residents of the United States pursuant to these plans during the period from September 2001 through June 2004. That we have not been qualified under state securities laws and the shares issued upon exercise of options granted during this period (other than options and shares returned to these plans, whether by cancellation, repurchase or otherwise) these options and shares are held by our current and former employees, including one of our executive officers, and our current and former consulting firms. We intend to make the rescission offer to the holders of these shares and options as soon as practicable after the completion of the offering of our Class A common stock and, in any event, within 30 days of the effective date of this registration statement, assuming the offering has been completed at such time. The
rescission offer will be kept open for at least 20 business days and will be registered under the Securities Act and qualified in each state where such qualification is required under applicable state securities laws.

We will offer to rescind prior purchases of our common stock acquired through the exercise of options that are subject to the rescission offer for an amount equal to the price paid for the shares plus interest, calculated from the date of the exercise through the date on which the rescission offer expires, at the applicable statutory interest rate per year. With respect to outstanding options to purchase our common stock that are subject to the rescission offer, we will offer to rescind the entire option grant, regardless of whether the option is vested, in exchange for an amount equal to 20% of the aggregate exercise price for the entire option, plus interest, calculated from the date of grant of the option through the date on which the rescission offer expires, at the applicable statutory interest rate per year.

If all holders of shares of our common stock and options subject to the rescission offer elected to accept our rescission offer, we would be required to make an aggregate payment of approximately $25.9 million to these holders. We believe this amount represents our aggregate exposure under federal and state securities laws for not seeking to register or qualify these shares or options under these laws. Our aggregate exposure under federal securities laws (and not federal securities laws) for failing to register or qualify these shares and options is approximately $11.7 million. Our exposure for state securities laws violations is less than our exposure for federal securities laws violations because many of the shares and options that were issued without registration or qualification under federal securities laws were issued under available exemptions from state registration and qualification requirements provided by state securities laws. Our anticipated rescission offers will be made in the various states in which we may not have complied with applicable securities laws and will cover an aggregate of approximately 21,706,238 shares of common stock, and outstanding options to purchase 5,592,248 shares of common stock, which were issued under our 1998 Stock Plan and 2003 Stock Plan. Our state rescission liability could require us to make an aggregate payment of approximately $11.7 million to holders of shares of our common stock and options subject to rescission under state securities laws. Because these holders will be offered either the option of having their shares or options, as the case may be, repurchased under provisions of either federal or applicable state laws (but not both), the $11.7 million aggregate liability under state securities laws is included in the aggregate $25.9 million amount discussed above, which is our aggregate exposure under both federal and state securities laws as of June 30, 2004.

Our making this rescission offer may not terminate a purchaser's right to rescind a sale of securities that was not registered or qualified under the Securities Act or applicable state securities laws and was not otherwise exempt from registration or qualification. Accordingly, should the rescission offer be rejected by any or all offerors, we may continue to be contingently liable under the Securities Act of 1933 and applicable state securities laws for the purchase price of these shares and the value of the options up to an aggregate amount of approximately $25.9 million, which includes statutory interest. In addition, it is possible that an optionholder could argue that offering to rescind the issuance of outstanding options for an amount equal to 20% of the aggregate exercise price, plus interest, does not represent an adequate remedy for the issuance of the option in violation of applicable securities laws. If a court were to impose a greater remedy, our exposure as a result of the rescission offer could be higher. In addition, if it is determined that we offered securities without properly registering them under federal or state law, or securing an exemption from registration, regulators could impose monetary fines or other sanctions as provided under these laws. We understand that the Securities and Exchange Commission has initiated an informal inquiry into this matter and certain state regulators, including California, have requested additional information.

We expect that we will be able to fund any costs related to our rescission offer from our current cash balances. Furthermore, we do not believe our rescission offer would affect our ability to obtain financing in the future. Due to our belief that it is unlikely that the rescission offer will be accepted by our stockholders or option holders in an amount that would represent a material expenditure by us. This belief is based on the fact that our rescission offer will offer to repurchase shares and options at a weighted average price of $2.86, while our initial public offering price is $8.50.

We have received an exemption from Rule 102 of Regulation M under the Securities Exchange Act of 1934 from the Securities and Exchange Commission to conduct the rescission offer in the manner described above.
C. PIPEs (Private Investment in Public Equity). A PIPE transaction is a type of private placement offering, exempted from registration under Section 4(2) and Regulation D, Rule 506, in which the investors agree to purchase securities issued by a public company on the condition that a registration statement is effective within a
specified period of time. Essentially, the issuer privately sells securities, typically convertible preferred shares, to a limited number of investors. The issuer then files a registration statement with the SEC for resale of the underlying common shares as publicly registered securities. Upon approval, the investors are able to convert their preferred shares into common shares and then sell the shares on the open market.

1. Types of PIPEs. Basically, there are two types of PIPEs: traditional PIPEs and structured PIPEs. The main distinction between the two is that the structured PIPEs offer the investors downside protection against declines in the issuer's stock price following completion of the deal.

a. A traditional PIPE involves the sale of common or preferred stock at a fixed price. These PIPEs do not offer downside protection but often offer the investors enhanced upside potential. They generally enable the investors to purchase the issuer's stock at a discount to the current market price of the stock. In addition to the discount, the investors usually receive warrants to purchase the issuer's stock at a price that is at or above the current market price. Thus, the investors lose if the stock significantly declines, but win if the stock appreciates.

b. A structured PIPE involves the sale of convertible debt or convertible preferred stock at a fixed or floating price based on the underlying price of the issuer's common stock. Structured PIPEs generally contain more complicated, and often much more unfavorable, terms to the issuer, which in some cases can lead to "death spirals" (described in more detail below). Such PIPEs can be negotiated to
include caps, floors, mandatory redemption provisions and reset provisions, all of which allow the investors to alter their exposure to changes in the underlying security.

Essentially, structured PIPEs often contain terms that trigger the grant of more shares to the PIPE investor if the issuer’s stock subsequently falters and contain no floor so that the conversion price is reset based on whatever the common stock is trading for at the time of conversion. The reset provision rewards the investor with more shares to match the original investment which means that the lower the stock price goes, the greater the dilution from the conversion and the less value each common share holds. This devaluation can drive the market price down further all of which is at the expense of the non-PIPE investors. Thus, although the structured PIPE investor makes money if the stock appreciates, it also is protected in the event the stock falters.

2. Black Box, Rule 152 Integration and “Burst” PIPEs. In addition to fulfilling all of the conditions for an offering to be considered private, issuers must also be careful that the private offering is not “integrated” into the subsequent public offering. Thus, if the two offerings are integrated as one offering, the issuer would be deemed to have sold the securities by general solicitation and the private placement exemption will be lost, resulting in a “burst PIPE.” An issuer with a burst PIPE is guilty of offering securities before a registration statement covering such offer has been filed. This violation is commonly known as “gun jumping.” Rule 152 of the '33 Act provides a safe harbor for PIPE issuers to avoid integration of the two offerings. Under Rule 152, the two offerings will not be integrated if the entire private placement transaction is completed before the issuer files its registration statement. In a no-action letter, Black
Box, Inc. (avail. June 26, 1990) and a subsequent release in the SEC's Telephone Interpretation Manual Supplement (July 1999), the staff confirmed that it will not object to a PIPE transaction on the condition that a company registers the resale of securities prior to their issuance after the company has completed a Section 4(2)-exempt sale of the securities (or in the case of convertible securities, of the convertible security itself) to the investor, and the investor is at market risk at the time of the filing of the resale registration statement.

In other words, the investor must be irrevocably bound to purchase a set number of securities for a set purchase price that is not based on market price or a fluctuating ratio, either at the time of effectiveness of the resale registration statement or at any subsequent date. When a company attempts to register for resale shares of common stock underlying unissued, convertible securities, the staff's PIPE analysis applies to the convertible security, not to the underlying common stock. Additionally, there can be no conditions to closing that are within an investor's control or that an investor can cause not to be satisfied. For example, closing conditions in capital formation transactions relating to the market price of the company's securities or the investor's satisfactory completion of its due diligence on the company are unacceptable conditions. The closing of the private placement of the unissued securities must occur within a short time after the effectiveness of the resale registration statement.

3. **Advantages to Issuers.** PIPEs are attempts by issuers to combine the speed and certainty of private placement with the pricing benefits that flow from the increased liquidity of freely tradable, registered securities. Often issuers that engage in PIPE transactions are cash-strapped companies that are trying to avoid financial disaster. The advantages are the following:
a. the issuer is guaranteed cash from the investor;

b. the issuer does not need to discount the conversion price as much as it would need to in a traditional private offering because the investors will have liquidity with the registered securities (this smaller discount translates to less ownership dilution for existing shareholders);

c. the total value of the offering can be less than the value required for a secondary offering (fewer shares sold than would normally be in a larger public offering also translates to significantly less ownership dilution);

d. PIPE offerings can be quickly completed (some in as little as 30 days from the initial issuer-to-investor contact); and

e. a PIPE offering is usually much less expensive in the advertising area (issuers can bypass altogether the usual "road shows" and other advertising), documentation requirements and investment banking fee area.

4. Disadvantages to Issuers – the Toxic Convert. Certain PIPE transactions have created situations leading to the devaluation and even destruction of companies while enriching the PIPE investors. Such PIPEs have been referred to as "toxic converts" or "death spirals" because they seek to capitalize on the issuer's need for fast cash while inserting sometimes egregious protection provisions for the PIPE investors at the expense of the current shareholders. The key to these toxic PIPEs is a purchase agreement that guarantees the ultimate conversion price will be reset to a certain percentage below the market price on the day of
conversion. Additionally, the reset provision has no floor, which means that no matter how low the stock goes, the PIPE investor can convert at a discount. Thus, a guaranteed reset provision means that the lower the stock price goes, the greater the dilution from conversion of the preferred stock of the PIPE investment, and the less value each common share will hold. If the stock price declines following the completion of the private offering stage of the PIPE deal, the market recognizes the potential dilution of ownership that will result on the conversion date and devalues the stock accordingly. This devaluation drives the market price down further.

The PIPE investors, however, can benefit from the devaluation of the issuing company's common shares and therefore might seek to encourage such an event to occur. By selling the common stock short on a large scale, the PIPE investors can initiate the devaluation tailspin by flooding the market with shares. They can then cover their short position when they convert their private investment into registered common shares. Even if those shares have become worthless, the PIPE investors cover their short with the converted common shares, and recover their investment through their short selling. If the shares are devalued enough, the reset provision along with the discount premium might allow toxic PIPE investors to gain enough common stock to control the company, when they can choose to liquidate all of the company's assets, continue the business, or sell it to the highest bidder. PIPE investments that contain these highly discounted reset provisions and permit short selling by investors have been nicknamed "toxic converts" and "death spirals," because of the way the PIPE investment causes ever-increasing devaluation frequently culminating in liquidation or bankruptcy for the issuing company. The number of death spirals has been estimated at anywhere between 10% and 30% of the total number of PIPE transactions.
Recent rulings in U.S. Federal and Canadian provincial superior courts are pushing two closely watched short-selling fraud suits closer to trial. The decisions suggest that PIPE players mired in short-sale fraud suits can expect extensive case-by-case litigation.

Practical Consideration: If an issuer plans to issue adjustable convertible securities, it may avoid falling into the death spiral trap by employing one or more of the following techniques: (1) restricting investors’ ability to short sell the stock; (2) placing a floor on the conversion price; (3) restricting the number of securities an investor can convert during any one period; or (4) offering escalating discounts (the longer the holding period of the convertible securities, the steeper the discount from the market price). Issuers should also consider conducting due diligence on prospective investors to determine whether the investors have previously participated in toxic financings.

5. The Future of PIPEs. The recent run-up in the equity markets has left many businesses hoping that the long-dormant public offerings market will again become predictably robust. But as long as investors remain gun-shy, leaving even seasoned issuers with a narrow range of options for raising capital, public companies will continue to turn to PIPEs. Even though the equity markets have rebounded of late, there are no signs that the PIPE market is going to slow down any time soon. In the first two months of 2004, 260 PIPE transactions have already closed totaling approximately $3 billion. If the 2004 pace continues, then numbers should approximate the same for 2003, where there were approximately 1,315 PIPE deals totaling about $18.3 billion. Compare these numbers to previous years—1,052 PIPE deals totaling about $16.4 billion in 2002 and 1,294 PIPE deals totaling about $22.4 billion in 2001—and the PIPE market does not look like it is diminishing soon.
to the information furnishing provisions of Rule 12g-12(b). The rule available
for resales only and not for direct sales by issuers.

I. Quibs: A Quib is any of the entities described below that, together with
certain consolidated subsidiaries, own or invest on a discretionary basis at
least $100 million in securities of unaffiliated issuers (excluding certain
instruments). See Rule 144A(a)(2)). The following are Quibs:

(i) an insurance company as defined in Section 2(13) of the 1933 Act
(Purchases by “separate accounts” of an insurance company that
are not registered under the Investment Company Act of 1940 (the
“1940 Act”) are deemed purchases by the insurance company.);

(ii) an investment company or family of investment companies
registered under the 1940 Act;

(iii) a “business development company”, as defined in Section 2(a)(48)
of the 1940 Act;

(iv) a small business investment company licensed under
Section 301(c) or (d) of the Small Business Investment Act of
1958;

(v) specified governmental employee benefit plans;

(vi) an “employee benefit plan” within the meaning of Title I of
ERISA;

A. The Rule: Rule 144A, provides an exemption for resale of qualified securities of
issuers other than specified investment companies (closed-end investment
company securities may be eligible for resale under the Rule) to persons
reasonably believed to “qualified institutional buyers” (Quibs) where steps are
taken to make the buyers are aware of the seller’s reliance on the Rule and
specified information is available to the Quibs, if the issuer is not subject to the
periodic reporting provisions of the 1934 Act or exempt from reporting pursuant

the relevant antifraud provisions of 1934 Act Rule 10b-5 and 1934 Act
Section 9.

4. ADR Issues. Regulation S offerings by foreign issuers with U.S. ADR
facilities may raise issues as to whether deposits of additional shares
underlying ADSs may be accepted during the applicable restricted periods
under Regulation S. Regulation D and Regulation S offerings may result
in the creation of separate “restricted” ADR facilities in the U.S. for the
restricted securities and global depository receipts (GDRs) facilities for the
Regulation S securities, respectively.

Rule 144A.

Rule 144A, the choice de jure for many foreign private issuers and U.S. issuers of debt
securities, provides an exemption for resales of securities issued in exempt transactions,
generally pursuant to Regulation D or Regulation S.
certain trust funds administered by banks or trust companies whose participants are exclusively plans described in (v) and (vi) immediately above;

(viii) a corporation (other than a bank, as defined in Section 3(a)(2) of the 1933 Act or a savings and loan or other institution referenced in Section 3(a)(5)(A) of that Act, or a foreign bank or savings and loan or equivalent institution);

or

(ix) an investment adviser registered under the Investment Advisers Act of 1940.

2. 

Dealerr. A securities dealer registered under Section 15 of the 1934 Act may qualify as a Quib, with certain exceptions, if it owns or invests on a discretionary basis at least $10 million in securities of unaffiliated issuers or acts as a riskless principal in a transaction on behalf of Quib.

3. 

Banks. To qualify as Quibs, banks, as defined in Section 3(a)(2) of the 1933 Act, and savings and loan associations or other institutions, referenced in Section 3(a)(5)(A) of that Act, or a foreign bank or savings and loan or equivalent institution must both own or invest $100 million in securities of unaffiliated issuers and have a net worth of at least $25 million, as specified in as Rule 144A.

4. 

Certain Other Entities. An entity, all of the equity owners of which are Quibs also is a Quib.

5. 

Reliance. In determining whether an entity is a Quib, a sellr. may rely on publicly available financial statements of the entity, dated with 16 months of the date of sale, in the case of a U.S. entity, or 18 months of the date of sale, in the case of a foreign entity, or a certification of the chief financial officer or other specified executive of the entity. Rule 144A(d)(1). In addition, the seller must only reasonably believe that the buyer is a Quib.

6. 

Eligible Securities. The securities sold in a Rule 144A transaction, which initially issued were not of a class listed on a national securities exchange or admitted to quotation on the Nasdaq Stock Market. Rule 144(d)(3).

There are special rules for convertible or exchangeable securities and warrants. Among other things, institutional purchasers contemplating resale under Rule 144A of privately purchased securities probably should obtain the following representations, warranties and covenants from the issuer, in appropriate circumstances:

(a) representations that, at the time of issuance, the securities to be issued are not:

(l) of the same class as securities listed on a U.S. registered stock exchange (apparently they could be of the same class as securities listed on a foreign stock exchange) or quoted in the Nasdaq Stock Market; or, if the securities to be issued are common equity, do not have substantially similar characteristics and the holders do not enjoy substantially
similar rights and privileges (within the meaning of Rule 12g-5 under the 1934 Act) as the class so listed or quoted, or if the securities to be issued are preferred equity, do not have substantially identical terms relating to dividend rate, accumulation, participation, liquidation preference, voting rights, convertibility, call redemption and other material matters as securities of a class so listed or quoted, or if the securities to be issued are debt, do not have substantially identical terms as to interest rate, maturity, subordination, security, convertibility, call, redemption and other material matters as securities so listed or quoted (the SEC has indicated that securities issued in series generally would be deemed different classes);

(ii) convertible or exchangeable into securities so listed or quoted, if the “effective conversion premium” (as defined in Rule 144A(a)(6) and n.25 of Securities Act of 1933 Release No. 6862 (“Rel. 33-6862”) is less than 10%;

(iii) warrants that may be exercised for securities so listed or quoted, (AA) for a period of less than three years from the date of issuance, or (BB) that have an “effective exercise premium” (as defined in Rule 144A(a)(7) and n.26 of Rel. 33-6862) of less than 10%; or

(iv) securities of an open-end investment company investment trust or face-amount certificate company, registered or required to be registered under the 1940 Act.

b. Covenants by an issuer not subject to reporting under the 1934 Act (or not exempt from such reporting under Rule 12g3-2(b)) to keep current and provide upon request the information required by 1934 Act Rule 144A(d)(4) (i.e., reasonably current financial statements and a brief description of business comparable to that required by Rule 15c2-11(a)(3)(viii) and (ix)).

c. Registration covenants would only apply necessary, if the purchaser contemplated reselling outside of Rule 144A, since the eligibility of securities for resale under Rule 144A is determined at the time of issuance. Therefore, it would not appear that such securities would ever become ineligible for sale under that Rule. The benefits of the Rule could be lost to the reseller, if the issuer does not provide the information required by Rule 144A(d) on request. But see IV. A/B Exchange Office below.

d. The Rule contemplates that a person may purchase securities from an issuer with a view to reselling them under Rule 144A. See Preliminary Note 7 to the Rule. Therefore, it is not necessary for the purchaser to provide customary investment representations for 1933 Act purposes.
In this context, such as warrants with an effective exercise premium of less than 10% are being offered, as they may be in connection with high-yield debt offerings by U.S. issuers. Rule 144A would not be available for the offerings of the warrants or the underlying shares. In those circumstances, the initial offering would have to be made pursuant to Regulation D or some other exemption and "Rule 415(a)(1)(i)" or registration rights relied upon as an exit strategy. An initial purchaser also could split off the warrants and rely on Rule 144A for resales of the debt securities to Quibs.

B. Practice. Rule 144A raises a number of issues in practice.

1. Documentation, Including Legal Opinions. Documentation normally is the documentation produced in the initial private placement or Regulation S offering, plus any statement to the purchasing Quib by the seller that the seller is relying on Rule 144A (see Rule 144A(d)(2)) and the purchaser's right to information about certain non-reporting companies (see Rule 144A(d)(4)) and any certification of Quib status or the eligibility of the securities under Rule 144A. See III.A.6 above.

a. Disclosure Documentation. The confidential private placement memorandum ("PPM"), described under 1B Documentation, including 1940 Act Issues, above, will be used by the Placement Agent/Initial Purchaser in connection with offers limited to Quibs (and possibly to institutional "accredited investors") to satisfy the information requirements of Rule 144A(d)(4).

b. Legends. Legends may vary depending upon whether the Placement Agent/Initial Purchaser intends to make offers solely to Quibs.

c. Representations in Subscription Agreements. Typical representations, warranties and agreements obtained in the initial placement are:

(i) Quib status or institutional accredited investor status, if not an offering limited to Quibs;

(ii) the subscriber's acquisition is for its own account or for an account for which it is acting as fiduciary or agent in a discretionary capacity;

(iii) acknowledgment of limitations on transfer;

(iv) other acknowledgments typical in private placements.

d. Legal Opinions. Legal opinions may be required by the Initial Purchaser or Placement Agent, as discussed under 1 D.3. Legal Opinions and Legends above. Legal opinions ordinarily are not required by the parties in connection with Rule 144A sales to Quibs after the initial placement. However, since the securities are "restricted", transfer agents may insist on opinions as to the legality of the transfer without registration under the 1933 Act, see...
2. **Publicity.** See discussion of Rule 135c under II B 2 a. Rule 135c above.

3. **Trading Practices Rules.** Rule 144A offerings are not subject to Regulation M. See Rule 10b-10.

4. **Regulation T.** Purchases by brokers of debt securities in connection with Rule 144A transactions are not an "extension of credit" for purposes of Regulation T but are an "arranging for credit" within the "investment banking" exception under those rules. If the broker determines that, as to the purchasers from the broker, that the credit arrangement is permissible under Regulations U. Regulation T, 12 C.F.R. § 220.131, 55 F.R. 29566 (July 30, 1990).

5. **SEC Net Capital Rules.** Under the net capital rules specified types of securities sold in Rule 144A transactions are deemed to have a "ready market" subject to haircuts of only 2% to 15% rather than the 100% haircut applicable to "non-marketable" securities under those rules.

6. **Investment Company Portfolio.** Rule 144A securities, although "restricted securities," are treated differently than other restricted securities for purposes of the limits on restricted securities in the portfolios of certain mutual funds (15%). The funds' board of directors may determine whether and to what extent to include Rule 144A securities within the category of restricted securities for those purposes. See Securities Act of 1933, Release No. 600 (April 23, 1990), 32 F. R. 58-62 and accompanying text.

7. **Sales to Institutional "Accredited Investors." Section 4 (1-1/2).** While Rule 144A requires resales to be made only to Quota and Regulation D is not available for resales, resales in privately negotiated transactions to institutional accredited investors pursuant to Section 4 (1-1/2) exemption. See Securities Act of 1933 Release No. 6168 (February 1, 1980), n. 178. Since Rule 144(d) permits tacking of holding periods of securities obtained from non-affiliates of the issuer, accredited investor purchasers in these transactions are no worse off than Quota, in this respect, and they can resell to Quota.

8. **Resales.** Although resales of Rule 144A securities in registered offerings or pursuant to Rule 144A, Regulation S, and Section 4 (1-1/2), as described above, are permitted, Rule 144A securities are "restricted securities" and otherwise must be sold pursuant to Rule 144, after a one year holding period or, by non-affiliates of the issuer pursuant to Rule 144(b), after a two year holding period. In each case, tacking of holding periods of previous owners, who are not affiliates of the issuer, from the time that the previous owners acquired the securities from the issuer or an affiliate of the issuer is permitted.
C. Considerations: The SEC promulgated the "Blue Sky" laws with respect to transactions in securities of 1934 Act reporting companies pursuant to Rule 144A (which Act refers to transactions except pursuant to Sections 4(1) and 4(3) of the 1933 Act. Rule 144A is not based on interpretations of Section 4(1) and Section 4(3)). However, in some circumstances, states are permitted to impose requirements for fees, consent to service and sales reports.

D. Secondary Trading - Closed Trading Systems: Various initiatives have been developed to facilitate resales of Rule 144A securities among Quibs, none have had much success.

1. PORTAL: The NASD has created a closed trading system, the PORTAL. Market, as a real-time electronic marketplace to support trading and clearance and settlement of Rule 144A Securities. SEC Securities Exchange Act of 1934 Release No. 33326 (December 13, 1993). The system has yet to gain wide acceptance. The Market is available to NASD members who register as PORTAL dealers or brokers or non-members who register as PORTAL qualified investors. PORTAL dealers and qualified investors must be Quibs. PORTAL brokers, who may purchase or sell PORTAL securities as principal or agent, need not be Quibs. Transactions in PORTAL need not be pursuant to Rule 144A if another exemption from 1933 Act registration is available. Eligible securities are assigned CUSIP or CIN numbers different from unrestricted securities of the same class.

2. Other: Other closed trading systems have been considered by the major U.S. stock exchanges, but have not gotten off the ground.

3. Market Making: Placement agents may undertake to make over-the-counter markets among Quibs in Rule 144A securities, although they will provide no assurance in this regard.

4. DTC Eligibility: Rule 144A securities are eligible for DTC's book entry delivery and other services if the securities are investment grade or included within a SEC approved SRO system, such as PORTAL.

5. ADRs: American Depository Receipts ("ADRs") facilitate trading, settlement and voting of foreign securities and receipt of dividends, other distributions and information from foreign issuers. ADRs represent American Depository Shares ("ADSs") issued upon deposit of foreign shares with a custodian for a U.S. depository bank under a depository agreement with the issuer. (Depository arrangements may be established without the agreement of the issuer, as well as an "unsponsored program"). Foreign securities issued in Regulation S transactions may be deposited after the lapse of the applicable distribution compliance period, if the securities are exempt from registration in connection with their resale in the U.S. The ADRs must be separately registered by the depository and the issuer on Form F-6, which does not require information about the
of the deposited securities. If the ADR program is "unsponsored," the issuer need not sign the Form F-6. If the foreign shares to be deposited are to be listed on a U.S. stock exchange or admitted to quotation on the Nasdaq Stock Market, the foreign shares to be deposited must be registered under the 1934 Act and the issuer becomes subject to the periodic reporting provision of that Act applicable to foreign issuers. ADSs registered on Form F-6 no longer have to be listed if the foreign shares to be deposited are listed. See Rule 12a-8. An ADR program also could be established in connection with an A/B exchange offer. See IV. A/B Exchange Offers below. "Restricted" ADR programs may be established for Rule 144A transactions. The program would be separately established from any program for publicly traded securities of the same class and the "restricted" ADRs would be assigned CUSIP numbers different than those for the publicly traded securities of that class.

E. Integration. Rule 144A offerings are not integrated with 1933 Act Section 4(2) or Regulation D offerings in which the purchaser from the issuer resells pursuant to Rule 144A. Rule 144A, Preliminary Note 7, Rule 144A(e) Rule 144A offerings also are not integrated with contemporaneous Regulation S offerings.

IV. A/B Exchange Offers.

Despite the relative ease of Rule 144A resales, purchasers in these transactions would prefer, or may be required by their investment policies or other requirements, to hold freely tradeable securities. Closed trading systems, such as PORTAL (see III.D.

Secondary Trading and Closed Trading Systems above) or, in some cases, the ability to trade over the Internet (see V.D. Internet Issues below) apparently have not provided sufficient additional liquidity. Thus, the practice has developed of obtaining an agreement from the issuer to make a registered exchange offer of securities with essentially identical characteristics to those offered in 144A or Regulation S transactions immediately after the sale to the initial group of Qubs or the termination of the Regulation S distribution compliance period. (Also, an indenture for debt securities may have to be qualified under the Trust Indenture Act of 1939.) This technique, with certain exceptions discussed under IV.B. Limitations - Market Intermediaries below, provides those exchanging their holdings with freely tradeable securities. The requirement to make an A/B exchange offer also may be coupled with a registration rights agreement providing the initial purchaser or others with a shelf registration upon request or "piggyback" registration rights.

A. Practice. The parameters for A/B exchange offers are found in SEC staff "no action" letters beginning with Exxon Capital Holdings Corporation (avail. May 13, 1988) ("Exxon Capital"), which dealt with privately placed broker-re marketed preferred stock. In Morgan Stanley and Company Incorporated (avail. June 3, 1991) ("Morgan Stanley"), the concept was applied to investment grade and other non-convertible debt and preferred stock issued in Rule 144A transactions, subject to the issuer, prior to the effectiveness of the registration statement, providing the staff with the following representations:
F. Resale. Securities purchased in Regulation D transactions are "restricted securities" Rule 502(d). Thus, they only may be resold in transactions exempt from registration under the 1933 Act or after being registered under that Act. The exemptions most often relied upon are Rule 144A [see III. Rule 144A below] the so-called "Section 4(1-1/2)" exemption, generally in connection with sales to institutional accredited investors [see III D. 7. Resales below] or, after one or two year holding periods, pursuant to Rule 144 and Rule 144(k), respectively, [see II. C. 1.(i) Reduction of Rule 144 and Rule 144(k) Holding Periods below].

G. Liability. Securities offered and sold pursuant to Regulation D Rule 506 are not subject to private civil liability provisions of Sections 11 and 12(a)(2) of the 1933 Act. Those offerings subject private actions based on an implied private right of action under SEC Rule 10b-5 for materially misleading disclosure if the plaintiff may prove that the defendant acted with scienter. Inure to comply with Rule 506 in any material respect also will subject sellers to liability under section 12(a)(1) of the 1933 Act.

The Overseas Tranche — Regulation S

The overseas tranche of the offering may be made pursuant to Regulation S. Use of Regulation S raises issues as to publicity, permissible market activities and syndicate coordination.

A. The Regulation. Regulation S is essentially territorial in its application. Regulation S does not provide a safe harbor for resales into the U.S. The securities so resold must be registered or an exemption from registration such as Rule 144A, must be available.

1. The General Statement — Rule 901. For purposes of the registration provisions of Section 5 of the 1933 Act, offers and sales that occur outside the U.S. are not subject to that Section.

2. The Safe Harbor. For purposes of determining what constitute offers and sales outside the U.S., the SEC has constructed an elaborate three-tiered safe harbor for original issuances, Rule 903, and a safe harbor for secondary sales, Rule 904.

a. Category One — Rule 903(a)(1). For securities of a foreign issuer in which there is no "substantial U.S. market interest," as defined in Rule 902(m), certain securities issued in an offering directed to a single foreign country (an "overseas directed offering"); as defined in Rule 902(j)); securities backed by the full faith and credit of a foreign government, or non-transferable securities offered under specified conditions to foreign employees in compensatory circumstances under an employee benefit plan established under foreign law, the requirements are:

   (i) the offers and sales are made in "offshore transactions", as defined in Rule 902(j) (essentially offers are not made to "U.S. persons", as defined in Rule 902(a) and, at the time
the levy under is originated, the buyer is reasonably believed to be outside the U.S.

(ii) There are no "directed selling efforts", as defined in Rule 902(b), in the U.S. See II.B.2 Publicity below.

b. **Category Two — Rule 903(c)(2)**. Securities of any 1934 Act "reporting issuer", other than investment company required to register under the 1940 Act or a U.S. issuer offering equity securities, that has filed the required 1934 Act reports for at least 12 months (see Rule 902(i)) and certain debt, non-participating preferred or asset backed securities of non-reporting foreign issuers need not be registered if the securities are offered and sold in "offshore transactions", there are no "directed selling efforts" in the U.S.; and:

(i) specified "offering restriction" are implemented. See Rule 902(b);

(ii) offers and sales during a 40-day "restricted period" (see Rule 902(m)) are not made to "U.S. persons"; and

(iii) "distributors", as defined in Rule 902(c), confirm or give notice to purchasers that they are subject to the same restrictions as the distributor during the "restricted period."

c. **Category Three — Rule 903(c)(3)**. The safe harbor is a safe harbor for securities of any issuer if they are offered and sold in "offshore transactions"; there are no "directed selling efforts" in the U.S. and:

(i) "offering restrictions" are implemented;

(ii) offers and sales of debt securities are subject to a 40-day "distribution compliance" period (see Rule 902(f)) and certain other conditions;

(iii) offers and sales of equity securities are subject to a one-year "distribution compliance period" and certain other conditions; and

(iv) "Distributors" are subject to the conditions specified in II.A.2.b (iii) above.

d. **Other.** Non-convertible preferred stock, certain asset-backed securities and guaranteed securities are subject to the same conditions as would be applicable to the issuer with respect to its debt. See Rule 903(c)(4) and (5).

3. **Resales — Rule 904.** The safe harbor is available for resales in "offshore transactions" not involving "directed selling efforts" in the U.S. by persons, including officers or directors of the issuer or a distributor, under certain conditions but dealers or persons receiving a selling concession in such transactions are subject to somewhat more restrictive limitations. See Rule 904(c)(1). Rule 903 of Regulation S now codifies the SEC staff's
4. Other Resale Considerations. Resales in the U.S. may be effected pursuant to registration under the 1933 Act or Rule 144A or some other exemption from registration.

B. Practice. Various documentation and other practices have been developed to assume compliance with Regulation S.

1. Documentation, Including Legal Opinions. Documentation for the type of offerings discussed in this offering may closely resemble that for a U.S. underwritten offering. In addition, depositary agreements may be entered into to establish restricted ADR programs. See III D 5 ADRs below.

As to opinion practice, see generally Rowe, Some Opinion Issues in Regulation S and Rule 144A Offerings, Outline in Opinions in SEC Transactions - 1995, PLI Course Handbook Series No. 18 896. The SEC has imposed certification, legend and other requirements in connection with Regulation S offerings of equity securities of U.S. and certain foreign private issuers, which impact the documentation with respect to these offerings.

2. Publicity.

a. Rule 135c. Rule 135c permits U.S. 1934 Act reporting companies and foreign issuers exempted from 1934 Act reporting by Rule 12g3-2(b) to announce that they propose to make, are making or have made exempt offerings. These notices cannot be used for purposes of conditioning the U.S. market for the securities being offered and must state that the securities being offered have not been registered under the 1933 Act and may not be offered or sold in the U.S. absent registration or an exemption. The notices must be filed with the SEC under cover of Form 8-K (reporting domestic issuers) or Form 6-K (reporting foreign issuers) pursuant to Rule 12g3-2(b) (foreign issuers exempt from reporting), as the case may be. Generally, the notice is limited to the name of the issuer, the title, amount and basic terms of the securities, the time of the offering and its manner and purpose. "Underwriters" may not be named. (Presumably, this prohibition also applies to naming initial purchasers and placement agents.) Announcements in compliance with Rule 135c do not constitute directed selling efforts in the U.S. for purposes of Regulation S. See Rule 902(b)(7).

b. Offshore Press Contacts. Despite the provisions of Rule 135c, Preliminary Note 7 to Regulation S ("Nothing in these rules precludes access by journalists for publications with a general circulation in the United States to offshore press conferences, press releases and meetings with company press spokespeople in which an offshore offering... is discussed, provided the information is made available to the foreign and United States press generally and
is not intended to induce purchases of securities by persons in the United States. Therefore, informal advice from the SEC staff (see, e.g., Reuters Holding plc. (avail. March 6, 1990)), concern remained as to the parameters of permissible offshore press contacts, in view of the prohibition of "directed selling efforts" in the U.S. under Regulation 8 and "gun jumping" under Section 5 of the 1933 Act. In Securities Act of 1933 Release No. 7470 (October 10, 1997) ("Rel. 33-7470"), the SEC clarified these issues in three areas: (i) offshore press conferences; (ii) meetings with company representatives offshore; and (iii) written press related materials released offshore. This was accomplished by adopting a new Rule 135e; adding a proviso to Rule 502(c); amending Preliminary Note 7 to Regulation S; and adopting a new Rule 902(b)(8). (Certain provisions of the SEC's rules relating to tender offers were amended similarly. See Rule 14d-1(c).)

Rule 135e: Rule 135e provides that, for purposes of Section 3 of the 1933 Act only, it would not be deemed an offer of a security if a foreign selling security holder or their representatives provide any journalist with access to press conferences or meetings with the representatives outside the U.S. or written press related materials, at or in which an offering of securities is discussed, provided:

(i) There is an intent to make a bona fide offering offshore offering is not being made in or will not be conducted solely in, the U.S. (Rule 135(e)(6)(1) and the Note thereto);

(ii) access is provided to both U.S. and foreign journalists (one-on-one contacts are permissible, if the opportunity is open to both foreign and U.S. journalists; an exclusive one-on-one also would be permissible, if a general press conference is held contemporaneously); and

(iii) written press materials pertaining to offerings that are being or will be conducted in the U.S., in addition to not containing or attaching any purchase orders or coupons that could be returned to indicate an interest in the offering, must state that:

(AA) they are not an offer of securities for sale in the U.S.;

(BB) the securities may not be offered or sold in the U.S. absent registration or an exemption therefrom;

(CC) any public offering in the U.S. will be made by means of a prospectus that may be obtained from the issuer or the selling security holder and will contain detailed information about the company and its management and financial statements (this provision appears to disregard the possibility of an exempt offering and the practice of distribution of prospectuses by underwriters); and
(D1) That, if true, the issuer intends to register the securities to be offered in the U.S.

(EE) In addition, the exception would not cover paid advertisements and analyst's reports. See Rule 33-7470.

The drafting of Rule 135c, including the rather cumbersome provisions relating to written press materials, and Rule 33-7470, evidenced great concern for potential abuse of the process. However, amendments did go beyond existing guidance in terms of clarification by eliminating concepts of intent.

d. **Rule 502(c).** The provision to Rule 502(c) provides that press activities that comply with Rule 135c do not constitute "general solicitation" or "general advertising" for purposes of Regulation D.

e. **Rule 902(b)(4).** Rule 902(b)(4) provides that press activities in compliance with Rule 135c would not constitute "directed selling efforts" in the U.S. for purposes of Regulation S.

f. **Analysts' Reports.** Analysts' reports can raise issues as to whether they constitute "directed selling efforts" in the U.S. or "inducements to purchase" for purposes of the SEC's trading practice rules. However, analysts' research reports included in written press-related material, even if not covered by Rules 138 or 139, would be covered by the safe harbor (although not expressly). Publication of such reports by the analyst still would continue to be subject to consideration under those rules. See 33-7470, n. 23 and accompanying text. Also, with the adoption of Regulation M, discussed under V F 2. Relaxation of Trading Practice Rules - Regulation M, that Regulation expressly provides that research reports that comply with 1933 Act Rules 138 and 139 do not constitute "inducements to purchase or other unlawful activity proscribed by that Regulation." See Rule 102(b)(1). See also Securities Act of 1933 Release No. 7132 (February 2, 1995) clarifying applicability of Rules 138 and 139 to foreign issuers.

3. **Trading Practices Rules.** Due to sometime trading of Rule 144A securities in foreign markets and the SEC's view as to the global reach of its trading practices rules, the nature of exemptions currently available and SEC staff no action positions under those rules, an issue can arise as to whether a Rule 144A offering is a "distribution" for purposes of those rules.

However, securities of foreign issuers offered and sold to Qubos only in transactions exempt from registration under the 1933 Act pursuant to Section 4(2) of the Act, or Rule 144A or Regulation D are not subject to Regulation M. See Rule 102(b)(10). For other types of offerings, the SEC may take no action positions or grant exemptive orders to accommodate foreign trading practices. On the other hand, since Regulation M remains a prophylactic provision and not a safe harbor, conduct cannot be engaged in for the purpose of creating actual, or apparent, active trading in or
Distribution of informal written materials like these in advance of a final prospectus runs the risk of violating Section 5(b) of the Securities Act of 1933:

It shall be unlawful for any person, directly or indirectly—

1. to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to carry or transmit any prospectus relating to any security with respect to which a registration statement has been filed under this title, unless such prospectus meets the requirements of section 10.

It’s usually safest to assume that any written material circulated to investors by an underwriter in connection with a forthcoming offering is a “prospectus” under Section 2(a)(10) of the Securities Act, unless it satisfies the nc row exception described in Rule 134 under the Securities Act.

For example, if sales memorandums or emails summarizing research analyst’s earning estimates are delivered in appropriately to investors during the pre-registration or waiting periods – they are indeed “prospectuses” and very likely do not satisfy the requirements for prospectuses specified in Section 10 of the Securities Act. This is known as “gun-jumping.”

Below are examples of risk factors in prospectuses regarding gun-jumping in IPOs:

1. Salesforce.com – from its IPO prospectus (6/4/04)

If our involvement in a lengthy May 9th New York Times article about salesforce.com or any other publicity regarding salesforce.com or the offering during the waiting period were held to be “gun jumping” in violation of the Securities Act of 1933, we could be required to repurchase securities sold in this offering. You should only rely on statements made in this prospectus in determining whether to purchase our shares.

In a New York Times article dated May 9, 2004 and entitled “It’s Not Google. It’s That Other Big I.P.O.,” information regarding this offering and salesforce.com was published. The New York Times article included quotes from Marc Benioff, our Chairman of the Board and Chief Executive Officer, regarding the development of salesforce.com and its business strategy. In preparation of the article, the reporter was allowed to spend most of a full day with Mr. Benioff. As a result, it could have been expected that a lengthy article would be published. Portions of this New York Times article were subsequently reprinted by a number of news outlets. While some of the factual statements about salesforce.com in the article are disclosed in this prospectus, the article presented statements about our company in isolation and did not disclose many of the related risks and uncertainties described in this prospectus.

In addition to the New York Times article, there has been substantial additional press coverage regarding us and this offering during the offering process. These articles also presented statements about our company in isolation and did not disclose many of the related risks and uncertainties described in this prospectus.

You should carefully evaluate all the information in this prospectus, including the risks described in this section and throughout the prospectus. We have in the past received, and may continue to receive, a high degree of media coverage, including coverage that is not directly attributable to statements made by our officers and employees. You should only rely on the information contained in this prospectus in making your investment decision.

In order to reduce the risk of investors’ possible reliance on the New York Times article and other news reports and articles, we stopped our offering on May 13, 2004. We then allowed a “cooling off” period to pass so that the effect of this article and other reports, articles and information would be dissipated.

It is uncertain whether our involvement in the May 9th New York Times article or any of our other publicity related activities could be held to be a violation of Section 5 of the Securities Act of 1933. If our involvement or such activities were held by a court to be in violation of the Securities Act, we could be required to repurchase the shares sold to purchasers in this offering at the original purchase price for a period of one year following the date of the violation. We would contest vigorously any claim that a violation of the Securities Act occurred.
2. Open Solutions - from its IPO prospectus:

Two employees of Bear, Stearns & Co. Inc., one of our underwriters, circulated unauthorized materials to some potential institutional investors, which may have constituted a prospectus that does not meet the requirements of the Securities Act of 1933, and, if that is the case, recipients of these materials that purchase shares of our common stock in the offering may be entitled to rescission rights.

Prior to the effectiveness of the registration statement of which this prospectus forms a part, an employee of one of the underwriters of this offering distributed an unauthorized sales memorandum to approximately 15 potential institutional investors. We were not involved in any way in the preparation or distribution of the sales memorandum, and the information contained in the sales memorandum does not reflect our views as to matters addressed in the sales memorandum.

The sales memorandum may constitute a prospectus that does not meet the requirements of the Securities Act of 1933. The 15 prospective institutional investors who received the sales memorandum from the underwriter have been notified that it was distributed in error and should be disregarded and none of those potential investors will be permitted to purchase shares of our common stock from the underwriters in this offering. Each of the 15 potential investors who received the sales memorandum from the underwriter has stated to the underwriter that it has not circulated the sales memorandum any further, and that it has disregarded the contents of the sales memorandum.

In addition, a Bear, Stearns & Co. Inc. salesperson circulated an e-mail message to a separate potential institutional investor which contained the name of the Bear, Stearns & Co. Inc. research analyst and purported to contain that analyst’s estimates with respect to our revenues and earnings per share for our 2003 and 2004 fiscal years. The e-mail did not actually reflect that analyst’s actual estimates. We did not participate in the preparation of, or authorize the distribution of, the information described above. The prospective institutional investor who received the e-mail from the underwriter has been notified that it was distributed in error and should be disregarded and that potential investor will not be permitted to purchase shares of our common stock from the underwriters in this offering. Accordingly, anyone in receipt of these estimates should consider these estimates together with the other information contained in this prospectus. Any estimate or projection of future operating performance is necessarily based upon a number of underlying estimates or assumptions that may or may not prove to be accurate. In addition, these underlying estimates or assumptions are subject to significant economic, competitive and other uncertainties that are beyond a company’s control. For these reasons, estimates of future operating performance are inherently unreliable. You should only rely on the information set forth in this prospectus and should only make an investment decision after carefully reviewing and evaluating all of the information in this prospectus, including the risks described in this section and throughout the prospectus.

If the distribution of the sales memorandum or the e-mail were to constitute a violation of the Securities Act of 1933, and the recipients were able to participate in the offering despite the prohibition described above, any recipients able to purchase shares of our common stock in this offering may have the right, for a period of one year from the date of their purchase of the shares, to obtain recovery of the consideration paid in connection with their purchase. Any liability would depend, in part, upon the number of shares purchased by such a recipient. If any liability is asserted, we intend to contest the matter vigorously. In addition, Bear, Stearns & Co. Inc. has agreed to indemnify us for losses that we may incur as a result of the distribution of the sales memorandum or the unauthorized e-mail. We do not believe that we will be subject to any material liability as a result of the distribution of the sales memorandum or the unauthorized e-mail.

3. iPayment - from its IPO prospectus:

Publicity Regarding Financial Forecasts

During an Internet road show broadcast made to potential investors from April 28, 2003 through May 8, 2003, a Bear, Stearns & Co. Inc. research analyst announced that an assumed initial per share offering price for our stock of $15.00 would represent 15.8 times a pro forma earnings per share estimate for 2003 and less than 13 times a pro forma earnings per share estimate for 2004. We did not authorize the statements described above. Accordingly, you should consider the earnings forecasts made by the Bear, Stearns & Co. Inc. research analyst on the Internet road show together with the other information contained in this prospectus.

Any estimate or projection of future operating performance is necessarily based upon a number of underlying estimates or assumptions that may or may not prove to be accurate. In addition, these underlying estimates or assumptions are subject to significant economic, competitive and other uncertainties that are beyond a company’s control. For these reasons, estimates of future operating performance are inherently unreliable. You should only rely on the information set forth in this prospectus and should only make an investment decision after carefully reviewing and evaluating all of the information in this prospectus, including the risks described in this section and throughout the prospectus.

Bear, Stearns & Co. Inc. has removed this research analyst from any coverage of our company. In addition, any article or other media report concerning the actions of the Bear, Stearns & Co. Inc. research analyst discussed above may have a material adverse effect on the market price of our common stock.
4. Whiting Petroleum – from its IPO prospectus:

Prior to the effectiveness of the registration statement with respect to the shares of our common stock being sold in this offering, one of the underwriters distributed unauthorized written materials relating to our company to at least one potential institutional investor. The written materials were in email form and consisted of a "road show" presentation that included information not otherwise contained in this prospectus.

5. Overnite Corp. – from its IPO prospectus:

Prior to the effectiveness of the registration statement with respect to the shares of our common stock being sold in this offering, two financial institutions distributed unauthorized written materials relating to our company to 13 potential institutional investors. The written materials included a research model prepared by an analyst at BB&T Capital Markets, which included the research analyst's financial projections for our company for the remainder of fiscal year 2003, as well as fiscal years 2004 and 2005. The written materials also included email communications from an analyst at J.P. Morgan Securities Inc., an underwriter for this offering, which included this research analyst's views regarding our valuation as compared to that of one of our competitors and included this research analyst's projections for earnings per share for fiscal years 2004 and 2005.

6. Billy Dead – from its IPO prospectus:

The appearance of these news reports, articles and other information cited above or otherwise previously made available may have constituted one or more prospectuses that did not meet the requirements of the Securities Act of 1933 and may have caused us to violate Section 5 of the Securities Act, which would allow an investor who purchased shares in the offering to have the right, for one year from the date of purchase, to bring an action for rescission or for damages resulting from such purchase. If any such claim were asserted, we would contest it vigorously, although there can be no assurance that any such contest would be successful.
About This Guide

This Guide summarizes the significant legal implications for a company completing its initial public offering of common stock on the New York Stock Exchange ("NYSE") and for its directors, officers and employees. The relevant rules generally arise under the Securities Exchange Act of 1934 (the "Exchange Act"), the Securities Act of 1933 (the "Securities Act") or the rules of the NYSE. This Guide is divided into three principal sections:

Part I:    Board of Directors and Corporate Governance Issues

Part II:   Public Disclosure Obligations

Part III:  Trading in Company Securities

This Guide summarizes very complex legal requirements and should not be considered a definitive explanation of applicable laws. The purpose of this Guide is to educate representatives of the Company generally about the legal consequences of being a publicly held company. For an understanding of the details and nuances of the rules discussed and their application to specific circumstances, we encourage you to consult with us.

This Guide is limited to a discussion of the principal legal rules governing the Company's day-to-day activities as a public company. It does not address the securities laws and other legal requirements applicable to corporate transactions such as a public offering of securities, a merger or a tender offer. We would be happy to advise the Company on the legal implications of those transactions as they arise.

Some of the NYSE rules described in this Guide provide companies undertaking an initial public offering with a transition period for coming into compliance with the rules. However, because those rules will soon be applicable to the Company, this Guide describes those NYSE rules as if they are currently in effect.
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Part I:

Board of Directors and Corporate Governance

A. The Board of Directors

1. Composition

NYSE rules require that a majority of the members of the Company’s Board of Directors be “independent directors” (Section 303A.01 of the Listed Company Manual). For a director to be considered independent, the Board of Directors must make an affirmative determination that he or she has no material relationship with the Company, either directly or as a partner, shareholder or officer of an organization that has a relationship with the Company, and must publicly disclose the basis for that determination (Section 303A.02). The following is a summary of the categories of persons who are not considered independent directors under the NYSE rules (for purposes of this list, references to the Company include any parent corporation or subsidiary of the Company):

- a person who is or within the past three years was an employee of the Company, or who has an immediate family member who is or within the past three years was an executive officer of the Company;

- a person who received, or who has an immediate family member who received, direct compensation from the Company of more than $100,000 in any 12-month period within the last three years, other than compensation for service on the Board of Directors or a Board committee, compensation for services as an interim executive officer and certain deferred compensation;

- a person who is, or who has an immediate family member who is, a current partner of the Company’s internal or external auditor;

- a person who is a current employee of the Company’s internal or external auditor;

- a person who has an immediate family member who is a current employee of the Company’s internal or external auditor and who participates in that firm’s audit, assurance or tax compliance (but not tax planning) practice;

- a person who was, or who has an immediate family member who was, within the past three years (but is no longer), a partner or employee of the Company’s internal or external auditor and who personally worked on the Company’s audit within that time;

- a person who is or within the past three years was, or who has an immediate family member who is or within the past three years was, employed as an executive officer of another company where any of the Company’s present executive officers at the same time serves or served on that other company’s compensation committee; and

- a person who is a current employee, or who has an immediate family member who is a current executive officer, of a company that has made payments to, or received payments from, the Company for property or services in any of the last three fiscal years in excess of the greater of $1,000,000 or 2% of such other company’s gross revenues in such year.

In addition, the NYSE rules (Section 303A.03) require that the Company regularly convene executive sessions of its non-management directors and publicly disclose information concerning the presiding director at those
sessions. If the group of non-management directors includes a director who is not independent, then the independent directors should meet separately at least once per year.

2. The Roles and Duties of Directors

The roles and duties of the members of the Company’s Board of Directors are generally governed by Delaware corporate law. The legal duties imposed on directors by Delaware law are the same for private companies as they are for public companies, and thus the Company’s initial public offering did not subject the Company to a new set of regulatory standards (as it did with respect to the public disclosure of information and trading in Company securities). However, because the existence of a public market for the Company’s common stock and the presence of a large number of public stockholders increase the scrutiny of directors’ actions and the risk of a claim alleging a breach by directors of their duties, a brief summary of the roles and duties of directors is warranted.

a. The Responsibilities of the Board of Directors

Delaware law provides that “the business and affairs of every corporation...shall be managed by or under the direction of a Board of Directors.” It is generally recognized that corporations are managed “under the direction of” rather than “by” their directors. Accordingly, management of the day-to-day activities of a corporation is delegated to the corporation’s chief executive officer and professional staff. The principal responsibility of the Board of Directors is to oversee the management of the corporation.

To effectively discharge this responsibility, the Board of Directors, either directly or through its committees, should:

- review and approve fundamental operating, financial and other corporate plans, strategies and objectives;
- evaluate the performance of the Company and its senior executives and take appropriate action, including removal, when warranted;
- evaluate the Company’s compensation programs on a regular basis and determine the compensation of its senior executives;
- require, approve and implement senior executive succession plans;
- evaluate whether corporate resources are used only for appropriate business purposes;
- establish a corporate environment that promotes timely and effective disclosure (including robust and appropriate controls, procedures and incentives), fiscal accountability, high ethical standards and compliance with all applicable laws and regulations;
- review and approve material transactions and commitments not entered into in the ordinary course of business;
- develop a corporate governance structure that allows and encourages the Board to fulfill its responsibilities;
- provide advice and assistance to the Company’s senior executives, and
- evaluating the overall effectiveness of the Board and its committees.

b. Fiduciary Duties

Directors of a Delaware corporation owe two principal fiduciary duties to stockholders: the duty of care and the duty of loyalty.

Duty of Care. The duty of care obligates each director of the Company, in taking any corporate action, to act on an informed basis, in good faith and in a manner he or she reasonably believes to be in the best interests of the Company, and with such care as a reasonable person would use under similar circumstances.
If an action by directors is challenged in court, the directors are generally entitled to the benefits of the "business judgment rule," which provides a framework for a court's analysis of whether directors have satisfied their duty of care with respect to a particular action or decision. The purpose of the business judgment rule is to prevent judicial "second guessing" of directors' decisions, except in clear cases of abuse. The business judgment rule establishes a presumption that directors, in making a business decision, acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the Company. If the business judgment rule applies, the directors' action or decision will be sustained if it can be attributed to any rational business purpose. The business judgment rule will be held inapplicable — stated another way, its presumption that directors acted properly will be overcome — if (i) it is clear that the directors did not act properly or with due care (the business judgment rule does not protect gross negligence), or (ii) the directors' decision or action involves self-dealing or a conflict of interest.

**Duty of Loyalty.** The duty of loyalty obligates each director, in performing his or her duties as a director of the Company, to put the interests of the Company ahead of his or her personal interests. This duty prohibits a director from usurping any corporate opportunity for his or her own benefit. It also prohibits a director (or his or her affiliate) from engaging in a transaction with the Company unless:

- the transaction is approved by at least a majority of the disinterested directors or the stockholders (who must be aware of the director's interest in the transaction), or

- the transaction is fair to the Company, with the director having the burden of establishing the entire fairness of the transaction.

**B. Liabilities of Directors and Officers**

**1. Liabilities of Directors for Breach of Fiduciary Duties**

If the directors of the Company are found to have breached their duty of care or their duty of loyalty in taking a corporate action, such action may be prohibited or rescinded. Additionally, directors can be held personally liable to stockholders under certain circumstances for damages resulting from breaches of their duty of care or their duty of loyalty.

In an attempt to limit the personal liability of its directors, the Company, as permitted by Delaware law, has included in its Certificate of Incorporation a provision which eliminates the personal liability of a director to the Company or its stockholders for monetary damages for a breach of his or her fiduciary duties, except for breaches involving specified circumstances such as a breach of a director's duty of loyalty or acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law. It should be noted, however, that this provision affords no protection to directors in suits brought by parties other than the Company or its stockholders.

The Certificate of Incorporation of the Company also includes provisions requiring the Company to indemnify its directors (and officers). In general, Delaware law permits indemnification of a director or officer against liabilities and expenses arising out of legal proceedings brought against such director or officer by reason of his or her status as a director or officer if the director or officer acted in good faith and in a manner he or she reasonably believed to be in or not opposed to the best interests of the Company. This expands the scope of protection afforded by the limitation of liability provision discussed in the preceding paragraph in that it (i) covers officers as well as directors and (ii) provides protection to directors and officers with
respect to suits brought by parties other than the Company or its stockholders.

2. Liability for Inaccurate or Misleading Disclosures

The Securities Act and the Exchange Act contain a number of provisions under which liabilities may be imposed upon directors and officers in connection with SEC filings by the Company or other public statements by the Company or by them individually. For example, each director and each officer signing the registration statement, can be held liable for a material inaccuracy or omission in a registration statement for a public offering of securities (such as the Registration Statement on Form S-1 filed in connection with the Company’s initial public offering), unless he or she is able to demonstrate that, after reasonable investigation, he or she had reasonable grounds to believe that there was no such inaccuracy or omission. Similarly, officers of the Company signing a periodic SEC report filed under the Exchange Act (such as a Quarterly Report on Form 10-Q or an Annual Report on Form 10-K) can be held liable under a number of different provisions of the federal securities for a material inaccuracy or omission in such a report. Moreover, the chief executive officer (the “CEO”) and the chief financial officer (the “CFO”) of the Company must make certain personal certifications in connection with the filing of Form 10-Qs and Form 10-Ks (which are discussed in more detail in Section II B of this Guide), and there are criminal penalties for knowingly making a false certification. In addition, it is possible for directors and officers to be found liable for false or misleading statements by the Company in documents other than SEC filings, such as Company press releases.

It is not clear whether directors and officers are entitled to indemnification from the Company for liabilities incurred as a result of disclosure violations. The SEC’s position with respect to liability for inaccurate or misleading statements in a Securities Act registration statement is that indemnification is not available because such indemnification is against public policy. In addition, the Company was required to agree with the SEC, as part of its initial public offering, that it will not indemnify its directors or officers against liabilities under the Securities Act relating to the offering unless it has been judicially determined that such indemnification is permissible. Whether indemnification is available for other types of disclosure liabilities depends in large part on the facts and circumstances involved.

3. Other Liabilities and Restrictions

Section 304 of the Sarbanes-Oxley Act provides that if a public company restates its financial statements due to “material noncompliance of the [company], as a result of misconduct, with any financial reporting requirement under the securities laws”, the CEO and the CFO of the company must reimburse the company for bonus, incentive and equity-based compensation received from the company, as well as any profits realized from the sale of stock of the company, during the 12-month period following the public release of the financial statements that were restated.

One of the more publicized provisions of the Sarbanes-Oxley Act is Section 402, which prohibits a public company from, directly or indirectly, extending or maintaining credit in the form of a personal loan to any director or executive officer of the company. This prohibition may affect a number of transactions or items that the Company may not think of as loans, including cashless stock option exercises (discussed further in Section III.D below), split-dollar life insurance policies and advancements of expenses. The law in this area is still evolving, and we encourage you to consult with Wilmer Cutler Pickering Hale and Dorr on any matters that might be implicated by this prohibition.

Rule 13b2-2 under the Exchange Act, which was adopted pursuant to requirements of the Sarbanes-Oxley Act, prohibits officers and
directors of a public company, as well as persons acting under their direction, from taking any action to coerce, manipulate, mislead or fraudulently influence the company’s auditors if that person knew or should have known such action could render the financial statements materially misleading.

C. Committees of the Board of Directors

1. Audit Committee

a. Composition

NYSE rules require that the Company have an Audit Committee comprised solely of at least three directors, each of whom (i) is independent, within the meaning of both the NYSE rules described above and Rule 10A-3 under the Exchange Act and (ii) is financially literate, with at least one member having experience in finance or accounting (Sections 303A.06 and 303A.07). Rule 10A-3 precludes a person from being independent if either he or she accepts, directly or indirectly, consulting, advisory or other compensatory fees from the Company (other than compensation for service on the Board of Directors or a Board committee and certain retirement compensation), or he or she is an “affiliate” of the Company or any of its subsidiaries. “Affiliate” is defined as a person who, directly or indirectly, controls, is controlled by, or is under common control with, the Company. While a person may be considered an affiliate of the Company by virtue of his or her stock ownership, there is a safe harbor for a person who holds 10% or less of the Company’s stock, if a person’s stock ownership exceeds 10%, all relevant facts and circumstances need to be examined to determine whether that ownership results in affiliate status.

In addition, the SEC has adopted rules required by the Sarbanes-Oxley Act of 2002 (Item 401(h) of Regulation S-K) that require each public company to disclose in its Annual Report on Form 10-K whether or not (and if not, why) its Audit Committee has at least one member who is an “audit committee financial expert.” This is defined as a person who, through education and experience as, or experience supervising or overseeing, an accountant or financial officer (or other relevant experience), has the following attributes:

- an understanding of generally accepted accounting principles and financial statements;
- the ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves;
- experience preparing, auditing, analyzing or evaluating financial statements that present accounting issues generally comparable to the ones expected to be raised by the Company’s financial statements, or experience supervising someone engaged in those activities;
- an understanding of internal control over financial reporting; and
- an understanding of audit committee functions.

b. Operation

The Sarbanes-Oxley Act, new SEC rules and new NYSE rules have combined to impose on the Audit Committee significantly more responsibilities than an Audit Committee historically had. The principal duties and responsibilities of the Audit Committee are as follows:

- The Audit Committee is directly responsible for the appointment, compensation and oversight of the Company’s independent auditors.
- The independent auditors report directly to the Audit Committee.
- The Audit Committee must establish procedures for handling complaints received
by the Company regarding accounting matters and establish a method for employees to submit concerns regarding accounting matters on a confidential, anonymous basis.

- The Audit Committee has the authority to engage independent counsel and other advisors.

- The Audit Committee must approve in advance all audit services and all permitted non-audit services (including tax services) to be provided by the Company’s independent auditors.

- The Audit Committee must have a charter that outlines the Committee’s duties and responsibilities, including several additional ones specified in the NYSE rules, and provides for an annual performance evaluation.

2. Compensation Committee

NYSE rules require each listed company to have a Compensation Committee comprised solely of independent directors, and further require the Compensation Committee to have a charter addressing the Committee’s purpose and responsibilities and providing for an annual performance evaluation of the Committee. The Compensation Committee’s responsibilities must include, at a minimum, reviewing and approving corporate goals and objectives relevant to CEO compensation, evaluating the CEO’s performance in light of those goals and objectives, either as a committee or together with the other independent directors (as directed by the Board of Directors), determining and approving the CEO’s compensation level, making recommendations to the Board of Directors with respect to non-CEO compensation, compensation plans and equity-based plans, and producing a report on executive compensation to be included in the Company’s Proxy Statement (Section 303A.05).

A properly comprised Compensation Committee is desirable for tax and securities law reasons as well. Section 162(m) of the Internal Revenue Code prohibits public companies from taking a federal income tax deduction for annual compensation – including income received upon the exercise of stock options – in excess of $1,000,000 paid to certain executive officers. However, there is a “performance-based compensation” exception under Section 162(m) that exempts stock options and certain other compensation from this prohibition on deductibility. One of the requirements of that exception is that the options be granted by a Compensation Committee comprised of at least two persons, each of whom qualifies as an “outside director” within the meaning of Section 162(m). Moreover, in order for the Company to avail itself of the Rule 16b-3 exemption to the short-swing profit prohibitions of Section 16(b) of the Securities Exchange Act of 1934 (which is discussed in Section III.B.4 below), the Company’s Compensation Committee must be comprised of at least two persons, each of whom qualifies as a “non-employee director” within the meaning of Rule 16b-3. These two terms have different definitions, and a person could qualify as an outside director for Section 162(m) purposes but not as a non-employee director for Rule 16b-3 purposes, or vice versa.

3. Nominating and Corporate Governance Committee

NYSE rules require each listed company to have a Nominating and Corporate Governance Committee comprised solely of independent directors, and further require the Nominating and Corporate Governance Committee to have a charter addressing the Committee’s purpose and responsibilities and providing for an annual performance evaluation of the Committee. The Nominating and Corporate Governance Committees’ responsibilities must include, at a minimum, identifying individuals qualified to become Board members, selecting (or recommending to the Board of Directors for selection) the director nominees for the next annual meeting of stockholders, developing and
recommending to the Board of Directors a set of corporate governance principles, and overseeing the evaluation of the Board of Directors and management (Section 303A.04).

D. Code of Conduct and Corporate Governance Guidelines

Item 406 of Regulation S-K (adopted pursuant to a Sarbanes-Oxley Act mandate) requires each public company to:

- disclose in its Annual Report on Form 10-K whether or not (and if not, why) it has adopted a code of ethics for certain executive officers;

- either (i) file the code of ethics as an exhibit to the Form 10-K, (ii) post the code of ethics on the company’s website and disclose that in its Form 10-K or (iii) describe in the company’s Form 10-K how a person may obtain a copy of the code of ethics without charge from the company; and

- promptly publicly disclose any amendment or waiver of that code of ethics by filing a Current Report on Form 8-K or (subject to certain procedural requirements) posting such disclosure on its website.

In addition, NYSE Section 303A.10 requires each listed company to have a code of business conduct and ethics applicable to all employees and members of the Board of Directors. This code must be posted on the company’s website, and any waivers of the code for executive officers or directors must be approved by the Board of Directors or a Board committee and promptly publicly disclosed. The Company may adopt a single code of conduct and ethics that satisfies the requirements of both the SEC and NYSE rules.

NYSE rules also require each listed company to adopt, and post on its website, corporate governance guidelines addressing matters specified in the NYSE listing standards, including director qualification standards, director responsibilities, director access to management, director compensation, director orientation and continuing education, management succession, and an annual performance evaluation of the Board of Directors (Section 303A.09).
Part II:

Public Disclosure Obligations

Because the investing public is able to purchase and sell the Company’s common stock, the Company has certain obligations to publicly disclose material information concerning the Company.

For both legal and investor relations reasons, the Company is required, on an ongoing basis, to publicly disclose - generally by means of a press release - material information concerning the Company. In addition, as discussed in Section II.E below, the Company is obligated to file various reports and statements with the SEC to provide the investing public with access to its financial statements and other significant information about its business. The Company may choose to file other SEC documents - such as a registration statement for the purpose of offering its securities for sale to the public - but a discussion of those documents is beyond the scope of this Guide.

A. NYSE Rules

NYSE Section 202.05 requires the Company to release quickly to the public any news or information which might reasonably be expected to materially affect the market for its securities. The NYSE recognizes, however, that there are circumstances in which legitimate corporate objectives create a need for confidentiality that may outweigh policy interests favoring disclosure. For example, the NYSE rules are generally not interpreted to require disclosure of merger negotiations prior to the time an agreement is signed, even if the advanced stage of the merger negotiations would be considered material information, provided the information is confined to a small group of individuals involved in the negotiations.

NYSE rules also require the Company to promptly dispel, generally through a press release, unfounded rumors that result in unusual market activity or price variations in its securities (Section 202.03). Responding to market rumors, however, involves risk to the Company and may conflict with the Company’s “no comment” policy, and should generally be done only after consultation with counsel.

NYSE rules also require the Company to publicly disclose:

- the grant of an equity award outside of a plan that has been approved by stockholders, pursuant to the NYSE exception permitting non-stockholder approved grants as a material inducement to the hiring of such person (Section 303A.08); and

- any waiver of its code of business conduct and ethics applicable to executive officers or directors (Section 303A.10).

The rules and policies of the NYSE establish the presumption that any development concerning the Company that is material (i.e., likely to be considered significant by a reasonable investor) should be promptly disclosed to the public, generally through a press release. If the Company for any reason does not wish to make the public disclosure of the development at that time, the Company, with the assistance of counsel, should carefully evaluate the development to determine whether public disclosure is necessary.

B. Regulation FD

1. General

Regulation FD, which is short for Fair Disclosure, prohibits the Company from intentionally disclosing material nonpublic information to specified types of securities market professionals and securityholders unless the Company simultaneously publicly discloses the information. In addition, if the Company non-intentionally discloses material nonpublic
information to persons covered by the regulation, the Company must publicly disclose the information promptly.

2. Company Representatives Subject to Regulation FD

Regulation FD only applies to disclosures made by the following Company representatives:

- directors and executive officers;
- persons performing investor relations or public relations functions; and
- employees and agents who regularly communicate with securities market professionals and securityholders.

Statements made by other Company employees do not trigger disclosure obligations under Regulation FD, unless the employee is acting at the direction of senior management.

3. Recipients Triggering Public Disclosure Obligation

Under Regulation FD, only disclosures of material nonpublic information to the following classes of recipients trigger the Company’s public disclosure obligation:

- brokers, dealers and persons associated with them, such as securities analysts;
- investment advisers, institutional investment managers, investment companies and persons associated or affiliated with them; and
- securityholders, if it is reasonably foreseeable the securityholder will buy or sell the Company’s securities on the basis of that information.

4. Disclosures Not Subject to Regulation FD

The public disclosure obligations of Regulation FD are not triggered by disclosure:

- to persons owing a duty of trust or confidence to the Company, such as attorneys, accountants and investment bankers;
- to persons who “expressly agree” to keep the disclosed information confidential;
- to rating agencies, if the information is disclosed solely for the purpose of developing a credit rating and the entity’s ratings are publicly available; or
- in connection with registered securities offerings, other than certain continuous "shelf" offerings.

The confidentiality agreement referenced in the second bullet above may be either oral or written. The agreement need not include a further commitment by the recipient of the confidential information not to trade based on that information (although trading on that information would likely violate the SEC’s insider trading rules).

The release adopting Regulation FD makes clear that the regulation is not intended to apply to ordinary-course business communications with parties such as customers, suppliers, strategic partners and government regulators or to disclosures to members of the media.

Because Regulation FD only applies to disclosures made to “any person outside the issuer,” the SEC has stated that Regulation FD does not apply to communications of material nonpublic information by the Company to its employees. However, there are good business reasons for the Company to limit the disclosure of confidential Company information to those employees who need that information in the performance of their jobs. In addition,
employees are generally bound by confidentiality obligations, and improper disclosure or use of confidential Company information by an employee could subject the employee to legal liability, including liability under the SEC's insider trading rules.

5. Material Nonpublic Information

Perhaps the most difficult issue in interpreting and applying Regulation FD is determining what constitutes material nonpublic information.

Regulation FD does not define either "material" or "nonpublic." In the release adopting Regulation FD, the SEC stated that these terms have the meanings established in existing case law. The release, quoting from leading cases on the issue, notes that information is "material" if there is "a substantial likelihood that a reasonable shareholder would consider the information important" in making a decision to buy or sell the Company's securities. Stated another way, there must be a substantial likelihood that a reasonable shareholder would view the information "as having significantly altered the 'total mix' of information" available about the Company. Material information can include positive or negative information about the Company. Even prospective developments, such as a possible acquisition, or management's expectations regarding future financial results, can be material if the anticipated magnitude of the event, discounted by the likelihood of its occurrence, is nevertheless something that a reasonable investor would consider important.

Information concerning any of the following subjects, or the Company's plans with respect to any of these subjects, is the type of information that is likely to be considered material:

- a change in control or a significant change in management of the Company;
- the public or private sale of a significant amount of additional securities of the Company;
- the establishment of a program to repurchase securities of the Company;
- a stock split;
- a default on outstanding debt or preferred stock of the Company or a bankruptcy filing;
- a new product release or a significant development, invention or discovery;
- the loss, delay or gain of a significant contract, sale or order or other important development regarding customers or suppliers; or
- a change in or dispute with the Company's auditors.

This list is illustrative only and is not intended to provide a comprehensive list of circumstances that could give rise to material nonpublic information.

Information is "nonpublic" if it has not been disseminated in a manner making it available to investors generally.

6. Intentional and Non-Intentional Disclosures

Intentional disclosure of material nonpublic information occurs when the person making the disclosure knew, or was reckless in not knowing, that the information disclosed was both material and nonpublic. An example of intentional disclosure is knowingly including nonpublic projections on a slide shown during a private conference with analysts. Another example is a wink or other gesture in response to an analyst question about whether the Company is on track
to meet its forecasts, which intentionally signals an answer to the question. Intentional disclosure of material nonpublic information in a private setting is a violation of Regulation FD.

Non-intentional disclosure is any disclosure of material nonpublic information that occurs when the person making the disclosure does not know, and is not reckless in not knowing, that such information is material and nonpublic. An example of non-intentional disclosure is an executive’s response to an unanticipated question posed during a private meeting with analysts that provides material information that the executive mistakenly believed had already been publicly disclosed. It is important to be aware that the terms “intentional” and “non-intentional”, as used in Regulation FD, do not necessarily have their common meanings. A slip of the tongue would constitute intentional disclosure for purposes of Regulation FD if the speaker knew, or should have known, that the information was both material and nonpublic.

Non-intentional disclosure of material nonpublic information triggers an obligation on the part of the Company to publicly disclose that information promptly. “Promptly” means as soon as reasonably practicable after a director, executive officer or investor relations or public relations employee learns of the non-intentional disclosure, provided that the disclosure must be made within 24 hours or, if the next trading day does not begin for more than 24 hours, prior to the beginning of the next trading day.

7. Manner of Required Public Disclosure

There are several ways in which the Company can make the public disclosure required by Regulation FD. One means that is always sufficient is the filing with the SEC of a Current Report on Form 8-K. Including information in another SEC filing (such as a Form 10-Q, Form 10-K, Proxy Statement or Rule 425 filing under Regulation MA) also generally constitutes adequate public disclosure of that information, provided the information is not buried within the SEC filing.

Regulation FD’s public disclosure requirement can also be satisfied by disseminating the information by a method or combination of methods “reasonably designed to provide broad, non-exclusionary distribution of the information to the public.” A press release distributed through widely circulated news or wire services is generally sufficient. However, the SEC noted in adopting Regulation FD that if a company knows its press releases are routinely not carried by major business wire services, the company should use other or additional means of public dissemination. In addition, disclosure of information in a conference call open to the general public, through a webcast or dial-in number, is also generally sufficient, provided the public is given adequate notice of the call and the means of accessing it. The Company should bear in mind, however, that what constitutes sufficient disclosure for purposes of Regulation FD may not be sufficient for purposes of the NYSE rules, which generally require that material information be disseminated through a press release.

The SEC does not currently consider the posting of information on the Company’s website to constitute, by itself, sufficient dissemination of that information.

8. Liability and Enforcement Issues

There is no private right of action for violations of Regulation FD. The SEC enforces Regulation FD through administrative actions. Such actions are generally initiated by an informal (that is, “voluntary”) request by the SEC staff for information about the circumstances giving rise to the communication at issue. This may be followed by an SEC subpoena requiring the production of additional information. The SEC may also initiate its investigation by subpoena rather than by voluntary request.
C. Rule 10b-5

1. General

Section 10(b) under the Exchange Act and Rule 10b-5 thereunder make it unlawful for anyone to engage in any deceptive or fraudulent act in connection with the purchase or sale of a security. Because the investing public may rely on statements by the Company in making decisions to purchase or sell the Company’s common stock, virtually every public statement by the Company or its representatives may be deemed to be made in connection with the purchase or sale of the Company’s common stock and can subject the Company to liability under Rule 10b-5.

Rule 10b-5 prohibits the Company from making any public statement that is inaccurate or misleading in any material respect. This rule applies to both written statements — such as those contained in press releases — and oral statements — such as those made in conference calls with securities analysts and stockholders. In addition to being factually accurate, the Company’s public disclosures should not contain undue hyperbole, and should not unduly emphasize either positive or negative facts or issues to the exclusion of countervailing factors. The SEC has stated that “corporate releases which disclose personnel changes, the receipt of new contracts, orders and other favorable developments, but do not even suggest existing adverse corporate developments do not serve the public needs and may violate the anti-fraud provisions of the [Exchange Act].”

For a discussion of what “material” means for purposes of Rule 10b-5, see Section II.B.5 above.

2. Entanglement and Adoption

Two legal concepts that are relevant to the Company’s potential liability under anti-fraud rules are “entanglement” and “adoption.” Entanglement refers to a situation in which the Company becomes sufficiently involved (or “entangled”) in the preparation of a document or statement by another party (such as a securities analyst) — by providing information to that party or by modifying and approving the statements to be made by that party — that the statements made by that party can be attributed to the Company as a matter of law. Adoption refers to a situation in which the Company, as a result of its actions following a public statement or the publication of a document by a third party — such as publicly endorsing that statement, distributing that document or including on the Company’s website a hyperlink to that document — is deemed to have “adopted” that statement or document and is therefore legally liable for its contents. These concepts are particularly relevant with respect to the Company’s interactions with securities analysts and to its website disclosures.

3. Duty to Correct and Duty to Update

If the Company has publicly made an inaccurate or misleading statement, the Company has an obligation to correct that statement. If the Company has publicly made a forward-looking statement that has subsequently become inaccurate or misleading due to changes in circumstances, the Company may have an obligation to update that prior statement. Some courts have imposed such a “duty to update” on companies, while other courts considering the issue have held that while a company has a “duty to correct” a statement that was untrue or misleading when made, it does not have a “duty to update” statements that were true and not misleading when made. Whether it is necessary, under applicable legal requirements, or advisable, for investor relations reasons, for the Company to update prior forward-looking statements will depend on the facts and circumstances of the statement in question. However, the Company should try to avoid any actions or statements that voluntarily impose a duty to update upon the Company.
4. Buying and Selling Company Securities

While Rule 10b-5 requires that all public statements by the Company be accurate and not misleading, it does not, as a general rule, impose on the Company the affirmative obligation to publicly disclose material information. However, if the Company is offering any of its securities for sale to the public, or is offering to repurchase any of its securities from the public, Rule 10b-5 requires the Company to publicly disclose all material information concerning the Company, to ensure that members of the investing public who may buy securities from the Company or sell securities to the Company can make an informed decision. Similarly, if the Company were selling or repurchasing its own securities in a private transaction with another party (including the issuance of shares in a merger transaction), the Company would be obligated to disclose all material information concerning the Company to that party. Note also that while such disclosure would be mandated by Rule 10b-5, the Company would have to take steps to ensure that such disclosure did not violate Regulation FD.

D. Use of Non-GAAP Financial Measures

The SEC in 2003 adopted Regulation G, which applies to public disclosures of “non-GAAP financial measures”. In addition to Regulation G, the SEC at the same time adopted Item 10(e) of Regulation S-K, which applies stricter requirements when non-GAAP financial measures are included in an SEC filing.

1. What is a Non-GAAP Financial Measure?

A non-GAAP financial measure is a numerical measure of a company’s historical or future financial performance, financial position or cash flows that:

- excludes amounts, or is subject to adjustments that have the effect of excluding amounts, that are included in the most directly comparable measure calculated in accordance with GAAP in the statement of income, balance sheet or statement of cash flows of the company; or
- includes amounts, or is subject to adjustments that have the effect of including amounts, that are excluded from the most directly comparable GAAP measure.

Examples of non-GAAP financial measures include:

- measures of operating income that exclude one or more expense or revenue items that are identified as “non-recurring” (such as net income before restructuring changes); and
- EBITDA (earnings before interest, taxes, depreciation and amortization).

Non-GAAP financial measures do not include:

- financial measures required to be disclosed by GAAP, SEC rules or another regulatory body (such as segment information required to be disclosed by GAAP);
- operating and other statistical measures (such as unit sales and numbers of employees);
- ratios or statistical measures that are calculated using exclusively one or both of (i) GAAP financial measures and (ii) operating and other measures that are not non-GAAP financial measures (such as gross margin or revenues per employee); and
- financial information that does not have the effect of providing numerical measures that are different from the comparable GAAP measures, such as:
  - disclosure of amounts of expected indebtedness;
• disclosure of amounts of planned debt repayments; and
• disclosure of estimated revenues or expenses of a new product line, so long as such amounts were estimated in accordance with GAAP.

In addition, the rules do not apply to a disclosure relating to a proposed business combination transaction, if the disclosure is contained in a communication that is subject to the SEC’s communication rules applicable to business combination transactions.

2. Regulation G

Whenever the Company, or a person acting on its behalf, publicly discloses any material information that includes a non-GAAP financial measure, Regulation G requires that the non-GAAP financial measure be accompanied by:

- a presentation of the most directly comparable GAAP financial measure; and
- a reconciliation (by schedule or other clearly understandable method) of the non-GAAP financial measure to the most directly comparable GAAP financial measure. This reconciliation must be quantitative for historic measures, but may be qualitative for forward-looking information if a quantitative reconciliation would not be available without an unreasonable effort.

In addition, the Company, or a person acting on its behalf, may not publicly present a non-GAAP financial measure that, taken together with the accompanying information, misstates a material fact or omits to state a material fact necessary to make the presentation of the non-GAAP financial measure not misleading in light of the circumstances under which it is presented.

If the Company publicly discloses a non-GAAP financial measure orally, telephonically, by webcast, by broadcast or by similar means, the Company may satisfy the requirements of Regulation G regarding presentation of, and reconciliation to, the most directly comparable GAAP financial measure by posting the required accompanying information on the Company’s website at the time the non-GAAP financial measure is publicly disclosed and by disclosing its website address in the same presentation in which the non-GAAP financial measure is publicly disclosed.

3. Documents Filed with the SEC

If the Company uses a non-GAAP financial measure in filings with the SEC, Item 10(e) of Regulation S-K requires the following, in addition to complying with the requirements described above with respect to Regulation G:

- the presentation of the most directly comparable GAAP financial measure must be of equal or greater prominence, as compared to the presentation of the non-GAAP financial measure;
- the Company must provide an explanation of why the Company’s management believes the non-GAAP financial measure provides useful information to investors; and
- the Company must provide, to the extent material, a statement disclosing the additional purposes, if any, for which the Company’s management uses the non-GAAP financial measures.

The requirements described in these two bullet points can be satisfied by disclosing such information in the Company’s most recent annual report filed with the SEC (or a more recent filing).

In addition to these mandated disclosure requirements, Item 10(e) of Regulation S-K prohibits:

- excluding charges or liabilities that require cash settlement (or would have required cash settlement absent an ability to settle in another manner) from non-GAAP liquidity
measures, other than EBIT (earnings before interest and taxes) and EBITDA (earnings before interest, taxes, depreciation and amortization);

- adjusting a non-GAAP performance measure to eliminate items identified as non-recurring, infrequent or unusual, when (1) the nature of the charge or gain is such that it is reasonably likely to recur within two years, or (2) there was a similar charge or gain within the prior two years;

- presenting non-GAAP financial measures on the face of the Company’s GAAP financial statements or in the accompanying notes, or on the face of any GAAP-required pro forma financial information; and

- using titles or descriptions of non-GAAP financial measures that are the same as, or confusingly similar to, titles or descriptions used for GAAP financial measures.

E. SEC Reporting Obligations

The Company is obligated by the Exchange Act to file certain reports and statements with the SEC and to distribute certain documents to its stockholders. Set forth below is a description of these reports and statements. Please bear in mind that some of these documents can take several weeks or more to prepare, and that the assistance of counsel is generally necessary in connection with the preparation and filing of these documents.

The Company’s SEC reporting obligations demand the most time and effort during the three-month period following each fiscal year end. During this period, the Company will prepare and file with the SEC and/or distribute to stockholders an Annual Report on Form 10-K, an Annual Report to Stockholders, and a Proxy Statement, as well as make other preparations for its annual meeting of stockholders.

The documents required to be filed by the Company with the SEC must generally be submitted in electronic format through EDGAR, the SEC’s Electronic Data Gathering, Analysis and Retrieval system. Documents filed via EDGAR become publicly available immediately upon filing. The Company should determine whether it wishes to develop the ability to make EDGAR filings from within the Company or wishes to use an outside filing agent (such as a financial printer).

1. Quarterly Reports on Form 10-Q

The Company must file a Quarterly Report on Form 10-Q with the SEC following the end of each of the first three fiscal quarters of each fiscal year. Currently, the Company’s Form 10-Q is due within 45 days after the end of the quarter. If and when the Company becomes an “accelerated filer”, its Form 10-Q will be due within 35 days after quarter end. An accelerated filer is, in summary, a company that, as of the end of any fiscal year, had a public float of at least $75 million (measured as of the end of the second fiscal quarter of that year), has been filing Exchange Act reports for at least one year, and has filed at least one Annual Report on Form 10-K (Rule 12b-2).

Form 10-Q consists of two Parts. Part I contains:

- unaudited financial statements for the fiscal quarter and for the year to date, and for corresponding periods in the preceding fiscal year;

- management’s discussion and analysis of the Company’s financial condition and results of operations for those periods;

- disclosures about the Company’s exposure to market risk; and

- information about the Company’s evaluations of its disclosure controls and procedures and its internal control over
financial reporting (which are discussed in Section II.G below).

Part II of the Form 10-Q includes, to the extent applicable, information on the following matters:

- legal proceedings;
- sales of unregistered securities (if not previously disclosed in a Form 8-K);
- uses of proceeds from the Company’s initial public offering;
- repurchases by the Company of its equity securities;
- defaults under senior securities;
- matters voted on by stockholders;
- material changes to the Company’s procedures by which stockholders can recommend nominees for election as a director of the Company; and
- an updated exhibit index.

A Quarterly Report on Form 10-Q must be signed by the CFO or chief accounting officer of the Company. In addition, the CEO and the CFO of the Company must execute two different certifications, which must be attached as exhibits to the Form 10-Q.

Section 302 of the Sarbanes-Oxley Act and Rule 13a-14(a) under the Exchange Act require each Form 10-Q to include certifications by the CEO and the CFO in which each certifies:

- he/she has reviewed the report;
- based on his/her knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made not misleading;
- based on his/her knowledge, the financial statements and financial information included in the report fairly present in all material respects the financial condition and results of operations of the Company;
- as to the establishment, maintenance and evaluation of the Company’s disclosure controls and procedures and internal control over financial reporting, and
- the signing officers have disclosed to the Company's auditors and Audit Committee (A) significant deficiencies or weaknesses in the Company’s internal control over financial reporting and (B) any fraud involving employees who have a significant role in the Company’s internal control over financial reporting.

Section 906 of the Sarbanes-Oxley Act and Rule 13a-14(b) under the Exchange Act require each Form 10-Q to include a separate, additional certification by the CEO and the CFO that the report fully complies with the requirements of the Exchange Act, and that the information contained in the report fairly presents, in all material respects, the financial condition and results of operations of the Company. An officer who willfully makes a false certification under Section 906 is subject to a fine of up to $5 million and imprisonment of up to 20 years.

2. Annual Reports on Form 10-K

The Company must file an Annual Report on Form 10-K with the SEC following the end of each fiscal year. Currently, the Form 10-K is due within 90 days after the end of the fiscal year. If and when the Company becomes an accelerated filer, its Form 10-K will be due within 60 days after fiscal year end.

The Annual Report on Form 10-K must include information on the following matters:

- the Company’s business;
• real property owned or leased by the Company;

• legal proceedings;

• any matters submitted for a stockholder vote in the Company’s fourth quarter;

• the trading market for the Company’s common stock;

• sales of unregistered securities in the Company’s fourth quarter (if not previously disclosed in a Form 8-K);

• uses of proceeds from the Company’s initial public offering;

• repurchases by the Company of its equity securities during the fourth quarter;

• five-year selected financial data;

• management’s discussion and analysis of financial condition and results of operations;

• disclosures about the Company’s exposure to market risk;

• audited financial statements;

• quarterly financial data for the two preceding fiscal years;

• if there has been a change in the Company’s auditors, certain information about disagreements with the Company’s auditors and related matters;

• information about the Company’s disclosure controls and procedures and its internal control over financial reporting, as well as an internal control report of management and an attestation report of the Company’s auditors (which reports are described in Section II.G.2. below);

• the Board of Directors, committees of the Board of Directors, executive officers and the Company’s code of ethics.

• compensation of executives officers and directors and related matters;

• stock ownership of significant stockholders and management and stock plan information;

• related-party transactions;

• fees paid to the Company’s auditors; and

• an updated exhibit index.

Some of the information required in the Form 10-K may be incorporated by reference from the Company’s Proxy Statement or its Annual Report to Stockholders.

The Annual Report on Form 10-K must be signed by (i) the Company’s CEO, (ii) its CFO, (iii) its controller or principal accounting officer, and (iv) a majority of the Company’s directors. The requirement for the signatures of the directors on the Form 10-K is designed to encourage the directors to review it carefully to ensure its accuracy and completeness as a disclosure document.

In addition, the Form 10-K must include the same two certifications of the CEO and the CFO of the Company as are required for each Form 10-Q.

3. Current Reports on Form 8-K

The SEC recently adopted changes to the Form 8-K rules, which took effect on August 23, 2004. These rule changes accelerated the filing deadline for most Form 8-Ks to four business days after the triggering event, from the previous five business day and 15 calendar day deadlines. In addition, the new rules expand the disclosure items that trigger a Form 8-K filing. The following events now require the filing of a Form 8-K:
entry into a definitive material agreement of the type required to be filed as an exhibit to Form 10-Q or Form 10-K;

• termination of such a material agreement;

• the initiation of bankruptcy proceedings;

• a significant acquisition or disposition of assets by the Company;

• any oral or written public announcement of material non-public information regarding the Company's results of operations or financial condition for a completed fiscal period – this information is generally deemed furnished, and not filed, meaning that the information disclosed is not considered filed for purposes of certain provisions of the Exchange Act imposing liability for inaccurate or misleading statements in filings under the Exchange Act (although such information remains subject to the anti-fraud provisions of Rule 10b-5), and is not automatically incorporated by reference into registration statements under the Securities Act;

• creation of a material direct financial obligation or a material off-balance sheet obligation;

• triggering events that accelerate or increase a material direct financial obligation or a material off-balance sheet obligation;

• exit or disposal activities that involve material costs;

• material impairments of assets;

• notice of delisting of the Company's securities or notice of failure to comply with a listing standard, or a transfer of a securities listing;

• unregistered sales of equity securities;

• material modifications to rights of security holders;

• a change in the Company's independent auditors;

• non-reliance on previously issued financial statements or a related audit report or completed interim review;

• a change in control of the Company;

• departure or election of directors or principal officers;

• amendment of charter or by-laws or change in fiscal year;

• temporary suspension of trading under certain employee benefit plans of the Company; and

• amendments or waivers to the Company's code of ethics that apply to the Company's CEO, CFO, principal accounting officer or controller (unless the Company has elected to disclose that information through its website in accordance with the procedures provided for such disclosure).

Despite the four-day rule for filing a Form 8-K to furnish financial information about a completed fiscal period, it is generally advisable for the Company to file the Form 8-K containing its quarterly or annual earnings releases prior to its earnings conference call (which generally follows within a day after the issuance of the press release), in order to take advantage of the provisions of Form 8-K that permit a company to avoid filing a Form 8-K with respect to financial information disclosed orally during its earnings conference call.

It is permissible, and often advisable, for the Company to file a Current Report on Form 8-K with respect to certain other events that it deems of importance to stockholders. For example, a Form 8-K filing may be used to satisfy the Company's public disclosure obligations under Regulation FD. Such a filing may disclose
information under either Item 8.01 or Item 7.01. Information disclosed under Item 7.01 is not considered filed for purposes of the Exchange Act and is not automatically incorporated by reference into registration statements filed under the Securities Act.

4. Proxy Statements

All solicitations of proxies from stockholders, in connection with the Company’s Annual Meeting of Stockholders or otherwise, must be conducted in accordance with the proxy solicitation rules of the SEC under the Exchange Act. These rules provide that the Company may solicit proxies only by means of a detailed Proxy Statement containing prescribed information relating to the stockholders meeting, the Company, its management (including compensation), its principal stockholders, and the matters to be voted upon. A Proxy Statement relating to an annual meeting of stockholders that solicits proxies only with respect to certain routine matters need not be filed with the SEC in advance of its dissemination to stockholders (Rule 14a-6(a)).

Other Proxy Statements must be filed with the SEC in preliminary form, and the SEC has ten days in which to give the Company comments upon the Proxy Statement (or notice that it intends to comment upon the Proxy Statement). If nothing is heard from the SEC by the end of this ten-day period, the Company is free to mail the Proxy Statement in its original form, or with non-material changes. The Company must file a copy of the final version of the Proxy Statement with the SEC. If the SEC does give comments (or notice of forthcoming comments) in this ten-day period, the mailing of the Proxy Statement is delayed until the comments are addressed and the SEC clears the Proxy Statement.

The Company has to prepare, file and distribute a Proxy Statement in connection with each Annual Meeting of Stockholders. A Proxy Statement for a typical Annual Meeting of Stockholders must include or address the following matters:

- details concerning the meeting itself;
- the votes required for the various matters presented to stockholders at the meeting;
- stock ownership of significant stockholders and management;
- information about the Company’s directors and the director nomination process;
- committees of the Board of Directors and attendance at Board and committee meetings;
- how stockholders can communicate with the Company’s directors;
- compensation of executive officers and directors and related matters;
- related-party transactions;
- a stock performance graph;
- a report of the Compensation Committee;
- a report of the Audit Committee;
- information concerning any stock plan, charter amendment or other matter submitted for stockholder approval; and
- information concerning the Company’s auditors and audit fees.

The proxy rules permit a stockholder to submit to the Company a proposal for inclusion in the Company’s Proxy Statement. In addition, the SEC has proposed rules that would require the Company, in certain circumstances, to include in its Proxy Statement up to three stockholder nominees for election as directors. The proxy rules also permit other persons or groups who wish to oppose a matter for which the Company is soliciting stockholder proxies (such as the election of management’s nominees for director) to solicit proxies in opposition to the proxies solicited by the Company. Such “proxy
contests" are often mounted by dissident stockholders or corporate raiders who wish to gain control of a company’s Board of Directors by submitting their own nominees for election by stockholders. There is a complex body of rules that applies to stockholder proposals and proxy contests.

The Company may occasionally have to convene a special meeting of stockholders for approval of a matter such as a merger or other unusual corporate transaction. Special rules apply to those meetings and the Proxy Statement disclosure required in connection with them.

5. Annual Reports to Stockholders

Prior to or contemporaneously with the distribution to stockholders of the Proxy Statement or information statement described above relating to any stockholders meeting at which directors are to be elected (generally the Company’s Annual Meeting of Stockholders), the Company must furnish to its stockholders an Annual Report to Stockholders. This Annual Report must include information relating to the Company’s business, management and other matters, and must include audited financial statements and a management’s discussion and analysis of the Company’s financial condition and results of operation. This Annual Report must be sent to the SEC, but is not “filed” for purposes of the liability provisions relating to documents filed under the Exchange Act (although it is subject to the antifraud provisions of Rule 10b-5). The Annual Report need not be submitted to the SEC in advance for review.

Some companies prefer to combine the Annual Report on Form 10-K and the Annual Report to Stockholders into a single document.

6. Website Postings

If and when the Company becomes an accelerated filer, it must disclose in its Annual Report on Form 10-K whether it makes its Form 10-Ks, Form 10-Qs and Form 8-Ks available on its website promptly following their filing with the SEC. This disclosure rule effectively requires companies to post these SEC filings on their websites in order to avoid the awkward disclosure that would otherwise be required.

The Company is required by Rule 16a-3(k) under the Exchange Act to post on its website, within one business day after filing, each Form 3, Form 4 and Form 5 filed by directors, officers and 10% stockholders of the Company. These filings are discussed in Section III.B.2 below.

NYSE rules require the Company to post on its website certain corporate governance documents including charters of key board committees, corporate governance guidelines, and code of business conduct and ethics (Section 303A.09).

7. Reports Required by the NYSE

The Company is required by NYSE rules (i) to publish and distribute to its stockholders annual reports containing audited financial statements of the Company and its subsidiaries and (ii) to publish (though not necessarily distribute to its stockholders) quarterly reports containing unaudited financial statements (Section 203.03).

F. Disclosure Policy

The Company’s Board of Directors has adopted a Disclosure Policy, which covers topics such as the following:

- restrictions on which Company personnel are authorized to communicate on behalf of the Company with investors, securities market professionals and the media;
- observation of a “no comment” policy; and
- policies for publicly disclosing information to the public.

While neither SEC rules nor NYSE rules require the Company to adopt a written Disclosure Policy, the SEC has stated: “The existence of an
appropriate [disclosure] policy, and the issuer’s general adherence to it, may often be relevant to determining the issuer’s intent with regard to a selective disclosure.” The Disclosure Policy, which should be distributed or made available to all Company personnel, helps promote a consistent approach within the Company to disclosure matters and help reinforce basic disclosure rules among all Company employees. It is important that the Company adhere to its rules and monitor and enforce employee compliance with these rules.

G. Controls and Procedures

There are legal requirements imposing obligations on the Company with respect to the maintenance, evaluation and disclosure of two different types of controls:

- “Disclosure controls and procedures” refers to the controls and procedures for ensuring that information — including both financial and non-financial information — required to be disclosed by the Company in its SEC reports is accurately recorded, processed, summarized and reported within the time periods specified in SEC rules.

- “Internal control over financial reporting” means a process designed by, or under the supervision of, the Company’s CEO and CFO, and effected by the Company’s Board of Directors and employees, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements in accordance with GAAP, and which includes policies relating to the accurate maintenance of records and the safeguarding of assets.

1. Disclosure Controls and Procedures

Rule 13a-15 under the Exchange Act, enacted in the wake of the Sarbanes-Oxley Act reforms, requires public companies to maintain disclosure controls and procedures. Rule 13a-15 also requires the Company to evaluate, with the participation of its CEO and CFO, the effectiveness of its disclosure controls and procedures as of the end of each fiscal quarter. This evaluation must be done by the Company’s management, with the participation of the CEO and CFO. The Company must disclose, in each Form 10-Q and Form 10-K in a section entitled “Controls and Procedures”, the results of that evaluation. In addition, the Rule 13a-14(a) certification discussed above requires that the CEO and CFO certify in each Form 10-Q and Form 10-K as to the design and evaluation of the Company’s disclosure controls and procedures as well as the report on such evaluation.

2. Internal Controls

Section 13(b)(2) of the Exchange Act has for years imposed obligations on public companies regarding internal controls that are designed to ensure the adequacy and integrity of the company’s financial statements, reports and internal accounting and operating procedures. These provisions require each public company to:

- make and keep books, records and accounts which, in reasonable detail, accurately and fairly reflect the company’s transactions and dispositions of assets; and

- devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that:
  - transactions are executed in accordance with management’s general or specific authorization;
  - transactions are recorded as necessary to permit preparation of financial statements in conformity with GAAP and to maintain accountability for assets;
  - access to assets is permitted only in accordance with management’s general or specific authorization; and
the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to differences.

The SEC has promulgated rules under Section 13(b)(2) that (i) prohibit any person from directly or indirectly falsifying any book, record or account subject to Section 13(b)(2)(A) of the Exchange Act, and (ii) prohibit directors and officers from directly or indirectly making any materially false, misleading or incomplete statement to an accountant in connection with an audit or any filing with the SEC.

Rule 13a-15 under the Exchange Act, which was adopted in 2003 and also covers the evaluation of disclosure controls and procedures, requires the Company to maintain internal control over financial reporting. This rule also requires the Company to evaluate, with the participation of its CEO and CFO, the effectiveness of its internal control over financial reporting as of the end of each fiscal year, and any material change in its internal control over financial reporting that occurred during each of the Company’s fiscal quarters. The Company must disclose in each Form 10-Q any change in its internal control over financial reporting that occurred during the quarter covered by that report, and must disclose in each Form 10-K any change its internal control over financial reporting that occurred during the fourth quarter. In addition, the Company must include in each Form 10-K both a management report on its internal control over financial reporting and an attestation report of the Company’s independent auditors on management’s assessment of the Company’s internal control over financial reporting. The internal control report must include:

- a statement of management’s responsibility for establishing and maintaining adequate internal control over financial reporting for the Company;

- management’s assessment of the effectiveness of the Company’s internal control over financial reporting as of the end of the Company’s most recent fiscal year;

- a statement identifying the framework used by management to evaluate the effectiveness of the Company’s internal control over financial reporting; and

- a statement that the registered public accounting firm that audited the Company’s financial statements included in the Annual Report has issued an attestation report on management’s assessment of the Company’s internal control over financial reporting.

In addition, the Rule 13a-14(a) certification requires that the CEO and CFO certify as to the design and evaluation of the Company’s internal control over financial reporting, the required disclosure in the Form 10-Q or Form 10-K with respect to such evaluation, and the disclosure by such officers to the Company’s auditors and Audit Committee concerning deficiencies or weaknesses in the Company’s internal control over financial reporting and any fraud involving employees who have a significant role in the Company’s internal control over financial reporting.

H. California Disclosure Requirement

Public companies that are either incorporated or qualified to do business in California are required to file an annual report with the Secretary of State of California disclosing additional corporate information. The timing and mechanics of the California disclosure obligations are similar to some SEC requirements, but differ sufficiently such that public companies subject to the requirements must take additional steps to comply with them.

A public company subject to the California disclosure requirements must make annual filings with the California Secretary of State. The reports, which are available for public inspection, must contain information relating to the following:

- financial statements;
- management’s discussion and analysis;
- auditor's report;
- independent registered public accounting firm’s report; and
- other items as may be required by the California Secretary of State.
• compensation of directors and executive officers;

• loans made to any director at an interest rate lower than the rate available from an unaffiliated commercial lender;

• the company's auditor and a description of non-audit services provided by the auditor;

• bankruptcy filings during the preceding 10 years for the company, any director or executive officer;

• fraud convictions during the preceding 10 years for any director or executive officer that have not been overturned or expunged;

• material pending legal proceedings; and

• material legal proceedings in which the Company was found liable on final judgment or final order during the preceding five years.
Part III:
Trading in Company Securities

A. Insider Trading

1. General

The securities law that is most often applied to insider trading is Rule 10b-5 under the Exchange Act, which prohibits fraudulent statements or actions in connection with the purchase or sale of securities. Although Rule 10b-5 itself does not specifically address insider trading, for years courts have interpreted Rule 10b-5 to prohibit corporate insiders and certain other persons from trading on the basis of material nonpublic information.

In 2000, the SEC enacted two rules specifically directed at insider trading -- Rule 10b5-1 and Rule 10b5-2. These rules clarify the circumstances in which Rule 10b-5 can be applied to prohibit insider trading. Rule 10b5-1 provides that it is a violation of the antifraud provisions of Rule 10b-5 to, among other things, purchase or sell a security on the basis of material nonpublic information about that security or the issuer of the security, in breach of a duty of trust or confidence owed to the issuer or to the party providing the information. Rule 10b5-1 also defines what it means to buy or sell securities “on the basis of” material nonpublic information and provides affirmative defenses against insider trading liability. Rule 10b5-2 defines several circumstances in which a person has a “duty of trust or confidence,” the breach of which would give rise to insider trading liability.

The net effect of Rules 10b-5, 10b5-1 and 10b5-2, and the court cases interpreting these rules, is to prohibit any officer, director or employee of the Company from:

- disclosing to any person any material nonpublic information concerning the Company if it is reasonably foreseeable that such person may use that information in purchasing or selling Company securities.

In many cases, these same restrictions apply to officers, directors and employees of the Company with respect to material nonpublic information concerning any other company that he or she learns of in the course of service as an officer, director or employee of the Company. This includes information relating to the Company’s customers and suppliers, as well as potential merger or acquisition candidates.

As discussed above, Rule 10b-5 also affects the Company’s ability to purchase or sell any of its common stock or other securities if material nonpublic information about the Company exists.

For a discussion of what “material” means for purposes of insider trading, see Section II.B.5 above.

2. Rule 10b5-1 – the “Awareness” Standard

For years, courts had been split on whether insider trading liability required proof that a trader actually “used” material nonpublic information or whether proof that a trader was in “knowing possession” of such information at the time of a trade was sufficient. Rule 10b5-1 resolved this split by providing that a person has traded “on the basis of” material nonpublic information – and thus violated Rule 10b-5 – if the person was “aware” of the material nonpublic information when making the purchase or sale. It is not necessary to prove that the trader used or was otherwise influenced by the information in making the trading decision.
Any insider aware of material nonpublic information about the Company must either disclose it to the investing public (so that all potential buyers or sellers of the Company’s securities have equal access to that information) or abstain from trading in the Company’s securities until full disclosure has been made. Because of insiders’ obligations to the Company concerning nondisclosure of confidential information and the Company’s policies on who is authorized to make public disclosures, the practical effect of Rule 10b-5 is to prohibit any insider with material nonpublic information about the Company from trading in its securities until the Company has publicly disclosed such information. Moreover, the public release by the Company of material information does not immediately free insiders with prior knowledge of that information to trade in the Company’s securities. Insiders must refrain from trading until the market has had an opportunity to absorb and evaluate the information. As a general rule, we recommend that insiders wait two full trading days after the public release of the information before trading in the Company’s securities.

3. Affirmative Defenses under Rule 10b5-1

Rule 10b5-1 sets forth two affirmative defenses to insider trading liability under Rule 10b-5. These defenses effectively serve as safe harbors for persons or entities who trade while aware of material nonpublic information. While one of these defenses – intended primarily for securities firms and financial institutions – is not likely to be relevant to the Company or its employees and directors, the other defense – available to an individual or entity that purchases or sells a security pursuant to a binding contract, specific instruction or written plan that the person or entity put into place before becoming aware of the material nonpublic information – may prove quite useful.

a. Defense Based on Prior Contract, Instruction or Plan

Under this defense, a person or entity who trades while aware of material nonpublic information concerning the Company will not be liable for insider trading if that person or entity can demonstrate that he or she took one of the following steps while he or she was not aware of any material nonpublic information:

- entered into a binding contract to purchase or sell the security;
- instructed another person to purchase or sell the security for the instructing person; or
- adopted a written plan for trading securities.

The contract, instruction or written plan must either:

- specify the amount, price and date of the transaction;
- include a written formula, algorithm or computer program for determining the amount, price and date of the transaction; or
- not permit the person for whom shares are being purchased or sold to exercise any subsequent influence over how, when or whether to effect purchases or sales, while at the same time ensuring that the person effecting the trades is not aware of any material nonpublic information at the time of the trades.

b. Definitions

The definitions of amount, price and date are important elements of the Rule 10b5-1 affirmative defense:

- “Amount” means a specified number of shares or a specified dollar value of shares.
• "Price" means the market price on a particular date, a limit price or a fixed dollar price.

• "Date" means (1) in the case of a market order, the specific day on which the order is to be executed or (2) in the case of a limit order, a day on which the limit order is in force.

c. Other Requirements of the Defense

To take advantage of this affirmative defense, a person must carry out the trading activity in accordance with the specifications of the contract, instruction or written plan. If a person deviates from or alters the specifications while in possession of material nonpublic information, the defense will not be available for subsequent trades under that plan, and the defense may even be retroactively lost for prior trades under the plan. A person may, however, change the specifications of the contract, instruction or written plan during a time in which he or she does not possess material nonpublic information without losing the availability of the affirmative defense.

A person loses the availability of the rule’s affirmative defense if he or she enters into a corresponding or hedging transaction that has the effect of offsetting a trade made in accordance with a contract, instruction or written plan.

In order to rely on the defense, a person must enter into the contract, instruction or written plan in good faith and not with the intent to evade the insider trading prohibitions. Frequent amendment of, or deviation from, a trading program may make it difficult for an insider to demonstrate that he or she has satisfied the rule’s “good faith” requirement.

d. Benefits and Drawbacks of Pre-arranged Trading Programs

There are both benefits and drawbacks of pre-arranged trading programs. A pre-arranged program can offer the following benefits:

• A pre-arranged trading program provides an insider with an opportunity to diversify his or her holdings with confidence that the insider will not violate federal insider trading rules even if the insider is aware of material nonpublic information at the time a trade is executed under the program. (Note, however, that some state’s insider trading laws do not yet recognize the affirmative defense provided by Rule 10b-5-1.)

• Any pre-arranged trading program that is announced publicly could deflect adverse investor and media reaction to transactions that may otherwise suggest that an insider took advantage of material nonpublic information.

• Prior public announcement of a pre-arranged trading program could reduce the likelihood of a company becoming the target of shareholder litigation since allegations of insider trading are frequently an important part of class action litigation commenced against a company after a sudden drop in stock price.

However, pre-arranged trading programs also present several drawbacks:

• The insider loses some investment control over the trading activity.

• If public disclosure of a pre-arranged trading program is made, any failure of the insider to sell in accordance with the plan could raise questions in the market.

• Trading under a pre-arranged trading program does not eliminate the possibility that a lawsuit could be filed alleging insider trading. The insider has the burden of
proving that he or she sold pursuant to a pre-
arranged trading program established in
accordance with Rule 10b5-1.

4. Duty of Trust or Confidence;
Rule 10b5-2

Rule 10b-5 prohibits trading on the basis of
material nonpublic information in breach of a
duty of trust or confidence owed to the
Company or to the party providing the
information. While this prohibition clearly
applies to Company employees and directors
that are aware of material nonpublic information
concerning the Company, it also extends to
persons other than employees and directors of
the Company and can apply to information that
Company employees and directors have about
companies other than the Company.

Rule 10b5-2 provides that a person receiving
confidential information under the following
circumstances owes a duty of trust or
confidence, and thus would violate Rule 10b-5 if
he or she traded on the basis of that information:

- the person agreed to keep the information
  confidential;

- the persons involved in the communication
  had a history, pattern or practice of sharing
  confidences that resulted in a reasonable
  expectation of confidentiality; or

- the person who provided the information
  was a spouse, parent, child or sibling of the
  person who received the information, unless
  it is shown affirmatively, based upon facts
  and circumstances of that family
  relationship, that there was no reasonable
  expectation of confidentiality.

Thus, for example, the Company’s attorneys,
accountants, investment bankers and public
relations advisors, as well as the family
members of the Company’s employees and
directors, could be held liable for insider trading
if they traded on the basis of material nonpublic
information obtained from the Company or its
employees or directors. In addition, a Company
employee or director who is aware of material
nonpublic information about another company
acquired in the course of his or her service as an
employee or director of the Company under
circumstances in which there is an agreement or
expectation that such information will be kept
confidential may not purchase or sell the
securities of that other company.

5. Tipping

Rule 10b-5 has also been interpreted to prohibit
a Company employee or director from
disclosing material nonpublic information about
the Company (or about another company, if the
information was acquired under an agreement or
expectation of confidentiality) to any third party
if it is reasonably foreseeable that such third
party will trade in the securities of such
company. Such disclosure generally is also
prohibited, even if the third party had no
opportunity to trade in the Company’s securities,
under Company policy and confidentiality
agreements.

6. Sanctions

Violation of insider trading laws could result in
civil or criminal penalties under applicable
federal securities laws. The SEC and the US
Attorneys offices often vigorously pursue
alleged violations of the insider trading laws,
even in cases where the alleged illegal profit is
very small. The sanctions for individuals who
trade on inside information (or tip information to
others) include:

- a civil penalty of up to three times the profit
  gained or loss avoided;

- a criminal fine (no matter how small the
  profit) of up to $1 million;

- a jail term of up to ten years, and

- a temporary or permanent bar from serving
  as an officer or director of any public
  company.
Insider trading violations can also expose the Company (and possibly supervisory personnel) to civil or criminal liability.

In addition to these legal sanctions, violation of the foregoing laws or policies is grounds for discipline by the Company, including termination of employment. Moreover, any of the above consequences, or even an SEC investigation that does not result in prosecution, can tarnish one’s reputation (and that of the Company) and irreparably damage a career.

7. Insider Trading Policy

To help prevent violations of insider trading and other applicable laws, and to help avoid potentially embarrassing public disclosures and even the appearance of impropriety, the Company’s Board of Directors, as part of its approval of the Company’s initial public offering and related matters, adopted an Insider Trading Policy. The topics covered by the Insider Trading Policy include:

- a prohibition on trading while aware of, and tipping others concerning, material nonpublic information;

- “blackout periods” during which directors, executive officers and certain employees may not buy or sell Company securities;

- notification to the Company of acquisitions or dispositions of Company securities by directors and executive officers;

- trading under pre-arranged trading plans designed to take advantage of the affirmative defenses provided by Rule 10b5-1;

- short sales and other speculative trading activities; and

- penalties for violations.

B. Section 16

1. General

Section 16 of the Exchange Act (which became effective with respect to the Company on or about the date of the pricing of the Company’s initial public offering) imposes several obligations and restrictions with respect to the ownership and trading of securities of the Company on each director and officer of the Company and each person or entity who is the beneficial owner of more than 10% of the outstanding shares of common stock of the Company (directors, officers and 10% stockholders are referred to in this section of the Guide as “Insiders”).

For purposes of Section 16, an “officer” of a company means the president, the principal financial officer, the principal accounting officer, any vice president in charge of a principal business unit, division or function, and any other officer or person who performs a policy-making function. As this definition makes clear, a person’s title alone is not determinative of whether Section 16 applies.

For purposes of determining whether a stockholder beneficially owns more than 10% of the Company’s common stock, the SEC has adopted a “voting and investment power” test. A person is considered the beneficial owner of all equity securities for which such person, directly or indirectly, has or shares voting power or investment power (i.e., the right to dispose of the securities). Determining a corporation’s 10% stockholders for purposes of Section 16 is a fact-specific and often difficult issue. To further complicate matters, more than one person or entity may be deemed to beneficially own the same shares.
2. Reporting Beneficial Ownership

a. Form 3, Form 4 and Form 5

Section 16(a) of the Exchange Act required each Insider at the time of the Company’s initial public offering to file a Form 3 (entitled “Initial Statement of Beneficial Ownership of Securities”) with the SEC on the date that the Company’s Registration Statement on Form S-A (filed in connection with its initial public offering) became effective. In addition, anyone becoming an Insider in the future must file a Form 3 within 10 days after becoming an Insider. Future directors and officers are required to file Form 3’s even if they do not own any securities of the Company.

Section 16(a) of the Exchange Act also requires that, except as described below, each Insider must file a Form 4 (entitled “Statement of Changes in Beneficial Ownership”) with the SEC within two business days after the date of any transaction resulting in a change in his or her beneficial ownership of the Company’s equity securities. There are three general exceptions to the two business day reporting requirement.

First, the following types of transactions must be reported on a Form 4 within two business days following the date the director or officer receives notice of the transaction (but in no event later than five business days following the transaction), rather than two business days following the date on which the transaction occurs:

- a transaction pursuant to a Rule 10b5-1 plan or arrangement under which the director or officer does not select the date on which the purchases or sales take place; and

- a “discretionary transaction” (as defined in Rule 16b-3) pursuant to an employee benefit plan (such as transfers in or out of, or cash withdrawals from, a company stock fund in a 401(k) plan or other employee benefit plan) for which the director or officer does not select the date on which transactions take place.

Second, certain transactions can be reported on a year-end Form 5. A Form 5 must be filed with the SEC within 45 days after the end of each fiscal year by each person who was an Insider for any part of a Company’s fiscal year (unless he or she has no transactions to report on the Form 5). There are certain types of stock transactions that the SEC has designated as eligible for Form 5 filing, rather than a Form 4 filing. The most common transaction that can be reported on a Form 5 is an acquisition or disposition of securities by gift. Insiders must also report on a Form 5 all transactions that occurred during the fiscal year that should have been, but were not, reported earlier on Form 4.

Third, the following transactions are not required to be reported on either a Form 4 or a Form 5:

- an acquisition under an employee stock purchase plan satisfying the requirements of Section 423 of the Internal Revenue Code;

- a transaction (other than a “discretionary transaction”) under an employee benefit plan satisfying the requirements of Section 410 and 401(a)(26) of the Internal Revenue Code (such as a pension plan or a 401(k) plan) or under a related excess benefit plan;

- an acquisition through a stock split, stock dividend or other pro rata distribution to stockholders of the company;

- an acquisition under a dividend or interest reinvestment plan that satisfies the requirements of Rule 16a-11; and

- an acquisition or disposition pursuant to a domestic relations orders, such as a divorce decree.

Although these transactions do not require the filing of a Form 4 or Form 5, the next Form 4 or Form 5 filed after such a transaction must reflect
the effects of these transactions in the column reporting post-transaction security ownership.

b. Ownership That Must be Reported

Each Insider must report all equity securities (including security futures products and security-based swap agreements) of the Company of which he or she is the “beneficial owner”. For reporting purposes, “beneficial ownership” is based on whether the Insider has or shares a “pecuniary interest” in the Company’s equity securities. “Pecuniary interest” is defined as “the opportunity, directly or indirectly, to profit or share in any profit derived from a transaction in the subject securities.” (Note: the definition of beneficial ownership for purposes of determining whether a stockholder is a 10% stockholder required to file Forms 3, 4 and 5 (as discussed in Section III.B.1 above) is different from the definition of beneficial ownership for purposes of determining what securities must be reported on Forms 3, 4 and 5 as beneficially owned.)

In addition to securities that are owned by him or her directly or held in “street name” for his or her account, an Insider is generally deemed to have a pecuniary interest in the following types of securities:

- securities owned by any member of the Insider’s immediate family sharing the same household; and

- securities owned by a corporation, partnership, trust or other entity controlled by him or her or such a family member (generally to the extent of his or her proportionate economic interest in such entity).

Insiders are also required to report the direct or indirect ownership of “derivative securities”, which are options, warrants, convertible securities, stock appreciation rights or similar rights with a value derived from the value of an equity security.

The circumstances under which an Insider may be a beneficial owner of securities are complex, and the descriptions provided above are intended merely to highlight the areas where an Insider should be alert to the possible application of Section 16(a). An Insider facing such a situation should consult counsel for guidance as to his or her particular reporting obligations.

When there is uncertainty as to the Insider’s beneficial ownership of securities, the Insider should report such securities as being beneficially owned. Such a report does not amount to an admission of beneficial ownership if accompanied by a disclaimer of beneficial ownership. If the reporting Insider wishes to disclaim beneficial ownership of securities, he or she should make the disclaimer near the bottom of the reverse side of the Form 3, Form 4 or Form 5. An appropriate form of disclaimer is as follows:

“The undersigned disclaims beneficial ownership of the securities indicated, and the reporting herein of such securities shall not be construed as an admission that the undersigned is the beneficial owner of any such securities for purposes of Section 16 of the Securities Exchange Act of 1934.”

c. Trusts

The rules regarding the application of Section 16 to shares of Company common stock held by trusts (which are primarily found in Rule 16a-8) are very complicated. Set forth below is a general summary of those rules.

A trust holding shares of common stock of the Company is itself subject to Section 16 only if the trust holds more than 10% of the outstanding shares of common stock. However, as discussed below, even if the trust itself is not subject to Section 16, the trustee, beneficiary or settlor of the trust may be subject to Section 16 with respect to the shares held by the trust.

A trustee of a trust holding shares of common stock of the Company is subject to Section 16
only if the trustee is an Insider. Where the trustee is an Insider, the trustee/insider would be subject to the Section 16 reporting obligations and short-swing profit restrictions with respect to only those trust shares in which the trustee/insider has a pecuniary interest. For example, the trustee/insider would be deemed to have a pecuniary interest in any shares in which a member of his or her immediate family has an interest as a beneficiary of the trust (regardless of whether such person shares the trustee/insider’s household). In addition, although not covered in any SEC rule, the SEC has taken the position that even if the Insider is not a trustee of the trust, he or she would be subject to Section 16 with respect to his or her pecuniary interest in the trust shares if the Insider in fact has or shares investment control with respect to trust transactions (e.g., where the Insider’s spouse is the trustee).

A beneficiary of a trust holding shares of common stock of the Company has Section 16 obligations with respect to shares held by the trust only if the beneficiary is otherwise subject to Section 16 and the beneficiary has or shares investment control with respect to trust transactions; in such case, the beneficiary would be subject to Section 16 with respect to the number of shares held by the trust that equates to his or her pro rata interest as a beneficiary of the trust.

A settlor of a trust holding shares of common stock of the Company is subject to Section 16 with respect to shares held by the trust only if (1) the settlor reserves the right to revoke the trust without the consent of another party and (2) the settlor has or shares investment control with respect to trust transactions (although a settlor could also have Section 16 obligations with respect to shares held by the trust by virtue of his or her status as a trustee or beneficiary).

d. Transitional Periods

Each director and officer who was serving as a director or officer at the time of the Company’s initial public offering (but not 10% stockholders) and who is required to file a Form 4 prior to the date six months after the effectiveness of the Company’s Registration Statement on Form 8-A (filed in connection with the initial public offering) must report in that Form 4 all changes in beneficial ownership that occurred both while he or she was a director or officer and during the six months preceding the change that prompted the filing of the Form 4, even though those changes may have occurred before he or she became subject to Section 16 as a result of the Company’s initial public offering. A person who became a director or officer of the Company after the initial public offering does not have to report equity transactions that he or she engaged in prior to becoming a director or officer (Rule 16a-2(a)).

A person who ceases to be a director or officer of the Company and who engages in a transaction in the Company’s equity securities (other than a transaction eligible for Form 5 reporting) subsequent to his or her departure must file a Form 4 to report that transaction if it occurs within the six-month period following an “opposite” transaction (i.e., a purchase within six months following a sale) that occurred while he or she was an Insider of the Company and that is not otherwise exempt from Section 16(b) (Rule 16a-2(b)).

A director or officer who is no longer considered an Insider under Section 16 should check a box on any Form 4 or 5 filed after he or she ceases to be an Insider indicating that he or she is no longer subject to Section 16.

A 10% stockholder has no Section 16 filing obligations with respect to any equity transactions that occurred prior to or after the time such person owned 10% of the outstanding common stock of the Company.

e. Voluntary Filings

A few types of transactions—such as gifts—need not be reported on a Form 4, but may instead be reported in a year-end Form 5. However, any such transaction may nonetheless be reported by the Insider on a Form 4 if the Insider so chooses. Such voluntary early filings
are often advisable because they avoid the risk that the Insider will fail to report the transaction at the required later date (when the transaction may no longer be fresh in the Insider’s mind).

f. Filing and Posting Procedure for Forms

The filing of Forms 3, 4 and 5 are personal obligations of each Insider. However, to help avoid the penalties associated with delinquent reports, the Company has designated a person to assist Insiders in preparing and filing Forms 3, 4 and 5.

Each Form 3, 4 and 5 must be filed electronically with the SEC (through the SEC Section 16 website, a third-party service provider or using third-party software) by 10:00 p.m. eastern time on the business day on which the filing is due. A copy of each such form filed with the SEC must also be filed with the NYSE and sent to the Company.

In addition, the Company must post on its website, by the end of the next business day, each Form 3, 4 and 5 filed by any of its Insiders. This posting requirement may be met by hyperlinking to the website of the SEC or another third party, if certain conditions are met.

g. Sanctions for Failure to File

As a means of increasing compliance by Insiders with their reporting obligations under Section 16(a), Regulation S-K Item 405 requires all publicly held companies to disclose in their Proxy Statements and Annual Reports on Form 10-K the names of all Insiders who failed to file timely reports during the previous fiscal year, and the number of late or unfiled reports by each such Insider. In complying with this requirement, the Company need only review Forms submitted by Insiders and may rely on a written representation from each Insider that no Form 5 is required (provided the Company retains the written representation for two years).

The SEC can also use its enforcement powers to promote compliance with the Section 16(a) reporting obligations. Sanctions available to the SEC include the power to issue cease-and-desist orders and the power to seek monetary penalties ranging from $5,000 to $100,000 for noncompliance with such orders. A court may increase the penalty to the amount of any gain realized through the violation of the securities laws or SEC rules. In addition, courts may bar an individual who violates the Section 16(a) reporting rules from serving as an officer or director of a public company. The Company, too, can incur liability by aiding and abetting violations by one of its Insiders. Finally, any person who willfully fails to file a report which he or she knew was required to be filed under the Exchange Act or who willfully misrepresents information reported in any such filing may be subject to criminal sanctions (up to 20 years imprisonment and/or a fine of up to $5,000,000) under Section 32(a) of the Exchange Act, in addition to SEC enforcement orders and possible civil liability.

3. “Short-Swing” Profits

Section 16(b) of the Exchange Act seeks to discourage trading by Insiders based on material nonpublic information by imposing on them liability to pay the Company any “profit” realized through any purchase and sale (or any sale and purchase) of equity securities of the Company within a period of less than six months. The standard of liability imposed by Section 16(b) is quite rigid. It is no defense that the Insider was not aware of material nonpublic information, did not realize the transaction would be considered a purchase or sale or did not realize that a transaction by another person could be attributed to him or her. The Company may not waive the liability or settle for less than the entire profit realized, unless recovery on the merits is in serious doubt. If the Company fails to recover the profit or to bring a suit to do so, any stockholder may sue the Insider on behalf of the Company to recover such profit, and collect attorney fees as well.

The reporting requirements of Section 16(a) are designed to aid enforcement of Section 16(b). Professional plaintiffs’ counsel regularly review
these public reports and bring actions, on a contingent fee basis, to recover "profits" from the Insider.

The following discussion outlines the parameters of Section 16(b) liability.

a. Applicability

In general, all securities of the Company which are deemed beneficially owned by an Insider for purposes of Form 3, Form 4 and Form 5 (see Section III.B.2.b above) are deemed beneficially owned for purposes of Section 16(b), and any purchase of such securities may be matched against any sale of such securities under Section 16(b). For example, if a director sells common stock, and his wife buys common stock less than six months later, any profit from this transaction would be recoverable by the Company.

Transactions by a director or officer prior to the time he or she became a director or officer are not subject to Section 16(b). However, transactions by a current director or officer prior to the time Section 16 became applicable to transactions in Company securities (i.e., the date of the effectiveness of the Company's Registration Statement on Form 8-A in connection with its initial public offering) are subject to Section 16(b) if they occurred within six months prior to an opposite transaction effected after that date. Transactions by a director or officer after the termination of his or her status as a director or officer are subject to Section 16(b) if they occur within six months after a non-exempt opposite transaction effected while he or she was a director or officer. For example, if a director of the Company were to buy shares of common stock on April 1, resign as a director on May 1, and sell shares of common stock on June 1, he or she would be liable to the Company for any profit realized on such purchase and sale.

The rules regarding the applicability of Section 16(b) to transactions by 10% stockholders are much simpler. A 10% stockholder cannot have any liability under Section 16(b) unless both the purchase and the sale occur while he or she is a 10% stockholder. Furthermore, current 10% stockholders have no liability under Section 16(b) for transactions occurring prior to the Company's initial public offering.

Note that the rules regarding whether Section 16(b) is applicable to a transaction before or after the period for which a person is an Insider are consistent with the rules (discussed in Section III.B.2.d above) regarding whether transactions before or after the period for which a person is an Insider must be reported on a Form 4.

b. "Purchase" and "Sale"

The rules for determining whether a matching purchase and sale of an equity security of the Company have occurred are broadly interpreted. The same securities do not have to be involved in the purchase and sale in order for such transactions to be matched. In addition, the purchase (or sale) of securities that are convertible into or exercisable for shares of common stock may be matched against the sale (or purchase) of either other securities which are so convertible/exercisable or shares of common stock. For example, a sale of warrants to acquire common stock may be matched against either a purchase of warrants or a purchase of common stock within less than six months before or after such sale.

The general rule is that a change in beneficial ownership that is voluntial on the part of the beneficial owner and for which he or she gave or received value (i.e., not a bona fide gift) is deemed a purchase or a sale. Stock option grants are considered voluntial because the optionee accepts the grant. While a mandatory stock dividend may not constitute a purchase of the security received, a different result may follow if the recipient could elect between a stock dividend and a cash dividend. Similarly, a reclassification of stock, where shares of one class are exchanged for shares of a different class, is generally not considered a purchase or sale. In the context of mergers and other non-cash reorganizations, however, the acquisition or disposition of stock may
constitute a purchase or sale if a court finds that the transaction provides the potential for speculative abuse by the Insider.

c. Determination of “Profit”

“Profit” is the difference between the price of any purchase and the price of any sale made within a period of less than six months, regardless of the order in which they occur. Liability cannot be avoided by buying stock represented by one certificate and selling stock represented by another, by application of a “first in, first out” rule or by any other approach designed to establish that particular securities were held for the requisite six-month period. All shares are fungible for purposes of Section 16(b). In addition, losses cannot be offset against gains. Transactions are paired so as to match the highest sale price with the lowest purchase price within a six-month period, the next highest sale price with the next lowest purchase price within the period, and so on, until all shares have been included in the computation.

The courts apply these provisions with mechanical rigidity to extract the maximum “profit”. An Insider can be liable to the Company for short-swing profit even though he or she has suffered an economic loss. For example, suppose an Insider purchases 10,000 shares of common stock at $7.00 per share, sells them at $6.50 per share, buys a second 10,000 shares at $8.00 per share and sells them at $7.50 per share, all within the same six-month period. The Insider would incur an out-of-pocket net loss on the transactions of $10,000. However, for purposes of Section 16(b) the Insider would incur a profit, and therefore a liability, of $5,000 to the Company, based on the difference between the sale of 10,000 shares at $7.50 per share (the highest sales price) and the purchase of 10,000 shares at $7.00 per share (the lowest purchase price).

The calculation of profit in transactions involving “derivative securities” such as stock options is often problematic. For example, it is not immediately clear what the profit should be in the following transaction: an Insider is issued, for $100, a warrant to purchase 10,000 shares of common stock at an exercise price of $10.00 per share (this is considered an acquisition of such 10,000 shares for purposes of Section 16(b), even though the warrant has not yet been exercised); and the Insider sells 5,000 shares of common stock for $12.00 per share less than six months later. The rules under Section 16(b) do not establish any definitive method for calculating profit in transactions involving derivative securities. However, the rules do provide that the profit in such a situation shall not exceed the difference in the market price of the common stock on the date of purchase and on the date of sale.

4. Common Exemptions from Section 16(b)

Rule 16b-3 under the Exchange Act provides that the grant or issuance by the Company to a director or officer of a stock option or other stock award is not considered a “purchase” by the Insider for purposes of Section 16(b) if:

- the option grant or stock award is approved by either the Board of Directors of the Company or a committee of the Board composed solely of two or more “Non-Employee Directors” (as defined in Rule 16b-3);

- the grant or award is approved by the Company’s stockholders; or

- the Insider holds such securities for at least six months before disposing of them (this condition would be satisfied if an Insider held an option for at least six months, then exercised it and immediately sold the underlying shares).

Stock option grants and restricted stock awards made under the Company’s stock plan, generally qualify for the Rule 16b-3 exemption, both because they are granted by either the Board of Directors or a committee of the Board composed solely of two or more Non-Employee Directors.
and because the options typically cannot be exercised (and the underlying shares thus cannot be sold) and the restricted stock cannot be sold within six months due to the vesting schedule of the options and restricted stock. All stock options granted under the Company’s director stock option plan comply with Rule 16b-3 by virtue of the fact that such Plan is a “formula plan” (i.e., a plan in which the terms and conditions of each grant are set forth in the Plan itself) which was approved by the Board of Directors and the stockholders; the SEC considers this to be tantamount to obtaining Board and stockholder approval of the individual option grants made under the Plan.

An exercise of a stock option is exempt from Section 16(b), by virtue of Rule 16b-6(b), provided the option is in-the-money at the time of exercise.

5. Short Sales

Section 16(c) of the Exchange Act prohibits Insiders from selling the Company’s equity securities if (i) the seller does not then own such securities, or (ii) he or she fails to deliver such securities within 20 days after the sale or fails to mail them for clearing within 5 days after the sale.

Section 16(c) is chiefly directed against “short sales” and “short sales against the box.” In a short sale, the seller attempts to profit from an anticipated drop in market price by selling securities he or she does not then own and covering with securities bought after the price decline. A short sale against the box is a hedging device in which the seller owns the securities he or she has sold but wishes to protect his or her long position against price declines while deferring realization of gain. In covering his or her sale, the seller either (i) delivers other securities bought during a price decline (while holding the securities already owned for long-term gain), or (ii) delivers the securities already owned if the price has increased.

C. Rule 144

The Securities Act requires that any sales of a security be made either pursuant to a registration statement filed with the SEC (such as the S-1 Registration Statement filed by the Company in connection with its initial public offering) or pursuant to a valid exemption from the registration requirements of the Securities Act. Most sales of the Company’s common stock on the NYSE are made in reliance on the exemption contained in Section 4(1) of the Securities Act, which applies to sales by persons other than the Company, an underwriter or a dealer. However, the definition of “underwriter” under the Securities Act is very broad, and the following two types of stockholder sales may be presumed to be made by an “underwriter” (and thus ineligible for the Section 4(1) registration exemption) unless they are made in compliance with Rule 144 under the Securities Act: (1) sales by “affiliates” of the Company for purposes of Rule 144, and (2) sales of “restricted” common stock by any stockholder of the Company. Accordingly, sales by affiliates, and sales of restricted common stock by any stockholder, must generally be made in compliance with Rule 144 to ensure compliance with the Securities Act.

An “affiliate” of the Company is any person who, directly or indirectly, controls, is controlled by, or is under common control with, the Company. All directors and executive officers are deemed affiliates of the Company, and persons or entities holding a significant percentage (generally 10% or more) of the outstanding shares of common stock are also generally considered affiliates of the Company. In addition, any entity controlled by a director, executive officer or 10% stockholder (such as a corporation, partnership or trust), and a spouse or other relative sharing the same home as a director, officer or 10% stockholder, is also subject to the requirements of Rule 144.

“Restricted” common stock is any common stock of the Company that was issued by the Company other than pursuant to a public
offering. All shares of common stock issued prior to the Company’s initial public offering, including shares issued upon the conversion of Preferred Stock issued prior to the offering, are considered restricted common stock (unless they have since been publicly resold). However, once shares of restricted common stock are sold in compliance with Rule 144, such shares are no longer considered restricted. In addition, as discussed below, shares of common stock that have been owned by a non-affiliate for at least two years are generally eligible for resale under Rule 144(k), which effectively means they are no longer considered restricted stock. All shares of common stock issued in the Company’s initial public offering or issued under the Company’s stock plan subsequent to the effective date of the Registration Statement on Form S-8 relating to such plans (which will occur shortly following the closing of the Company’s initial public offering) are not considered restricted.

The requirements and restrictions applicable to sales under Rule 144 are summarized below. The requirements of Rule 144 are complicated and often confusing. The discussion that follows is intended to provide you with an explanation of the provisions of Rule 144 applicable to sales of Company common stock. However, if you have a question regarding a particular proposed sale of Company common stock, please do not hesitate to call someone at Wilmer Cutler Pickering Hale and Dorr LLP.

1. Current Public Information

No sales may be made under Rule 144 unless adequate information regarding the Company is available to the public. Such information is deemed to be available only if the Company has been subject to the reporting requirements of the Exchange Act for a period of at least 90 days preceding the sale and has filed all periodic reports (other than Form 8-Ks) required to be filed under the Exchange Act during the 12 months (or such shorter period as the Company was required to file such reports) preceding such sale. The Company became subject to the reporting requirements of the Exchange Act upon effectiveness of its Registration Statement on Form S-1 and its Registration Statement on Form 8-A filed in connection with its initial public offering. No sales under Rule 144 can be made until 90 days after the date of such effectiveness.

2. Holding Period for Restricted Securities

If restricted shares of common stock are sold, the stockholder must have owned and paid for such shares for at least one year. To calculate this holding period, the holder generally is entitled to count (or “tack”) the holding period of a predecessor holder, provided, however, that no tacking is permitted in a private purchase of securities from an affiliate of the Company. Shares of common stock acquired upon conversion of Preferred Stock are considered to have been acquired when the Preferred Stock was acquired.

One exception to the rule that shares of restricted common stock must have been held for one year prior to sale under Rule 144 is that, beginning 90 days after the Company’s initial public offering, shares of common stock acquired before the Company’s initial public offering under the Company’s stock plans need not be held for one year prior to sale under Rule 144, assuming the issuance of those shares qualified for the exemption provided in Rule 701 under the Securities Act.

Affiliates selling shares of non-restricted common stock (such as shares acquired by an option exercise covered by a Form S-8 registration statement) are not required to have beneficially owned them for at least one year in order to comply with Rule 144.

3. Limitation on Amount of Securities Sold

A stockholder may not sell under Rule 144, during any three-month period, a number of shares of common stock which exceeds the greater of (i) 1% of the total number of
outstanding shares of common stock of the Company, or (ii) the average weekly trading volume of the common stock on the NYSE during the four weeks preceding the filing of the Form 144 (discussed in Section III.C.5 below) or the date of sale (if no Form 144 is required to be filed).

A stockholder selling common stock under Rule 144 must aggregate all sales by the following persons and entities, among others, in determining his or her compliance with this limitation:

- the seller’s spouse or any relative of the seller or the seller’s spouse sharing the same home as the seller;
- any trust or estate in which the seller and the above household members collectively own at least a 10% beneficial interest, or of which any of such persons serves as trustee or executor or in any similar capacity; and
- any company or other entity (other than the issuer) in which the seller and any of the above household members collectively own 10% or more of the equity interest.

The aggregation rules applicable to common stock which has been distributed by a partnership or limited liability company (such as a venture capital fund) to its partners or members, or which has been gifted, are complex. Prospective sellers should consult with counsel in those situations.

4. Manner of Sale

Sales under Rule 144 must be made in unsolicited “brokers’ transactions” or transactions directly with a “market maker”, as such terms are defined for purposes of Rule 144. In addition, the seller may not make any payment in connection with the sale other than to his or her broker and may not solicit or arrange for the solicitation of buy orders; and the broker may not solicit or arrange for the solicitation of buy orders, may only execute the seller’s order, and may receive no more than the ordinary and customary broker’s commission.

5. Notice of Sale

Concurrently with placing a sell order with his or her broker or executing a sale directly with a market maker, a seller of common stock relying on the Rule 144 exemption must file three copies of a notice on Form 144 with the SEC and one copy with the NYSE. This filing requirement does not apply if, during the three-month period before and after the sale, all sales of common stock by him or her under Rule 144 involved a total of not more than 500 shares and total proceeds of not more than $10,000. Unless the seller is certain he or she will not exceed these limits within the three months following any sale under Rule 144, a Form 144 should be filed, since the effect of a failure to file might be to bar further sales under Rule 144 during such period. Sellers should also note that the 500 share/$10,000 exception relates only to the filing requirement. Other applicable provisions of Rule 144 must be complied with, no matter how small the proposed sale is.

6. Rule 144(k)

A stockholder who is not an affiliate of the Company, who has not been an affiliate for the preceding three months, and who has held the restricted common stock for at least two years (with such holding period calculated as described in Section III.C.2 above), may sell such common stock pursuant to Rule 144(k) without regard to the requirements and restrictions described in paragraphs 1, 3, 4 and 5 above. In short, any non-affiliate who has held restricted shares of common stock for at least two years may resell such shares without compliance with Rule 144.
D. Cashless Option Exercises Under the Sarbanes-Oxley Act

Section 402 of the Sarbanes-Oxley Act prohibits a public company from making or arranging an extension of credit, in the form of a personal loan, to any director or executive officer of the company. This provision is ambiguous on its face, and neither the SEC nor any other governmental agency has issued rules or other interpretive advice with respect to it.

There has been much debate in the legal and business communities as to whether this law prohibits cashless exercises of stock options by directors and executive officers. The basis on which Section 402 could be read to prohibit cashless exercises is that a cashless exercise typically involves either:

- an issuance by the company of the shares acquired upon option exercise in exchange for a commitment that the broker will deliver a portion of the proceeds from the sale of such shares to the company in payment of the option exercise price – this could be viewed as an extension of credit by the company to the optionholder (in the amount of the option exercise price) during the period of time between the issuance of the option shares and the payment of the option exercise price upon settlement of the sale of the option shares; or

- a loan by the broker to the optionholder to fund the option exercise price, which loan is promptly repaid by the optionholder from the proceeds of the sale of the shares acquired upon option exercise – if this takes place pursuant to a program established with the cooperation of the company, this could be viewed as an extension of credit arranged by the company.

There are also a variety of arguments that can be made in favor of the proposition that Section 402 does not prohibit cashless option exercises. However, in the absence of any regulatory or judicial guidance on the meaning of Section 402, there is some risk that a cashless option exercise by an executive officer or director of the Company would violate Section 402. The extent of the risk depends in large part on the details of the cashless exercise program used by Company insiders, cashless exercise programs can take a variety of forms, some of which involve less risk under Section 402 than others. We encourage you to examine the details of any cashless exercise program used by Company insiders and assess the Section 402 risk in light of these details, we would be happy to assist you in this assessment.

E. Pension Fund Blackout Periods

SEC Regulation BTR, which was adopted pursuant to a Sarbanes-Oxley Act requirement, prohibits, subject to a number of exceptions, the following transactions during a pension fund blackout period:

- an acquisition of issuer equity securities by a director or executive officer if the acquisition is in connection with his or her service or employment as a director or executive officer; and

- a disposition of issuer equity securities by a director or executive officer if the disposition involves issuer equity securities acquired in connection with his or her employment or service as an executive officer or director.

A “pension fund blackout period” means any period of more than three consecutive business days during which the ability of at least 50% of the participants or beneficiaries under all individual account plans (as defined under ERISA, but excluding a one-participant retirement plan) maintained by the company to purchase, sell or otherwise acquire or transfer an interest in any equity security of the company held in such an individual account plan is temporarily suspended by the company or a
fiduciary of the plan. However, a pension fund blackout period does not include the following periods which the SEC exempts from the definition of “blackout period” under Section 306(a) of the Sarbanes-Oxley Act: (i) regularly scheduled and timely disclosed periods during which plan participants may not transfer their interests in Company equity securities; and (ii) blackout periods imposed in connection with persons commencing or ceasing participation in the plan by reason of a merger, acquisition or divestiture.

Any profits from such prohibited trades must be disgorged to the company. A company must notify officers, directors and the SEC of applicable blackout periods. There are additional ERISA notice requirements with respect to blackout periods for individual account plans.

F. Section 13(d) and 13(g)

In general, any person or entity (or group of persons or entities acting together) who makes an acquisition of common stock which results in such person or group owning more than 5% of the outstanding shares of common stock of the Company must report his or her ownership of Company securities by filing either a Schedule 13D or a Schedule 13G with the SEC. Schedule 13Ds and Schedule 13Gs should generally be prepared and filed only with the assistance of counsel.

1. Schedule 13D

Under Section 13(d) of the Exchange Act, any person who, after acquiring directly or indirectly the beneficial ownership of common stock of the Company, is directly or indirectly the beneficial owner of more than 5% of the outstanding shares of common stock, with certain exceptions described below, must file a Schedule 13D with the SEC within 10 days after such triggering acquisition. Schedule 13D requires disclosure relating to the stockholder’s identity and background, the source and amount of funds or other consideration used in the acquisition, the purpose of the acquisition, the stockholder’s total equity interest in the Company, and other information. A Schedule 13D must be amended “promptly” if material changes occur in the disclosed information.

2. Schedule 13G

Under Section 13(g) of the Exchange Act and the rules promulgated thereunder, any person or entity who acquires or owns more than 5% of the outstanding shares of common stock of the Company and who is not required to file a Schedule 13D must file a Schedule 13G with the SEC. The Schedule 13G must be filed either within 10 days after the triggering acquisition or by the following February 14th, depending on the circumstances of the investor. Examples of situations in which a stockholder is entitled to file a Schedule 13G rather than a Schedule 13D are:

- such stockholder’s total acquisitions of common stock, including the triggering acquisition (i.e., the acquisition which caused its stock ownership to exceed 5%), within the twelve months preceding the triggering acquisition did not exceed 2% of the outstanding shares of common stock;
- the stockholder owned more than 5% of the outstanding shares of common stock as of the date this provision became applicable to Company stockholders (i.e., the date of the effectiveness of the Company’s Registration Statement on Form 8-A in connection with its initial public offering) and has made no acquisitions of common stock subsequent to such time;
- the stockholder falls into one of several enumerated categories of investor (such as mutual funds, banks, brokers and dealers) and the triggering acquisition was made in the ordinary course of business and not to influence the control of the Company; and
- the stockholder qualifies as a “passive investor” (i.e., a stockholder who is not
seeking to acquire influence or control of the Company and who beneficially owns less than 20% of the Company’s outstanding voting securities).

Schedule 13G is a much shorter and easier document to complete than is Schedule 13D. Schedule 13G must be amended within 45 days after the last day of any calendar year in which material changes have occurred in the disclosed information (such as a change in the number of shares of common stock beneficially owned) and must be amended more frequently under certain circumstances.
REPORTING AND DISCLOSURE UNDER
THE SECURITIES EXCHANGE ACT OF 1934

What A Public Company Should Know

Gary M. Brown
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I. BECOMING SUBJECT TO THE SECURITIES
EXCHANGE ACT OF 1934 (the "Exchange Act").


1. Section 12(b) - Issuer must register securities
when traded on a "national securities exchange."
The so-called regional exchanges are officially
"national" exchanges.

2. Section 12(g)(1) - Must register class of equity
securities (other than exempted securities) when
held of record by at least 500 persons and issuer
has total assets exceeding $10 million (Note -
statute provides for registration when issuer has
$1 million in assets; however, under its
rulemaking authority, the SEC adopted Rule
12g-1 which exempts securities of registrants
having not more than $10 million in total assets).

   a. Section 12(g) requirement is operative
within 120 days after the end of the last
fiscal year if, on the last day of that year,
is the Section 12(g) thresholds.

   b.
b. Reasons for voluntary registration:

(i) Meet current public information requirement of Rule 144, although with adoption of Rule 144(k) and with the recent further relaxation of Rule 144's requirements, fewer companies have found this necessary.

(ii) Subject proxy solicitation to Exchange Act regulation and require disclosure by 5% holders under Section 13(d) in face of a proxy contest.

(iii) NASD requires securities to be registered pursuant to Section 12 in order to be traded on the NASDAQ system.

c. Certain exemptions include:

(i) "Foreign private issuers" - see Rules 12g3-2(a) and 12g3-2(b).

(ii) American Depository Receipts registered on Form F-6; see Rules 12g3-2(c) and 12a-8.

(iii) Certain interests in certain employee benefit plans; see Rule 12h-1.
B. Section 15(d).

1. Under Section 12(g), registration is not required until 120 days after end of the fiscal year in which issuer meets the holders/assets test.

2. Under Section 15(d), registration of securities under the Securities Act of 1933 (the "Securities Act") subjects companies to the periodic reporting requirements of Section 13. Practical effect usually is only to require earlier compliance with periodic reporting requirements. Duty to file under Section 15(d) is suspended following future fiscal years in which the securities are held of record by less than 300 persons as of the end of the year. Note that Section 15(d) obligations are not the equivalent of Section 12 registration.

C. Forms Used for Registration.

1. Form 10 or Form 10-SB - Generally used when no other form is prescribed.

2. Form 8-A - Generally used to register classes of securities of an issuer already required to file reports under Section 13 or 15(d) of the Exchange Act.

3. Forms 20-F and 40-F - Used by foreign issuers and by Canadian issuers under the Multijurisdictional Disclosure System.
D. Contrast with Registration Under the Securities Act.

1. Securities Act registration relates only to securities sold in a particular offering or transaction.

2. Under the Exchange Act, a company registers classes of securities.

3. Exchange Act registration has a number of other consequences:
   
a. Subjects company to periodic reporting (and certification) requirements (Section 13(a)).

b. Makes proxy and tender offer rules applicable (Sections 13(e) and 14).

c. Makes Section 16 (reporting and insider short swing profit provisions) applicable.

d. Makes 5% ownership rules (Section 13(d)) applicable.

e. Note - only the periodic reporting requirements apply to 15(d) filers.

E. Termination of Registration/Periodic Reporting.

1. Delisting – If Section 12(b) securities are delisted, Rule 12g-2 provides that the securities are deemed Section 12(g) securities unless exempt or the company fails to meet the Section 12(g) holders/assets tests.
2. An issuer may terminate Section 12(g) registration if the class of securities is held of record by: (a) less than 300 persons; or (b) less than 500 persons when the issuer's total assets have not exceeded $10 million on the last day of each of the issuer’s most recent three fiscal years.

3. Termination of registration is accomplished by filing a Form 15, which, effective upon filing, immediately suspends the duty to file periodic reports (see II below). Termination of registration becomes effective 90 days after filing or such period as the SEC may determine.

4. Section 12(g)(2) of the Exchange Act lists various securities that are exempt from the registration provisions. In addition, the SEC has promulgated Rule 12h-1, which provides additional exemptions from registration.

5. An issuer filing pursuant to Section 15(d) (see I.B. above) has its duty to file periodic reports automatically suspended if at the end of a fiscal year (other than the first) its securities are held of record by less than 300 persons.

II. PERIODIC REPORTING AND OTHER ASPECTS OF EXCHANGE ACT REGISTRATION.


1. Section 13.

a. Section 13(a) - the basic periodic reporting requirement - requires issuer with securities registered under Section 12 to file:
(i) information and documents as the Commission requires to keep current the information provided at the time of registration under Section 12; and

(ii) such annual and other reports as the Commission requires.

b. Section 13(d) imposes reporting requirements by persons who acquire beneficially more than 5% of any class of equity securities that is registered under the Exchange Act.

c. Section 13(e) imposes reporting (and other) requirements with respect to issuer tender offers.

d. Section 13(k), added by the Sarbanes-Oxley Act of 2002 ("Sarbox"), generally prohibits personal loans to executives and directors of public companies (whether Section 12 or 15(d)).

2. Section 14.

a. Basic requirements for proxy solicitation with respect to classes of equity securities registered under Section 12 of the Exchange Act.

b. Section 14 (and regulations) also impose reporting (and other) requirements with respect to tender offers.
3. **Section 16** - Imposes reporting obligations upon directors, officers and greater than 10% shareholders as well as strict liability on these persons for "profits" resulting from "purchases" and "sales" of the company's equity securities that occur in a period of less than six months.

4. **Section 10(b)** - Generally prohibits manipulative or deceptive devices or contrivances in contravention of such rules and regulations as the SEC may prescribe. Rule 10b-5 promulgated thereunder plays a role in the reporting obligations of public corporations.

5. **Sarbanes-Oxley** - Sarbox and the regulations promulgated pursuant thereto to date, while making no changes in the basic registration/disclosure regimen of the Exchange Act, did affect the obligations of companies (and others) in a number of ways including: (a) certification of periodic reports by CEOs and CFOs; (b) acceleration of certain filing dates; (c) enhanced disclosure of off-balance sheet arrangements and contingent obligations; (d) additional disclosure obligations relative to audit committees and codes of ethics; (e) additional disclosures relative to a company's internal and other controls; and (f) additional disclosure requirements and prohibitions relative to announcements and filings using "non GAAP financial measures" as well as corporate earnings releases. Sarbox also affects public companies in other ways, such as through the addition of "whistleblower" provisions as well as mandated rules on attorney professional conduct, loan prohibitions and certain forfeiture of executive incentive pay.
B. Principal Reports and Forms.

1. **10-K** - Annual report that prior to 1994 was required to be filed within 90 days after the close of the company’s fiscal year. This time period was shortened for "accelerated filers" to 75 days for fiscal years ending on or after December 15, 2003 and to 60 days for fiscal years ending on or after December 15, 2004. Non-accelerated filers will continue to be required to file within 90 days after the close of the company’s fiscal year.

   a. "Accelerated filers" are domestic reporting companies:

   - with a common equity public float of at least $75 million as of the last business day of their most recently completed second fiscal quarter;

   - that have been subject to Exchange Act reporting requirements for at least 12 calendar months, and have previously filed at least one annual report; and

   - that are not eligible to use the SEC’s special forms for small business issuers.

   b. The accelerated deadlines will apply to an accelerated filer after it first meets the conditions listed above in Part II.B.1.a. as of the end of its fiscal year.
c. The accelerated deadlines will not affect small business issuers that file on Forms 10-KSB and 10-QSB, foreign governments, foreign private issuers that elect to use Form 20-F and companies that do not have a common equity public float. These companies will continue to file under existing deadlines.

d. Accelerated filers also are required to disclose in their annual reports where investors can obtain access to their filings, including whether the company provides access to its Exchange Act reports on its Internet website, free of charge, as soon as reasonably practicable after the reports are filed with or furnished to the SEC. If the company does not make filings available on its website, it must state the reasons why and state whether the company will voluntarily provide paper or electronic copies of filings free of charge upon request.

e. Major portions of the 10-K may be incorporated by reference from the company's annual report to shareholders or the company's proxy statement. One of the most important requirements for the Form 10-K is Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A"). This disclosure item is designed to help investors understand the financial affairs of the company through
management's eyes. Among other things, it must discuss currently known trends, events or uncertainties that are reasonably likely to have material effects on the company's results of operation or financial affairs in the future. In recent years, the SEC, in several enforcement actions, has given notice that it will scrutinize MD&A very carefully. Rules promulgated pursuant to Sarbox also expanded items that are required to be covered in MD&A. In addition, in December 2003, the SEC issued Release 34-48960 giving guidance on the preparation of MD&A and encouraging companies to take a fresh approach to MD&A. (See III below).

2. 10-Q - Quarterly report that prior to 1994 was required to be filed within 45 days after the close of each of the first three fiscal quarters in a company's fiscal year. This time period was shortened for "accelerated filers" to 40 days for periods within fiscal years ending on or after December 15, 2004 and then to 35 days for periods within fiscal years ending on or after December 15, 2005. Non-accelerated filers will continue to be required to file within 45 days after the close of each of their first three fiscal quarters. Form 10-Q also includes an MD&A section.

3. 8-K - Current report.
   a. Currently required to be "filed" within 5 business days of certain changes in accountants, resignations of directors and
for changes or waivers relative to the company's code of ethics. Filing also required no later than the date that notice of blackout trading restrictions is required to be transmitted to directors and executive officers by Regulation BTR.

b. Required (for releases and announcements made after March 28, 2003) to be "furnished" within 5 business days of making any public announcement or release of material non-public information regarding the company's results of operation or financial condition for a completed fiscal period (i.e., an earnings release). Note that the "announcement" does not have to be in writing to trigger the new 8-K requirement.

c. Currently required to be filed within 15 calendar days of a change in control, material acquisitions or dispositions of assets, bankruptcy, or a determination to change the company's fiscal year.

d. Optional filing with respect to any other matter that the company regards as of material importance. No specific required filing time, but companies are encouraged to file promptly.

e. Optional filing as a method to comply with disclosure requirements pursuant to Regulation FD (see IV.B.3. below).
f. In the wake of Enron and other corporate scandals, the SEC indicated that it intended to expand the list of significant events requiring current disclosure on Form 8-K. On March 11, 2004, the SEC adopted changes to Form 8-K that expanded the list of events that will be required to be reported on a Form 8-K. Further, the SEC shortened the filing deadline on most 8-K items to the fourth business day following the occurrence. The shortened deadline, however, does not affect the required deadlines for Regulation FD disclosures or voluntary disclosures. The new 8-K requirements are effective August 23, 2004. The new items that now are required to be disclosed on Form 8-K are:

- entry into a material, non-ordinary course of business contract;
- termination of a material, non-ordinary course contract;
- termination or reduction of a business relationship with a customer that constitutes a specified percentage of the company's revenues;
- creation of a direct or contingent material financial obligation;
- events triggering a direct or contingent material financial obligation;
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- exit activities including material write-off and restructuring charges;

- any material impairment;

- a change in rating agency decision, issuance of a credit watch or change in a company's outlook;

- movement of the company's securities from one exchange to another, delisting of the company's securities from an exchange or quotation system, or a notice that a company does not comply with a listing standard;

- conclusion or notice that security holders should no longer rely on the company's previously issued financial statements or a related audit report; and

- any material events, including the beginning and end of lock-out periods, regarding the company's employee benefit, retirement and stock ownership plans.

Additionally, two items were moved from the 10-Q and 10-K to the Form 8-K:

- unregistered sales of equity securities by the company; and

- material modifications to the rights of security holders.

a. Proxy materials technically are not "periodic reports;" however, much (Part III) of the Annual Report on Form 10-K can be (and typically is) incorporated by reference from a company's definitive proxy statement. Note that definitive proxy materials must be filed with the Commission within 120 days after the end of the fiscal year in order to incorporate them into the Annual Report on Form 10-K.

b. Regulation 14A specifies the information that must be included in a proxy statement. After the executive compensation disclosure requirements set forth in Item 402 of Regulation S-K were extensively revised in 1992, all companies' proxy statements (should) contain tables (in specified tabular formats) regarding compensation paid to executive officers and directors. This was designed to make all companies' proxy statements more comparable.

c. Rule 14a-3(b), which specifies the content of the annual report to shareholders, requires that the annual report "accompany or precede" the proxy statement. Although the Annual Report on Form 10-K and the annual report to shareholders have similar requirements, they are not identical.
d. In Release No. 33-7766 (November 4, 1999), the SEC adopted rules (known as the "householding rules") that allow Exchange Act registrants to satisfy annual report delivery requirements by sending a single annual report with respect to two or more shareholders sharing the same address, subject to certain conditions.

e. Regulation 14C is another "gap filler" (similar to section 15(d)'s reporting requirements) that requires information to be furnished to shareholders that is substantially equivalent to that which would be contained in a proxy statement even if proxies are not going to be solicited with respect to a transaction.

f. On November 19, 2003, the SEC adopted rules requiring public companies to disclose both their processes for nominating corporate directors and for communications between shareholders and their boards of directors. Still pending is another aspect of the SEC's initiatives - rules that would allow shareholders meeting certain threshold requirements to have direct access to the proxy statements of public companies in order to nominate directors. The rules that were adopted must be complied with by companies in proxy or information statements first sent or given to security holders on or after January 1, 2004. Material changes to a company's procedures for
nominations must be disclosed on Forms 10-Q or 10-K filed for the first reporting period after January 1, 2004 in which the material change occurs. The disclosures now required in the proxy statement are:

- whether the company has a standing nominating committee and, if not, who determines director nominees and why the board believes this is appropriate;

- whether the nominating committee has a charter and, if so, whether the charter is available to shareholders (website or otherwise);

- the independence of the nominating committee members;

- whether the nominating committee will consider candidates nominated by shareholders and, if so, the evaluation process for those candidates;

- the nominating committee’s process for identifying and evaluating director candidates and whether the process is different for candidates submitted by shareholders;

- a statement of any specific minimum qualifications that the nominating committee believes that a director nominee must possess;

- a statement of who recommended each nominee (e.g., a shareholder, the CEO, non-management director, other
executive officer, third party search firm or other source;

- whether the company pays a fee to any third party to identify or assist in identifying and evaluating nominees;

- if the nominating committee received a director candidate from a shareholder (or group) who beneficially owned more than 5% of the company’s shares for one year (and the shareholder or group consent to such disclosure), the identity of the shareholder (or group) and the candidate and whether the nominating committee chose to nominate the candidate;

- whether the board has a process for shareholders to communicate with the board and, if not, why not;

- the procedures through which shareholders may communicate with the board or individual directors, including a description of any screening process; and

- a description of the company’s policy regarding director attendance at the annual meeting and a statement of the number of directors who attended the prior year’s annual meeting.

5. **Schedules 13D and 13G** – The forms required to be filed by persons acquiring beneficially more than 5% of a company’s equity securities. The short form Schedule 13G may be used by
"passive" investors who own less than 20% of an equity security or by qualified institutional investors.

a. Initial Schedule 13D or 13G must be filed within 10 days after the initial acquisition which created beneficial ownership of more than 5%. However, a qualified institutional investor must file only within 45 days after the calendar year in which it holds more than 5%, calculated as of the year end, or within 10 days after the end of the first month in which the beneficial ownership exceeds 10%, calculated as of the end of the month.

b. Schedule 13D must be amended promptly to reflect any material change, including a change in investment purpose. An acquisition or disposition equal to 1% or more of the class is deemed a material change (less than 1% may be material depending on the circumstances).

c. Schedule 13G must be amended within 45 days after the end of the calendar year to report any change in information. Also, an amendment must be filed promptly upon beneficial ownership exceeding 10% (calculated as of the end of the month for qualified institutional investors) and thereafter promptly upon beneficial ownership increasing or decreasing more than 5% (calculated as
of the end of the month for qualified institutional investors).

6. **Schedule 13E-3** – The form required to be filed by an issuer engaging in a "going-private" transaction.

a. A "going-private" transaction includes any of the following which has a reasonable likelihood or purpose of causing any class of the issuer’s equity securities which is subject to Section 12(g) or 15(d) of the Exchange Act to be held of record by less than 300 persons or causing any class of the issuer’s equity securities which is listed on a national securities exchange or authorized to be quoted on an inter-dealer quotation system of a registered national securities association to be neither listed nor authorized to be quoted:

(i) A purchase of any equity security by its issuer or an affiliate.

(ii) A tender offer (or request for tenders) for any equity securities by its issuer or an affiliate.

(iii) A solicitation subject to Regulation 14A of any proxy, consent or authorization of, or a distribution subject to Regulation 14C of information statements to, any equity security holder by the issuer (or affiliate) of the class of securities in connection with a
merger, consolidation, reclassification or similar transaction of an issuer or between an issuer and its affiliates, or a sale of substantially all of the issuer's assets to its affiliate or a reverse stock split of any class of the issuer's equity securities involving the purchase of fractional interests.

b. If the "going-private" transaction also involves an issuer or third-party tender offer, the information required by Schedule 13E-3 may be filed under cover of a Schedule TO (see II.B.7. below).

7. Schedule TO – The form required to be filed by a company engaging in a self-tender or by persons engaging in a tender offer which would result in the bidder's beneficially owning more than 5% of the class of securities for which the tender is made.

a. Must file as soon as practicable on the date that the tender offer commences, which is the date the means to tender has been first published, sent or given to security holders.

b. Schedule TO combines former Schedules 13E-4 and 14D-1 (formerly used for issuer and third-party tender offers, respectively). One filing on Schedule TO also will satisfy both the tender offer and going-private disclosure requirements.
c. Schedule TO's specific line items refer to applicable provisions of Regulation M-A.

d. Information may be incorporated by reference from documents previously filed with the SEC on EDGAR without refileing that information as an exhibit.

e. Filers no longer need to answer each item with a statement that the required information is incorporated by reference from certain pages or sections of the primary disclosure document. Instead, it is sufficient to include a general statement that all information in the disclosure document filed as an exhibit is incorporated by reference in answer to some or all of the items in the Schedule.

8. **Schedule 14D-9** – The form required to be filed in connection with a solicitation or recommendation by certain persons to security holders with respect to a tender offer. Must be filed as soon as practicable on the date the solicitation or recommendation is first published or sent or given to security holders.

9. **Forms 3, 4 and 5** - The basic reporting forms required to be filed by those persons subject to Section 16 of the Exchange Act.

a. Form 3 is required to be filed within 10 days of a person becoming a director, executive officer or greater than 10% shareholder.
b. A Form 4 must be filed by the second business day in which there is a change in the security holdings of a director, executive officer or 10% shareholder.

c. A Form 5 now is used primarily to report transactions involving gifts, inheritances and small acquisitions. It must be filed within 45 days after the end of a company's fiscal year.

d. Although these are not the company's reports, the company must monitor them because it is required to report delinquent filers in its proxy materials (under a prominent caption) and Annual Report on Form 10-K and indicate such disclosure being present by leaving unchecked the box on the front cover of the 10-K. (Item 405, Regulation S-K).

e. In Release No. 33-8230 (May 7, 2003), the SEC adopted rules that require electronic filing with the SEC of Forms 3, 4 and 5 as well as Internet website posting or equivalent availability of these forms by companies with corporate websites.

10. Exhibits - Item 601 of Regulation S-K specifies the exhibits that must accompany each form other than Schedules 13E-3, TO and 14D-9, each of which refer to particular exhibits set forth in Item 1016 of Regulation M-A.

C. Interrelationship with the Securities Act of 1933.
1. **Short form registration statements.**
   
a. Integrated disclosure system allows incorporation by reference of Exchange Act reports into Securities Act registration statements provided that the company has been subject to the Exchange Act for a sufficient period of time and has timely filed its reports.

b. These principally would be Form S-2, S-3, S-4 and S-8.

2. **Regulation D.**
   
a. Reporting companies may not use Rule 504 (sales of $1,000,000 or less).

b. When using Rules 505 and 506, the company may satisfy the information requirements of Regulation D with its Exchange Act reports.

3. **Rule 701.** Rule 701 (exemption for securities being offered to employees) is not available to a reporting company. Note, however, that if a company becomes public after having issued securities pursuant to Rule 701, holders of these restricted securities may sell 90 days after the issuer becomes subject to the Exchange Act reporting requirements.

4. **Rule 144.** Current public information requirement of Rule 144(c) is met if the company is subject to the Exchange Act and has filed all reports thereunder. This is verified by checking the company's most recent filing (10-Q or 10-K)
to see if the appropriate box is checked on the front cover.

5. **Rule (and Form) 12b-25.** Simply note that 12b-25 is not a filing extension. It is notice of a late filing and one must consider the consequences of this while the filing is outstanding. Late filing affects the company's ability to use short form registration statements and the availability of Rule 144 under the Securities Act. 12b-25 does not apply to Current Reports on Form 8-K.

6. Also note effects of the National Securities Markets Improvement Act of 1996, which preempts state regulatory authority over registration with respect to four broad classes of securities, including NYSE, AMEX, and NASDAQ/NMS securities.

III. **MANAGEMENT’S DISCUSSION AND ANALYSIS**

A. **Purpose of MD&A - MD&A**, the requirements for which are set forth in Item 303 of Regulation S-K, is required in Securities Act registration statements and Exchange Act reports. It requires the company to discuss historical performance and current financial condition. It also requires certain information as to trends, uncertainties and other circumstances that may have a material effect upon the company in the future. In Securities Act registrations, the MD&A complements "risk factor" disclosure. In Exchange Act periodic reporting, disclosure of business risks or uncertainties is increasingly a function of the MD&A. In its 1987 and 1989 releases on the subject, the Commission gave the following reasons for an MD&A requirement:
A Little Privacy, Please

More small outfits are deciding that being a public company isn't worth the hassle

JOHN A. CATSIMATIDIS, chairman and chief executive of New York-based supermarket chain Gristede's Foods Inc., is fed up with the headaches of running a listed company valued at a mere $16 million. He is sick of begging for attention from investors and bankers interested only in the market's big boys. And he's tired of the soaring cost of complying with all the new regulations governing public companies. "We'll just take the company private," he says.

Just when investors and bankers are counting on Google Inc. to bring the good times back to the market for initial public offerings, a slew of small fry have decided that being a public company isn't really worth it. Bankers expect a record number of U.S. companies to go private this year, topping last year's 86. Three years ago, only 53 did. Some outfits aren't even bothering to go public in the first place. Says Mark A. Filippelli, a senior managing director in investment banking at Cleveland-based KeyCorp: "Many entrepreneurs no longer dream of going public because they see the hassle outweighing the potential benefits."

ROUGH FOR THE LITTLE GUYS

Life has become a lot rougher for the listed little guys. Many are ending up in the stock-market version of a no-man's-land: out of sight of most investors but forced to shoulder the same expensive regulatory burdens as big companies.

As institutional investors increasingly call the shots, investment banks see much less of a need to provide research on small caps, depressing their share prices even more. "If you have a market cap of under $200 million, no one will watch you," says Dan T. Moore III, who decided to sell his company, Advanced Ceramics, to General Electric Co. in November, 2002, rather than take it public. Generally, only two analysts follow any company with a market cap of $170 million to $200 million, while 14 analysts issue research reports on companies valued at more than $7.5 billion, according to a study by KeyCorp. For many small companies, the situation is worse: No analysts cover them, and in some cases, they even pay research firms to issue reports on them.

At the same time, the rising cost of staying public makes going private seem even more attractive. Chicago law firm Foley & Lardner LLP estimates that the requirements imposed by the 2002 Sarbanes-Oxley corporate-governance law, new Securities & Exchange Commission rules, and stock-exchange listing requirements have doubled regulatory outlays since 2002, to an average of $2.3 million for companies with market caps under $900 million. And "there are more costs coming down the pipeline," says Ian Cookson, a corporate finance director at Chicago-based consultant Grant Thornton LLP, as new regulations are phased in. These include requiring companies to document their internal-control procedures for everything that
Reversing Course

Many small and midsize companies are being pushed out of the stock market because:

- New legislation such as Sarbanes-Oxley is sharply raising the cost of being a public company
- Investment banks are cutting back research on smaller companies, which limits their trading and depresses their value
- Stock markets are increasingly dominated by institutional investors, who shun smaller companies because it's hard to trade big blocks of shares
- A growing amount of capital is now available from private sources

the stock market by pension funds and other institutional investors, they're being welcomed by private-equity firms standing ready with financing raised from many of the very same institutional investors. The buyout firms are flush with cash, having raised an unprecedented $100 billion to invest in the past several years on top of easily available debt financing. "You have a combination of more private money than ever and more companies that don't see the value of being public anymore," says Steven M. Bernard, director of merger-and-acquisition market analysis at Milwaukee investment bank Robert W. Baird & Co.

Now, small companies are trading at a steep discount to larger ones

More than two-thirds of the deals involving companies going private since mid-2002 were management buyouts, generally funded by private-equity firms, according to Grant Thornton. In many cases, the buyout crowd plans to dress the companies up for deals, or perhaps eventually take them public again.

Armed with plenty of financing options, some smaller private companies are resisting the lure of raising quick and cheap money by going public. As a result, the average size of an IPO is mushrooming. And over the past two years, the median annual sales of a company going public have reached $164 million, up from $15 million in 1999 and 2000, according to Jay R. Ritter, a finance professor at the University of Florida. Companies such as Xcel Pharmaceuticals Inc. want to bulk up their product lines and operations before making a debut.

"While we desire to be public, it's not an absolute necessity," says Michael T. Borer, CEO of Xcel, which pulled its IPO in April.

Even bigger companies are staying away from the IPO route. Arthur F. Anton, president and CEO of component manufacturer Swagelok Co., a Cleveland company that boasts roughly $1 billion in annual sales, says he gets pitches from investment bankers all the time, but an IPO doesn't appeal to him, especially as regulatory costs rise. "Our whole philosophy is built around doing things for the long term," he says. "It just becomes a lot harder to manage [if you are public]. You can't pick your shareholders."

BACK TO NORMAL

Of course, there's little doubt that many of the companies taken public in the late '90s should probably not have gone that route, given that many were not even profitable. And investors are certainly better off not getting trapped in publicly traded zombies. "We've gone from one extreme to another, and we're getting back to normal," says the University of Florida's Ritter.

Still, what's normal looks to be different as more small companies find happiness by remaining or becoming private outfits. Gristede's, whose stock has steadily slipped from around $3.50 to 85¢ a share on the American Stock Exchange since 1995, is in the midst of an offering to buy back its shares. Only a chance to make a huge acquisition that would catapult his company into the big leagues would tempt CEO Catsimatidis to reconsider. But then he would be a big guy, and that offers little comfort to small outfits.

-By Emily Thornton in New York

May 24, 2004 | BusinessWeek | 75
BY ROBERT BARKER

When Companies ‘Go Dark,’ Investors Can Lose

At 37 minutes past 6 p.m. on Apr. 27, Niagara Corp. filed its quarterly profit report. The steelmaker, which took in revenues of $295 million in 2003, is little-known yet in some ways extraordinary. For one, Niagara enjoys solid standing with Detroit, which uses its specialty bars for such critical systems as steering racks. For another, its headquarters can be found within one of Manhattan’s most elegant towers, 667 Madison Ave. And, after years of tough industry conditions, the financial news from Niagara’s home office that day was most special: First-quarter sales had risen 24%, while earnings per share doubled. CEO Michael Scharf pronounced the results “excellent.”

INVESTORS, WHO HAVE TRADED Niagara shares since Scharf took it public in 1993, had to be delighted. They also had no time to celebrate. Nine minutes later, Niagara filed notice that it would deregister its stock with the Securities & Exchange Commission, stop filing public reports and proxy statements, and delist from NASDAQ. Trading over the counter, the stock plunged and lately rests about 30% lower, near $3.64 (chart).

This nightmare is growing. Two University of Alberta economists, Nadia Massoud and Andras Marosi, combed SEC filings and counted 135 deregistrations unrelated to mergers last year, up from 46 in 2001 and 75 in 2002. In a 36-stock sample, they also found that stocks lost an average of more than 12% within two trading days of deregistration news. “It’s a mystery to me why the SEC is not focusing on this,” said Nelson Obus, president of Wynnefield Capital, which owns 6% of Niagara. “It’s a cancer in the confidence that has to exist between management and investors.” Companies may deregister, or “go dark,” if they have fewer than 300 shareholders of record ($500 if assets fall below $10 million). With $186 million in assets, Niagara had 124 shareholders of record, but it likely has more actual holders because many accounts are in brokers’ names. This criterion for deregistration is being challenged by a group of investors who last July petitioned the SEC to count ultimate shareholders, not just registered ones, in permitting companies to go dark. SEC staffs are still studying the issue.

Why would Niagara deregister? Scharf’s critics see him as an excellent operating executive with a stellar record of delivering big gains to investors in earlier metals companies. But some speculate that Scharf aims to depress its value, buy a majority, and perhaps take over the company for a song. He owns 37% of the stock, and a brother, Gilbert, owns another 7%. Others worry that Scharf, who in 2003 received a salary and bonus of $880,000, up from $680,000 in 2002 and $480,000 in 2001, will enrich himself now that Niagara need not disclose executive pay.

Scharf told me none of these worries is valid. “I create shareholder value—that’s what I try to do,” he said. Instead, driving Niagara’s decision were the rising costs of staying public under the Sarbanes-Oxley Act and other new rules. Scharf was vague, however, about his estimate of the cost of staying public, putting it at “hundreds of thousands of dollars on an annual basis.” This seems small next to the $10 million in market value Niagara lost the week it quit NASDAQ. Scharf also said he did not know how many investors own the stock, even though public companies use such a count in mailing proxies. Finally, he would not elaborate on how much weight Niagara’s board gave a NASDAQ rule that this year would have forced it to have a majority of independent directors. It has six directors, with just three independent. One, Andrew Heyer, did not return my calls, and Scharf declined to help me reach the other two. “I am the spokesman,” he said.

What should you make of all this? First, small-cap stocks have had a great run, but the risk of sudden deregistration is growing. Second, with vast disclosures and SEC scrutiny, it’s no snap for a company to issue stock and take the public’s money. But once public, it shouldn’t be a snap to go dark.
SECURITIES MARKETS

The AIM Market: Special Considerations for US Companies

The London Stock Exchange’s Alternative Investment Market, or AIM, has recently surfaced as an alternative means for US emerging growth companies to access public capital markets—with an international flavor. An overseas “placing” and “flotation” on AIM is a markedly different experience than the traditional initial public offering in the United States and listing on a US stock exchange.

by Thomas J. Hall

A confluence of circumstances has led US-based companies to seek alternative sources of capital and alternative means to becoming publicly traded. Perhaps most important is the significantly increased cost to operate as a public company in the United States as a result of the Sarbanes-Oxley Act of 2002 and other regulatory changes. In addition, market forces continue to dictate a higher bar for companies to go public in the United States in terms of their business and financial track records. Globalization of US businesses also has intensified as companies seek greater growth opportunities and as they face greater competition from companies with global operations. One alternative that has emerged in recent years is the London Stock Exchange’s Alternative Investment Market (AIM).

The London Stock Exchange established AIM in 1995 to cater to small and mid-cap companies. There are currently more than 1,200 companies whose securities are traded on AIM, with a surge in new admissions since 2004 driven largely by an influx of international (non-UK) companies.1 In particular, since 2004, in excess of 30 US-based companies have been admitted to AIM. Although collective market capitalizations of companies listed on AIM has more than doubled since 2004,2 AIM is still heavily geared towards emerging growth companies. The average market capitalization of companies trading on AIM is below $100 million, while the average market capitalization of companies listed on the Nasdaq National Market is above $1 billion.3

AIM offers several advantages to US companies seeking access to public markets, two of which predominate. First, investor expectations and the admission criteria for flotation on AIM are lower than for a traditional US initial public offering. The AIM investor base targets investments in small and mid-cap companies, and AIM does not require companies to meet minimum market capitalization or financial thresholds as a condition to admission. Accordingly, many of the US companies that have recently gained admission to AIM were at an earlier stage of development than is typically required to attract the interest of US-based underwriters and public investors and to qualify for listing on the Nasdaq National Market. Second, the “market-based” regulatory regime that applies to companies admitted to AIM allows for a more flexible, less expensive approach to corporate governance that is better suited to small and mid-cap companies than the Sarbanes-Oxley Act of 2002 (which in most cases will not apply to US-based AIM companies) and the corporate governance requirements of US stock exchanges. Similarly, AIM imposes less onerous ongoing public reporting requirements, which allow companies to focus more on long-term growth without the expense and time required to comply with SEC reporting requirements.

Conversely, AIM does not present the same assortment of benefits as does listing on a US stock exchange. While AIM provides companies with a source of capital investment at valuations that may exceed valuations from venture capitalists or private equity investors in the United States, companies seeking admission to AIM (many of which are at earlier stages of development) should not expect to receive valuations as high as those that

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companies listing on a US stock exchange might command. Further, companies seeking a “liquidity event” may conclude that AIM will not fully meet this objective both because of the lower valuation of the company and the relatively low trading volumes on AIM (although trading volumes have increased over the past few years). Lower trading volumes can be attributable in part to what might be considered a key difference between AIM and US offerings: AIM offerings are often made to a small base of institutional investors, and many AIM investors are known for adopting a longer-term investment strategy than the retail investors associated with many US public offerings. As a result and because company insiders and substantial shareholders are sometimes requested to commit to longer “lock-in” restrictions against trading than is customary in US offerings, it can be difficult for employees and other shareholders to sell shares in the secondary market.

Regulatory Regime
Market-Based Regulation—The Nomad

Perhaps the most significant difference between admission of a company’s stock for trading on AIM (also known as “flotation”) and listing on a US stock exchange is AIM’s market-based regulatory scheme. While AIM promulgates rules that create a baseline regulatory framework, AIM companies are largely free from securities law oversight by regulatory authorities. Instead, AIM companies are required to be sponsored by a nominated advisor, or “Nomad.” The Nomad is similar to a lead underwriter, and is often an investment bank. Only a selected pool of advisors approved by the London Stock Exchange can act as a Nomad.

The primary roles of the Nomad are to assess the suitability of a company for admission to AIM and to certify to the London Stock Exchange that the company and its shares are appropriate for admission. The Nomad will assess suitability based on a variety of factors, including revenue and earnings, projected financial performance and growth potential, the company’s market sector and board and management team experience. The Nomad will also often consider whether the company has a connection to the United Kingdom or greater Europe, including existing operations or sales, or a European growth strategy following admission. The Nomad also helps prepare an admission document and advises the company on compliance with AIM rules and on meeting the expectations of investors, both during the admission process and on an on-going basis thereafter. This approach allows the Nomad to establish corporate governance and other compliance measures that are tailored to the circumstances of each individual company, and also provides the Nomad flexibility to adapt these standards to meet shifting regulatory and market demands.

A company must also enlist a broker. The broker assists with the roadshow for the offering, and brings together buyers and sellers of the shares to facilitate an orderly secondary trading market. In practice, companies generally select one investment firm to serve both the Nomad and broker roles.

Selection of a Nomad is a critical milestone for a company, both due to the ongoing partnership and because the ability of the Nomad to successfully market the deal may in some cases be more relationship-based...
than in US offerings. A Nomad will typically require an engagement letter up front that defines its roles, may provide for exclusivity in the working relationship (e.g., future transactions), specifies the critical economic terms and provides for indemnification by the company. Nomads will typically receive a commission based on shares sold, a cash fee with admission to AIM, an annual retainer, and a warrant to purchase company shares. By contrast, US underwriters often do not require a formal engagement until an underwriting agreement is signed at the pricing of the deal, and typically only receive a discount and commission on the shares sold. Companies are strongly advised to conduct in depth interviews with multiple Nomads before a selection is made, and to work with experienced counsel to ensure that the correct questions are asked up front.

Public Offering Rules

Securities offerings by US companies in connection with admission to AIM (known as “placings”) are not registered with the US Securities and Exchange Commission (SEC) or any other regulatory agency. Instead, US companies typically conduct placings in reliance on Regulation S under the Securities Act of 1933 (1933 Act). Regulation S provides that offers and sales of securities will not be subject to Section 5 of the 1933 Act so long as: (1) the offer and sale is made in an “offshore transaction”; (2) neither the company, the Nomad/broker nor related parties make “directed selling efforts” in the United States; and (3) offers and sales by the company are not made to US persons. Notwithstanding these prohibitions, companies may also offer and sell securities to US purchasers in a concurrent “private placement” transaction under Regulation D, subject to the prohibition against “general solicitation” in that regulation.

Shares issued by a US company in a placing are required to bear a restrictive legend for at least one year, and possibly two years or more, following the placing and must be resold in compliance with Regulation S or another available exemption under the 1933 Act. While these restrictions will generally not prohibit immediate resale over AIM of the shares issued in the initial placing, the legend requirement may impact the marketability of the shares. Trades of shares on AIM generally are made through CREST, a paperless settlement procedure that enables electronic transfer. However, the CREST system is not currently set up to handle legended securities issued by non-UK companies, so legended shares must be held in certificated form. Investors have been known to place “buy” orders only for “clean” shares, which in the past has resulted in legended shares trading at a discount to unlegended shares, and in some cases may lead to delays in finding buyers for legended shares.

One other important effect of Regulation S, both with respect to the initial placing and secondary trading, is the publicity restrictions on the company and the Nomad that arise out of the restriction against “directed selling efforts” in the United States under Regulation S. Companies, sellers of stock in the secondary market and their brokers are required to avoid activity that could reasonably be expected to encourage interest in the stock in the United States. These restrictions on publicity apply to the company during the course of the offering, and for one year following the offering in many cases. They can also hamper the ability of the broker to publicize the stock after the offering, because the broker may in many cases handle secondary trades. These restrictions do not apply to ordinary course commercial announcements, and are not as limiting with respect to publicity outside of the United States. However, limiting publicity in the United States may undermine some of the benefit of going public on AIM for US companies, and taken together with the compliance challenges posed by increasingly global communications, these rules are somewhat incongruous with the process of an overseas public offering.

Admission Document and Director Liability

A central component of the admission process, the admission document, is a key source of liability to the company and its directors. As noted, the

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Coming Attractions

- New NASD corporate financing rules
- Use of hedge fund materials by broker-dealers
- Foreign investment in the United States

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admission document is not required to be filed with the SEC, and is generally not required to be filed with any UK regulatory authority,\textsuperscript{10} for review or approval. However, the admission document is subject to the disclosure requirements mandated by the AIM rules. These rules are narrower both in scope and in length than the 1933 Act disclosure requirements for a registration statement. Thus, the admission document is a shorter and slightly less formal version of a US-style prospectus. Standard sections include a description of the business, information about management and the company’s corporate governance, risk factors, audited financial statements, and disclosure regarding the company’s capitalization and material agreements.

Directors of a US company face potential civil and criminal liability under UK securities laws (the Financial Services and Markets Act 2000) for misleading statements and omissions in the admission document. Directors of a US company also have exposure under US securities laws, likely even to overseas investors.\textsuperscript{11} In particular, offers and sales of securities are subject to Rule 10b-5 under the Securities Exchange Act of 1934 (1934 Act), which prohibits misleading statements and omissions. Directors’ and officers’ insurance policies are available to US companies listing on AIM and should be obtained during the admission process.

**Corporate Governance Regulation**

The Sarbanes-Oxley Act of 2002 (SOX) will in many cases not apply to US companies that are admitted to AIM. US companies that are not required to register under the 1934 Act (i.e., US companies with fewer than 500 holders of a class of securities or less than $10 million of assets as of the end of a fiscal year) generally are not required to comply with SOX. While international shareholders count towards the 500 shareholder limit, AIM placings are often made to a small number of investors, and therefore might not push a company above the threshold for 1934 Act registration and SOX. However, secondary trading of a company’s shares over AIM will lead to an increase in the number of shareholders,\textsuperscript{12} so US companies admitted to AIM must track the number of shareholders closely to ensure that they do not come within the scope of the 1934 Act and SOX in the future.

While the UK’s Combined Code on Corporate Governance applies to “Official List” companies traded on the London Stock Exchange, it does not apply to AIM companies. In addition, the Quoted Companies Alliance (QCA), a non-profit organization, released corporate governance principles for AIM companies that serve as another non-binding reference point. A Nomad will typically recommend or require that the company adopt selected components of the Combined Code or QCA principles, or otherwise adopt corporate governance practices that are customary for the United Kingdom and that will make the shares more marketable to AIM investors. Some of these practices are discussed here.

**Financial Statements**

Currently, US companies applying for admission to AIM have the option of reporting financial results in accordance with US GAAP or UK GAAP. Beginning with fiscal years commencing on or after January 1, 2007, AIM companies will be required to prepare financial statements in accordance with International Financial Reporting Standards (IFRS). IFRS is a set of accounting standards that is designed to be used around the world as a global standard. While large audit firms are familiar with this new set of standards, this change will likely result in additional effort and cost on the part of the company and its particular audit team in applying these new standards to the company, may require changes in business practices and may lead to a greater incidence of restatements during the first few years.

**Process Considerations**

Overall, the process for admission to AIM and placing shares potentially can be much shorter than the US initial public offering process, due to the absence of regulatory review and comment on the admission document and financial statements. Nevertheless, this process still typically ranges from three to six months in duration. Two critical timing variables are the availability of audited financial statements and recruitment of new members to the company’s board of directors to meet UK residency and independence recommendations by the Nomad. In addition, many of the US companies that have been admitted to AIM to date have opened an office in the United Kingdom and formed a UK parent holding company. While this approach will not be
conducive to all businesses, it can assist in terms of marketing the company to UK investors and (in some circumstances) may help qualify the company as a “foreign private issuer” under the US securities laws, which can reduce the company’s obligations under Regulation S and the risk that the company may become subject to SOX in the future.

The initial working group will typically consist of the company, its auditors, its counsel, the Nomad, and the Nomad’s counsel. The company typically will need to engage both US and UK counsel to navigate the securities and corporate law issues involved in each jurisdiction. Later in the process, the company also will need to choose a transfer agent experienced with AIM, as well as a public relations firm to assist with overseas publicity.

The initial phase of the process typically centers on financial and legal due diligence. The due diligence phase can be more process-oriented than what is customary for an initial public offering in the United States, and results in a greater number of deliverables and may make smaller AIM offerings impractical due to the transaction fees involved. For example, the AIM process, unlike the US offering process, often entails the following deliverables:

- **Long-Form Due Diligence Report.** This consists of a detailed commercial and financial analysis of the company’s business prepared by the company’s auditors.
- **Working Capital Report and Comfort Letters.** The company is required to attest as to the adequacy of its working capital in the admission document. To support this, the Nomad may request that the company’s auditors prepare a working capital report and that both the auditors and the company deliver working capital comfort letters to the Nomad. The Nomad may also request additional comfort letters from the company and the auditors, such as letters regarding the company’s financial reporting procedures.
- **Verification Notes.** The Nomad and the company’s UK counsel will prepare an extensive set of questions requiring written responses from the company’s board and senior management to provide backup for virtually all of the statements in the admission document.
- **Legal Due Diligence Report.** A significant difference between the UK and US process is that the company’s counsel performs substantially all of the due diligence on the company on behalf of the Nomad. The process culminates with a detailed report executed and delivered by the company’s US counsel to the Nomad, and “Rule 39” comfort letters delivered by the company and its US and UK counsel to the Nomad.

The working group will prepare a prospectus-style document that serves both as an offering document for purposes of the placing and as an admission document for the application to AIM. While international travel and the more informal nature of the process do not support the series of in-person drafting sessions typical of a US offering, the working group should meet for an in-person drafting session at least once, both to work through disclosure issues and to facilitate the due diligence efforts of the Nomad.

The Nomad will typically insist that some or all of the company’s shareholders enter into “lock-in” agreements that prohibit secondary sales for a period of time following the placing. Unlike the 180-day lockup that has become standard in US offerings, the parameters of lock-ins are often tailored to a company’s circumstances and are established through negotiation between the Nomad, the company and its shareholders. In addition, the AIM rules further mandate that, for businesses that have not generated revenue for at least two years, substantial shareholders, directors and certain employees enter into one-year lock-in agreements. The market stand-off agreements often employed by US companies, which normally would obligate shareholders to enter into lockups, often are not drafted broadly enough to apply to AIM offerings.

The AIM process is also marked by a significant number of agreements and closing documents. The company will enter into a Placing Agreement (similar to an underwriting agreement) and a Nomad and Broker Agreement, which supersedes the initial engagement letter. The closing is marked by delivery of several comfort letters, certificates and other documents among the parties, and can be more process-intensive than the typical closing of a US offering.
A few weeks before admission, the Nomad and company representatives embark on a roadshow that is similar to the US offering process. The roadshow may range from a few days to two weeks in duration, depending on the size of the overseas placing and whether the company is conducting a concurrent private placement in the United States. The company arranges for a glossy version of the admission document to be printed by a financial printer for distribution during the roadshow. This version, which is known as a "Pathfinder Prospectus," excludes pricing-related information but otherwise is essentially the same as the final admission document. Following the roadshow, the company will release a 10 business day advance notice of its intention to apply for admission to AIM.

In the last phase of the process, the company and the Nomad establish a final offering price by evaluating market demand, and circulate "placing letters" that are executed by investors. The Nomad then files a brief application to AIM, which includes its declaration regarding the company's suitability for admission and the final admission document. After a three business day period, the company is admitted and trading commences, followed by closing of the placing.

The Challenge of Different Cultures and Practices

Differences in law, custom and culture may present challenges throughout the AIM admission process. The experience of the Nomad with US companies is critical in this regard. As a result of these cultural differences, the Nomad will likely request the company to make changes in its corporate structure and practices to conform with UK practices.

Non-Litigious Environment

US companies may take some comfort in the widely-held perspective that the United Kingdom is not nearly as litigious as the United States when it comes to securities law matters. However, Nomads based in the United Kingdom are accustomed to receiving broader protections in the form of warranties, covenants, and indemnities (in the relevant transaction documents) than are typically requested by US underwriters. This difference in perspectives can lead to challenging negotiations between the parties.

Transaction Fees

The transaction fees involved with a placing and admission to AIM, while typically lower than for US public offerings, may dampen the benefits of admission, companies, particularly if the amount being raised is relatively small (e.g., less than $25 million). UK financial and legal advisors may have culturally different views in terms of process and the level of formality required than is customary in US practice, which taken together with the higher billing rates that UK legal advisors often charge, may contribute to higher transaction fees. These factors may mitigate the cost savings otherwise achieved as a result of not having to go through the SEC review process.

Capitalization Structure

While AIM rules do not prohibit preferred stock, the Nomad may recommend or require that outstanding preferred stock be converted into common stock in order to facilitate marketing of the offering. The use of preferred stock is much more common with US companies than with UK companies. The terms of US company preferred stock are unlikely to provide for automatic conversion to common stock at the closing of an AIM placing, whereas preferred stock typically converts to common stock automatically in a US offering above negotiated price and amount thresholds. Accordingly, the consent of preferred shareholders will be required for conversion (and in essence to move forward with the offering and admission), and depending on valuation and the anticipated restrictions on the ability of shareholders to liquidate their position, this may lead to a challenging negotiation with shareholders.

The corporate finance community in the United Kingdom also views a company's fully-diluted capitalization differently in some respects than is customary in the United States. One byproduct of this is that the Nomad will require that the company establish limits in its stock option plans on the granting of options following admission relative to the company's outstanding shares (although options granted prior to admission are not factored into this equation). Also, if preferred stock does remain outstanding, these shares will not be reflected in the market capitalization of the company that is reported on the AIM system or many brokers' systems.
Corporate Governance

A fundamental difference between US and UK corporate entities is that the governance of a UK public limited company is not divided between a board of directors and executive officers. Instead, the directors of a UK plc serve both roles. This cultural difference may lead to misconceptions regarding roles, compensation arrangements, and other matters.

As noted, a company seeking admission to AIM will not face the same corporate governance requirements as a company seeking to list on a US stock exchange. For instance, the requirement that a majority of the members of the board be independent does not apply, although this is encouraged. The board of a US company likely will be advised to form an audit committee, a compensation (“remuneration”) committee and perhaps a nominating committee, and will be encouraged to populate the first two of these committees solely with independent directors. In many cases, a Nomad will request that the Chairman and Chief Executive Officer positions be split between different persons. One key difference is that, as a prerequisite to moving forward with the Roadshow and admission, the Nomad will likely require that the board of directors include at least one director who is resident in the United Kingdom.

UK companies often include provisions in their charters that impose limits on the ability of the company to incur debt and to issue shares and provide pre-emption rights to shareholders with respect to new issuances of stock. They also are subject to takeover provisions that are more protective of the company than the typical state antitakeover statute in the United States. Accordingly the Nomad may recommend that the company make changes to its charter and bylaws to adopt some of these UK-style provisions to the extent practicable.

Post-Admission Matters
Secondary Market Trading

Secondary trading over AIM requires matching of purchase and sale orders. For AIM companies with low trading volumes, this can result in higher fluctuation in trading prices and delays in execution of purchase or sale orders. As discussed, the requirement to legend share certificates exacerbates the issue due to the paperwork and coordination required to effect trades outside of the CREST electronic settlement system, and the potential for restricted shares to trade at a discount.

The process for effecting trades of US company shares over AIM, including execution of representation letters, has not yet been standardized and may require customization depending on the company’s implementation of Regulation S. US purchasers are not precluded entirely from purchasing shares on AIM in the aftermarket, since they can either purchase unrestricted shares sold by existing shareholders, or can even purchase placing shares so long as certain representations are made by the seller and its broker. Companies must balance the flexibility this approach provides with the simplicity of blocking US purchasers from purchasing Regulation S shares during the first year following the placing. This choice will dictate the process for effecting trades, which must be coordinated with the UK transfer agent and brokers participating in the trading process.

Public Reporting and Shareholder Approval

The ongoing public reporting requirements for AIM companies are substantially less than what is required by the SEC for US public companies. Each AIM company is required to publicly issue and deliver to shareholders audited annual financial statements within six months following the end of each fiscal year, and to publicly issue six-month unaudited financial statements within three months after the end of the first six months period of each fiscal year. Each company also is required to issue public notices “without delay” of certain material developments in the business, changes in expected performance, substantial transactions, related party transactions, changes in the board or of significant shareholders and certain other items. These lesser standards are well-suited for emerging growth companies, as this regulatory approach enables management to focus more on the long-term growth of the business without the distraction and added cost of quarterly reporting and the more extensive disclosure and other obligations required by the SEC, SOX, and US stock exchanges.

Finally, while Nasdaq requires listed companies to obtain shareholder approval for adoption
of most equity compensation plans, significant acquisitions and stock offerings and other events, the AIM rules do not mandate shareholder approval except in limited circumstances (although US state corporate law will still require shareholder approval in some cases).

Conclusion

The AIM market has reached the radar screen of many emerging growth US companies, but is not yet a mainstream path to accessing the capital markets. To date, most US companies that have been admitted to AIM have either had a business model with a clear connection to the United Kingdom or Europe generally, or operate within specific sectors such as mining and natural resources. Whether more US companies will be able to avail themselves of AIM will depend on several factors, including appetite by current AIM investors, broadening of the AIM investor base, increases in AIM trading volumes and endorsement of this path by US venture capitalists. AIM offers the potential for significant efficiencies relative to the US offering process, and while it may not be a substitute for the Nasdaq or New York Stock Exchange, it may provide access for companies that otherwise would not qualify or that cannot afford to become a public company in the United States. For those companies that elect to pursue this avenue, the choice of a Nomad and counsel experienced with taking US companies public on AIM is critical to a successful placing and admission process.

NOTES

1. According to AIM, there were 61 non-UK companies admitted to AIM in 2004, 120 in 2005, and 41 through April 30, 2006, compared to an average of just over 10 international companies admitted per year from 1995 to 2003.
2. Based on statistics provided by AIM through April 2006.
3. Based on statistics provided by a nominated advisor, by AIM, and by The Nasdaq Stock Market through April 2006.
4. A substantial percentage of companies are admitted to AIM without concurrently raising capital through a securities offering. However, this article is geared towards US companies that, in many cases, are likely to be considering AIM in large part due to the ability to raise growth capital.
5. Equity offerings by companies incorporated in the United States must meet the conditions specified in "Category 3" of Rule 903 of Regulation S. Lesser restrictions apply in the case of offerings under "Category 1" (only available to foreign issuers) and "Category 2" (available to foreign issuers or with respect to debt offerings by US reporting issuers) of Rule 903.
6. Shares issued in a "Category 3" offering under Rule 903 of Regulation S are required to bear a Regulation S legend for one year, but the shares also will be deemed "restricted securities" within the meaning of the 1934 Act and therefore may continue to bear a restrictive legend until the shares become freely tradable without restriction under the Rule 144(k) resale exemption.
7. In May 2006, AIM issued notice of a proposal to migrate trading of Regulation S securities from CREST to SIS, a Swiss-based settlement system. As proposed, this system would essentially prohibit US purchasers from purchasing Regulation S securities. Whether this system is implemented in its proposed form, or at all, will be determined following publication of this article.
8. Conversely, UK securities laws and the AIM rules impose fewer restrictions on companies during the offering process than a company would face during the US public offering process. For example, the broker is allowed to issue a research report on the company during the AIM admission process.
9. These publicity restrictions continue to apply during the one-year period post-admission with respect to "Category 3" offerings under Rule 903.
10. If the placing is deemed to be a public offering under the UK Financial Services and Markets Act 2000, the admission document used to offer the shares must comply with the rules for a formal "prospectus" under UK law, and will be subject to review and approval by the UK Financial Services Authority. However, an offer made to "qualified investors" and to fewer than 100 who are not "qualified investors" will not be deemed a public offering. Because AIM placings are generally made to a small number of institutional investors, these additional requirements typically do not apply.
12. Shares held by investors may be deemed to be held only in street name, with a broker or other entity as a record holder, which can help mitigate this issue.
13. For example, the use of "phased" lock-ins, where different categories of security holders are subject to different lock-in periods, is fairly common. Also, if a Nomad is marketing a company on the basis of a future event (such as regulatory approval) or financial results for a future period, company insiders may be subjected to lock-ins until after that event or release of financial results.
14. The QCA corporate governance principles for AIM companies require that a company have at least two independent directors on the board, that audit, remuneration, and nominating committees be formed, and that the audit and remuneration committees be composed of at least two members, all of whom should be independent.
15. See Rule 902(b). Because AIM is a "designated offshore securities market," so long as neither the seller nor any person acting on its behalf knows that the transaction has been pre-arranged with a buyer in the United States, shares may be purchased by US buyers over AIM.

Nos. 01-1473 & 01-1477

UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

2001 U.S. App. LEXIS 22409

September 28, 2001, Argued
October 17, 2001, Decided


DISPOSITION: Affirmed.

CORE CONCEPTS - Show Concepts


For LENA GALLAGHER, Plaintiff - Appellant (01-1473): Edwin J. Mills, STILL, STULL & BRODY, New York, NY USA. Marvin A. Miller, MILLER, FAUCHER & CAFFERTY, Chicago, IL.

For ABBOTT LABORATORIES, MILES D. WHITE, Defendants - Appellees (01-1477): Thomas M. Durkin, MAYER, BROWN & PLATT, Chicago, IL USA.

For ABBOTT LABORATORIES, MILES D. WHITE, Defendants - Appellees (01-1473): Michele Odorizzi, MAYER, BROWN & PLATT, Chicago, IL USA.


OPINIONBY: Easterbrook

OPINION: Easterbrook, Circuit Judge. Year after year the Food and Drug Administration inspected the Diagnostic Division of Abbott Laboratories, found deficiencies in manufacturing quality control, and issued warnings. The Division made efforts to do better, never to the FDA's satisfaction, but until 1999 the FDA was willing to accept Abbott's promises and remedial steps. On March 17, 1999, the FDA sent Abbott another letter demanding compliance with all regulatory requirements and threatening severe consequences. This could have been read as more saber rattling--Bloomberg News revealed the letter to the financial world in June, and Abbott's stock price did not even quiver---but later developments show that it was more ominous. By September 1999 the FDA was insisting on substantial penalties plus changes in Abbott's methods of doing business. On September 29, 1999, after the markets had closed, Abbott issued a press release describing the FDA's [*2] position, asserting that Abbott was in "substantial" compliance with federal regulations, and revealing that the parties were engaged in settlement talks. Abbott's stock fell more than 6%, from $
40 to $37.50, the next business day. On November 2, 1999, Abbott and the FDA resolved their differences, and a court entered a consent decree requiring Abbott to remove 125 diagnostic products from the market until it had improved its quality control and to pay a $100 million civil fine. Abbott took an accounting charge of $168 million to cover the fine and worthless inventory. The next business day Abbott's stock slumped $3.50, which together with the earlier drop implied that shareholders saw the episode as costing Abbott (in cash plus future compliance costs and lost sales) more than $5 billion. (Neither side has used the capital asset pricing model or any other means to factor market movements out of these price changes, so we take them at face value.)

Plaintiffs in these class actions under §10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and the SEC's Rule 10b-5, 17 C.F.R. § 240.10b-5, contend that Abbott committed [*3] fraud by deferring public revelation. The classes comprise all buyers of Abbott's securities between March 17 and November 2. (One class consists of persons who bought securities in alza, a firm that Abbott proposed to acquire through an exchange of securities and whose market price thus tracked Abbott's. For simplicity we treat these plaintiffs as purchasers of Abbott stock.) The district judge dismissed the complaints under Fed. R. Civ. P. 12(b)(6) for failure to state a claim on which relief may be granted. 140 F. Supp. 2d 894 (N.D. Ill. 2001). The market's non-reaction to Bloomberg's disclosure shows, the judge thought, that the FDA's letter was not by itself material or that the market price had earlier reflected the news, cf. In re Apple Computer Securities Litigation, 886 F.2d 1109 (9th Cir. 1989); Flamm v. Eberstadt, 814 F.2d 1169, 1179-80 (7th Cir. 1987); only later developments contained material information, which Abbott disclosed in September and November. Moreover, the judge concluded, plaintiffs had not identified any false or fraudulent statement by Abbott, as opposed to silence in the face of bad news. We are skeptical that these [*4] shortcomings justify dismissal for failure to state a claim on which relief may be granted; the judge's reasons seem more akin to an invocation of Fed. R. Civ. P. 9(b), which requires fraud to be pleaded with particularity, or the extra pleading requirements for securities cases created by the Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 78u-4(b)(1). But it is not necessary to decide whether Rule 12(b)(6), Rule 12(c), Rule 9(b), or the Reform Act supplies the best basis of decision. Nor is it necessary to decide whether the news was "material" before the FDA's negotiating position stiffened, to decide whether Abbott acted with the state of mind necessary to support liability under Rule 10b-5, or to address other potential stumbling blocks. What sinks plaintiffs' position is their inability to identify any false statement—or for that matter any truthful statement made misleading by the omission of news about the FDA's demands.

Much of plaintiffs' argument reads as if firms have an absolute duty to disclose all information material to stock prices as soon as news comes into their possession. Yet that is not the way the securities laws work. [*5] We do not have a system of continuous disclosure. Instead firms are entitled to keep silent (about good news as well as bad news) unless positive law creates a duty to disclose. See, e.g., Basic, Inc. v. Levinson, 485 U.S. 224, 239 n.17, 99 L. Ed. 2d 194, 108 S. Ct. 978 (1988); Dirks v. SEC, 463 U.S. 646, 653-54, 77 L. Ed. 2d 911, 103 S. Ct. 3255 (1983); Chiarella v. United States, 445 U.S. 222, 227-35, 63 L. Ed. 2d 348, 100 S. Ct. 1108 (1980); Strasky v. Cummins Engine Co., 51 F.3d 1329, 1331 (7th Cir. 1995); Backman v. Polaroid Corp., 910 F.2d 10, 16 (1st Cir. 1990) (en banc). Until the Securities Act of 1933 there was no federal regulation of corporate disclosure. The 1933 Act requires firms to reveal information only when they issue securities, and the duty is owed only to persons who buy from the issuer or an underwriter distributing on its behalf; every other transaction is exempt under § 4, 15 U.S.C. § 77d. (No member of either class contends that he purchased securities from Abbott, or an underwriter on Abbott's behalf, between March 17 and November 2.) Section 13 of the Securities Exchange [*6] Act of 1934, 15 U.S.C. § 78m, adds that the SEC may require issuers to file annual and other periodic reports—with the emphasis on periodic rather than continuous. Section 13 and the implementing regulations contemplate that these reports will be snapshots of the corporation's status on or near the filing date, with updates due not when something
"material" happens, but on the next prescribed filing date.

Regulations implementing § 13 require a comprehensive annual filing, the Form 10-K report, and less extensive quarterly supplements on Form 10-Q. The supplements need not bring up to date everything contained in the annual 10-K report; counsel for the plaintiff classes conceded at oral argument that nothing in Regulation S-K (the SEC's list of required disclosures) requires either an updating of Form 10-K reports more often than annually, or a disclosure in a quarterly Form 10-Q report of information about the firm's regulatory problems. The regulations that provide for disclosures on Form 10-Q tell us which items in the annual report must be updated (a subset of the full list), and how often (quarterly).

Many proposals have been made to do things differently—to [*7] junk this combination of sale-based disclosure with periodic follow-up and replace it with a system under which issuers rather than securities are registered and disclosure must be continuous. E.g., American Law Institute, Federal Securities Code xxvii-xxviii, § 602 & commentary (1978); Securities and Exchange Commission, Report of the Advisory Committee on the Capital Formation and Regulatory Process 9-14, 36-38 (1996). Regulation S-K goes some distance in this direction by defining identical items of disclosure for registration of stock and issuers' subsequent reports, and by authorizing the largest issuers to use their annual 10-K reports as the kernels of registration statements for new securities. But Regulation S-K does not replace periodic with continuous disclosure, and the more ambitious proposals to do this have not been adopted.

The all's proposal, for example, was embraced by the SEC, see 1933 Act Release No. 6242 (Sept. 18, 1980); 1933 Act Release No. 6242 (Jan. 31, 1982), but never seriously pursued, and revisions of Regulation S-K satisfied many of the original supporters of the all's proposal. The advisory committee report, prepared by a distinguished group of scholars [*8] and practitioners under the leadership of Commissioner Steven M.H. Wallman, did not persuade the SEC's other members and was not taken up by the agency as a legislative plan or even as the basis of a demonstration project. Whatever may be said for and against these proposals, they must be understood as projects for legislation (and to a limited extent for the use of the SEC's rulemaking powers); judges have no authority to scoot the political branches and adopt continuous disclosure under the banner of Rule 10b-5. Especially not under that banner, for Rule 10b-5 condemns only fraud; and a corporation does not commit fraud by standing on its rights under a periodic-disclosure system. The Supreme Court has insisted that this judicially created right of action be used only to implement, and not to alter, the rules found in the text of the 1933 and 1934 Acts. See Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 173, 125 L. Ed. 2d 119, 114 S. Ct. 1439 (1994) ("We have refused to allow [private] 10b-5 challenges to conduct not prohibited by the text of the statute."); United States v. O'Hagen, 521 U.S. 642, 651, 138 L. Ed. 2d 724, 117 S. Ct. 2199 (1997). [*9]

Trying to locate some statement that was either false or materially misleading because it did not mention the FDA's position, plaintiffs pointed in the district court to several reports filed or statements made by Abbott before November 2, 1999. All but two of these have fallen by the wayside on appeal. What remain are Abbott's Form 10-K annual report for 1998 filed in March 1999 and an oral statement that Miles White, Abbott's CEO, made at the annual shareholders' meeting the next month.

Plaintiffs rely principally on Item 303(a)(3)(ii) of Regulation S-K, which provides that registration statements and annual 10-K reports must reveal

any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or
The FDA's letter, and its negotiating demands, are within this description, according to the plaintiff classes. We shall assume that this is so. The 10-K report did state that Abbott is "subject to comprehensive government regulation" and that "government regulatory actions can result in . . . sanctions." Plaintiffs say that [*10] this is too general in light of the FDA's letter and Abbott's continuing inability to satisfy the FDA's demands. Again we shall assume that plaintiffs are right. But there is a fundamental problem: The 10-K report was filed on March 9, 1999, and the FDA's letter is dated March 17, eight days later. Unless Abbott had a time machine, it could not have described on March 9 a letter that had yet to be written.

Attempting to surmount this temporal problem, plaintiffs insist that Abbott had a "duty to correct" the 10-K report. Yet a statement may be "corrected" only if it was incorrect when made, and nothing said as of March 9 was incorrect. In order to maintain the difference between periodic-disclosure and continuous-disclosure systems, it is essential to draw a sharp line between duties to correct and duties to update. We drew just this line in Stranisky and adhere to it now. If, for example, the 10-K report had said that Abbott's net income for 1998 was $500 million, and the actual income was $400 million, Abbott would have had to fix the error. But if the 10-K report had projected a net income of $125 million for the first quarter of 1999, and accountants determined in May that the [*11] actual profit was only $100 million, there would have been nothing to correct; a projection is not rendered false when the world turns out otherwise. See Wiegos v. Commonwealth Edison Co., 892 F.2d 509 (7th Cir. 1989). Amending the 10-K report to show the results for 1999 as they came in--or to supply a running narrative of the dispute between Abbott and the FDA--would update the report, not correct it to show Abbott's actual condition as of March 9.

Updating documents has its place in securities law. A registration statement and prospectus for a new issue of securities must be accurate when it is used to sell stock, and not just when it is filed. Section 12(a)(2) of the '33 Act, 15 U.S.C. § 77(a)(2); Regulation S-K, Item 512(a). Material changes in a company's position thus must be reflected in a registration statement promptly. But this does not imply changes in a 10-K annual report, even when that report is used (as it can be with securities registered on Form S-3, or for a shelf offering under Rule 415) as the principal disclosure document. Instead of changing the 10-K report weekly or monthly, the issuer must file and distribute an addendum [*12] to that document bringing matters up to date. See Form S-3, Item 11. Anyway, as we've already mentioned, Abbott did not sell any stock to the class members during the period from March 17 to November 2, 1999.

As for White's statements at the annual meeting: he said very little that was concrete (as opposed to puffery), and everything concrete was true. White said, for example:

The outcome [of our efforts] has been growth more than five times faster than the diagnostics market. We expect this trend to continue for the foreseeable future, due to the unprecedented state of our new product cycle. By supplementing our internal investment with opportunistic technology acquisitions, Abbott's diagnostics pipeline is fuller than ever before.

The statement about past performance was accurate, and the plaintiffs have not given us any reason to doubt that White honestly believed that similar growth would continue, or that White honestly believed "Abbott's diagnostics pipeline [to be] fuller than ever before." Even
with the benefit of hindsight these statements cannot be gainsaid. Here is where Rule 9(b) pinches: Plaintiffs have done nothing to meet the requirements for [*13] pleading fraud with respect to the annual meeting, even if it were possible (which we doubt) to treat as "fraud" the predictive components in White's boosterism. See DiLeo v. Ernst & Young, 901 F.2d 624 (7th Cir. 1990).

Affirmed

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Final Rule: 
Selective Disclosure and Insider Trading

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 240, 243, and 249


RIN 3235-AH82

Selective Disclosure and Insider Trading

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission is adopting new rules to address three issues: the selective disclosure by issuers of material nonpublic information; when insider trading liability arises in connection with a trader's "use" or "knowing possession" of material nonpublic information; and when the breach of a family or other non-business relationship may give rise to liability under the misappropriation theory of insider trading. The rules are designed to promote the full and fair disclosure of information by issuers, and to clarify and enhance existing prohibitions against insider trading.

EFFECTIVE DATE: The new rules and amendments will take effect October 23, 2000.

FOR FURTHER INFORMATION CONTACT: Richard A. Levine, Sharon Zamore, or Jacob Lesser, Office of the General Counsel at (202) 942-0890; Amy Starr, Office of Chief Counsel, Division of Corporation Finance at (202) 942-2900.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission today is adopting new rules: Regulation FD,\(^1\) Rule 10b5-1,\(^2\) and Rule 10b5-2.\(^3\) Additionally, the Commission is adopting amendments to
Selective Disclosure and Insider Trading

Form 8-K.

I. Executive Summary

We are adopting new rules and amendments to address the selective disclosure of material nonpublic information by issuers and to clarify two issues under the law of insider trading. In response to the comments we received on the proposal, we have made several modifications, as discussed below, in the final rules.

Regulation FD (Fair Disclosure) is a new issuer disclosure rule that addresses selective disclosure. The regulation provides that when an issuer, or person acting on its behalf, discloses material nonpublic information to certain enumerated persons (in general, securities market professionals and holders of the issuer's securities who may well trade on the basis of the information), it must make public disclosure of that information. The timing of the required public disclosure depends on whether the selective disclosure was intentional or non-intentional; for an intentional selective disclosure, the issuer must make public disclosure simultaneously; for a non-intentional disclosure, the issuer must make public disclosure promptly. Under the regulation, the required public disclosure may be made by filing or furnishing a Form 8-K, or by another method or combination of methods that is reasonably designed to effect broad, non-exclusionary distribution of the information to the public.

Rule 10b5-1 addresses the issue of when insider trading liability arises in connection with a trader's "use" or "knowing possession" of material nonpublic information. This rule provides that a person trades "on the basis of" material nonpublic information when the person purchases or sells securities while aware of the information. However, the rule also sets forth several affirmative defenses, which we have modified in response to comments, to permit persons to trade in certain circumstances where it is clear that the information was not a factor in the decision to trade.

Rule 10b5-2 addresses the issue of when a breach of a family or other non-business relationship may give rise to liability under the misappropriation theory of insider trading. The rule sets forth three non-exclusive bases for determining that a duty of trust or confidence was owed by a person receiving information, and will provide greater certainty and clarity on this unsettled issue.

II. Selective Disclosure: Regulation FD
A. Background

As discussed in the Proposing Release, we have become increasingly concerned about the selective disclosure of material information by issuers. As reflected in recent publicized reports, many issuers are disclosing important nonpublic information, such as advance warnings of earnings results, to securities analysts or selected institutional investors or both, before making full disclosure of the same information to the general public. Where this has happened, those who were privy to the information beforehand were able to make a profit or avoid a loss at the expense of those kept in the dark.

We believe that the practice of selective disclosure leads to a loss of investor confidence in the integrity of our capital markets. Investors who see a security's price change dramatically and only later are given access to the information responsible for that move rightly question whether they are on a level playing field with market insiders.

Issuer selective disclosure bears a close resemblance in this regard to ordinary "tipping" and insider trading. In both cases, a privileged few gain an informational edge -- and the ability to use that edge to profit -- from their superior access to corporate insiders, rather than from their skill, acumen, or diligence. Likewise, selective disclosure has an adverse impact on market integrity that is similar to the adverse impact from illegal insider trading: investors lose confidence in the fairness of the markets when they know that other participants may exploit "unrealizable informational advantages" derived not from hard work or insights, but from their access to corporate insiders. The economic effects of the two practices are essentially the same. Yet, as a result of judicial interpretations, tipping and insider trading can be severely punished under the antifraud provisions of the federal securities laws, whereas the status of issuer selective disclosure has been considerably less clear.

Regulation FD is also designed to address another threat to the integrity of our markets: the potential for corporate management to treat material information as a commodity to be used to gain or maintain favor with particular analysts or investors. As noted in the Proposing Release, in the absence of a prohibition on selective disclosure, analysts may feel pressured to report favorably about a company or otherwise slant their analysis in order to have continued access to selectively disclosed information. We are concerned, in this regard, with reports that analysts who publish negative
views of an issuer are sometimes excluded by that issuer from calls and meetings to which other analysts are invited.\textsuperscript{8}

Finally, as we also observed in the Proposing Release, technological developments have made it much easier for issuers to disseminate information broadly. Whereas issuers once may have had to rely on analysts to serve as information intermediaries, issuers now can use a variety of methods to communicate directly with the market. In addition to press releases, these methods include, among others, Internet webcasting and teleconferencing. Accordingly, technological limitations no longer provide an excuse for abiding the threats to market integrity that selective disclosure represents.

To address the problem of selective disclosure, we proposed Regulation FD. It targets the practice by establishing new requirements for full and fair disclosure by public companies.

1. Breadth of Comment on the Proposal

The Proposing Release prompted an outpouring of public comment -- nearly 6,000 comment letters.\textsuperscript{9} The vast majority of these commenters consisted of individual investors, who urged -- almost uniformly -- that we adopt Regulation FD. Individual investors expressed frustration with the practice of selective disclosure, believing that it places them at a severe disadvantage in the market. Several cited personal experiences in which they believed they had been disadvantaged by the practice.\textsuperscript{10} Many felt that selective disclosure was indistinguishable from insider trading in its effect on the market and investors, and expressed surprise that existing law did not already prohibit this practice.

Other comments suggested that today's self-directed, online investors do not expect to rely exclusively on research and analysis performed by professionals, as was more common in the past. With advances in information technology, most notably the Internet, information can be communicated to shareholders directly and in real time, without the intervention of an intermediary. This online revolution has created a greater demand, expectation, and need for direct delivery of market information. As many individual commenters noted, under this paradigm, analysts still provide value for investors by using their education, judgment, and expertise to analyze information. On the other hand, investors are rightly concerned with the use of information gatekeepers who merely repeat information that has been selectively disclosed to them.
Noting that analysts predominantly issue "buy" recommendations on covered issuers, investors also made the point that current selective disclosure practices may create conflicts of interest; analysts have an incentive not to make negative statements about an issuer if they fear losing their access to selectively disclosed information. Thus, these commenters suggested that a rule against selective disclosure could lead to more objective and accurate analysis and recommendations from securities analysts.

We also received numerous comments from securities industry participants, issuers, lawyers, media representatives, and professional and trade associations. Almost all of these commenters agreed that selective disclosure of material nonpublic information was inappropriate and supported our goals of promoting broader and fairer disclosure by issuers. Some of these commenters believed the proposal was a generally appropriate way to address the problem of selective disclosure. Many others, however, expressed concerns about the approach of Regulation FD and suggested alternate methods for achieving our goals or recommended various changes to the proposal.

2. Need for Regulation

One fundamental issue raised by these commenters was whether Regulation FD is necessary. Some commenters stated that there is limited anecdotal evidence of selective disclosure. Others suggested that it appears that issuer disclosure practices are generally improving, so that we should refrain from rulemaking at this time, and instead permit practices to evolve and encourage voluntary adherence to "best practices" of disclosure. We do not agree with these views.

It is, of course, difficult to quantify precisely the amount of selective disclosure -- just as it is difficult to quantify precisely the amount of ordinary insider trading. Incidents of selective disclosure, like insider trading, by definition are not conducted openly and in public view. Nevertheless, we have noted numerous media reports in the past two years alleging selective, exclusionary disclosure practices. More generally, surveys of practices of issuer personnel indicate significant acknowledgement of the use of selective disclosure of material information. Based on these public reports, as well as our staff's experience, it is clear to us that the problem of selective disclosure is not limited, as some commenters have suggested, to just a few isolated
Some commenters cited a February 2000 NIRI survey suggesting an improvement in issuer disclosure practices, in that most issuers responding to the survey now are opening certain of their conference calls to individual investors.\textsuperscript{13} To the extent this demonstrates voluntary improvement in response to our efforts to focus attention on the problem,\textsuperscript{14} we believe this is a positive development. However, these voluntary steps, while laudable, have been far from fully effective. We note, for example, that all of the public reports of selective disclosure cited above occurred after the Commission had begun to focus public attention on issuer selective disclosure. Some occurred even after we proposed Regulation FD. This suggests that the problematic practices targeted by Regulation FD are continuing to occur. Finally, the overwhelming support from investors for Regulation FD demonstrates a strong perception among the investing public that selective disclosure is a significant problem, and shows a corresponding need to prohibit this practice in order to bolster investor confidence in the fairness of the disclosure process.

Some commenters contended that rulemaking on this topic was an inappropriately broad response to the issue.\textsuperscript{15} They suggested instead that we use existing tools (namely, the law of insider trading) to bring individual enforcement actions in those cases that appear to involve significant selective disclosures. While we have considered this approach -- and of course we remain free to bring such cases where a selective disclosure does violate insider trading laws -- we do not agree that this is the appropriate response to the legal uncertainties posed by current insider trading law. In other contexts, we have been criticized for attempting to "make new law" in an uncertain area by means of enforcement action and urged instead to seek to change the law through notice-and-comment rulemaking. We believe that this rulemaking is the more careful and considered response to the problem presented by selective disclosure.\textsuperscript{16}

3. Effect of Regulation FD on Issuer Communications

One frequently expressed concern was that Regulation FD would not lead to broader dissemination of information, but would in fact have a "chilling effect" on the disclosure of information by issuers.\textsuperscript{17} In the view of these commenters, issuers would find it so difficult to determine when a disclosure of information would be "material" (and therefore subject to the regulation) that, rather than face potential liability and other consequences
of violating Regulation FD, they would cease informal communications with the outside world altogether.\textsuperscript{18} Some of these commenters therefore recommended that the Commission not adopt any mandatory rule prohibiting selective disclosure, like Regulation FD, but instead pursue voluntary means of addressing the problem, such as interpretive guidance, or the promotion of a "blue ribbon" panel to develop best practices for issuer disclosure. Other commenters recommended various ways that Regulation FD could be made narrower or more well-defined, in order to ameliorate some of the concerns about chilling. Other commenters, however, took issue with the supposition that issuer disclosures would be chilled. As some commenters stated, the marketplace simply would not allow issuers to cease communications with analysts and security holders.\textsuperscript{19}

We have considered these views carefully. As discussed in the Proposing Release, we are mindful of the concerns about chilling issuer disclosure; we agree that the market is best served by more, not less, disclosure of information by issuers. Because any potential "chill" is most likely to arise -- if at all -- from the fear of legal liability, we included in proposed Regulation FD significant safeguards against inappropriate liability. Most notably, we stated that the regulation would not provide a basis for private liability, and provided that in Commission enforcement actions under Regulation FD we would need to prove knowing or reckless conduct.

4. Revisions to Narrow the Scope of Regulation FD

Nevertheless, to provide even greater protection against the possibility of inappropriate liability, and to guard further against the likelihood of any chilling effect resulting from the regulation, we have modified Regulation FD in several respects.

First, we have narrowed the scope of the regulation so that it does not apply to all communications with persons outside the issuer. The regulation will apply only to communications to securities market professionals and to any holder of the issuer's securities under circumstances in which it is reasonably foreseeable that the security holder will trade on the basis of the information.

Second, we have narrowed the types of issuer personnel covered by the regulation to senior officials and those persons who regularly communicate with securities market professionals or with security holders. The effect of these first two changes is that Regulation FD will not apply to a variety of legitimate, ordinary-course business communications or to disclosures to the
Third, to remove any doubt that private liability will not result from a Regulation FD violation, we have revised Regulation FD to make absolutely clear that it does not establish a duty for purposes of Rule 10b-5 under the Securities Exchange Act of 1934 ("Exchange Act"). The regulation now includes an express provision in the text stating that a failure to make a disclosure required solely by Regulation FD will not result in a violation of Rule 10b-5.

Fourth, we have made clear that where the regulation speaks of "knowing or reckless" conduct, liability will arise only when an issuer's personnel knows or is reckless in not knowing that the information selectively disclosed is both material and nonpublic. This will provide additional assurance that issuers will not be second-guessed on close materiality judgments. Neither will we, nor could we, bring enforcement actions under Regulation FD for mistaken materiality determinations that were not reckless.

Fifth, we have expressly provided that a violation of Regulation FD will not lead to an issuer's loss of eligibility to use short-form registration for a securities offering or affect security holders' ability to resell under Rule 144 under the Securities Act of 1933 ("Securities Act"). This change eliminates additional consequences of a Regulation FD violation that issuers and other commenters considered too onerous.

We have made two other significant changes to the scope of Regulation FD, which, while not specifically addressed to concerns about chilling disclosure, narrow its scope. In response to concerns about the interplay of Regulation FD with the Securities Act disclosure regime, we have expressly excluded from the scope of the regulation communications made in connection with most securities offerings registered under the Securities Act. We believe that the Securities Act already accomplishes most of the policy goals of Regulation FD for purposes of registered offerings, and we will consider this topic in the context of a broader Securities Act rulemaking. Also, we have eliminated foreign governments and foreign private issuers from the coverage of the regulation.

With these changes, we believe Regulation FD strikes an appropriate balance. It establishes a clear rule prohibiting unfair selective disclosure and encourages broad public disclosure. Yet it should not impede ordinary-course business communications or expose issuers to liability for non-intentional selective disclosure unless the issuer fails to make public disclosure after it learns of it. Regulation FD, therefore, should promote full
and fair disclosure of information by issuers and enhance the fairness and efficiency of our markets.

**B. Discussion of Regulation FD**

Rule 100 of Regulation FD sets forth the basic rule regarding selective disclosure. Under this rule, whenever:

1. an issuer, or person acting on its behalf,
2. discloses material nonpublic information,
3. to certain enumerated persons (in general, securities market professionals or holders of the issuer's securities who may well trade on the basis of the information),
4. the issuer must make public disclosure of that same information:
   a. simultaneously (for intentional disclosures), or
   b. promptly (for non-intentional disclosures).

As a whole, the regulation requires that when an issuer makes an intentional disclosure of material nonpublic information to a person covered by the regulation, it must do so in a manner that provides general public disclosure, rather than through a selective disclosure. For a selective disclosure that is non-intentional, the issuer must publicly disclose the information promptly after it knows (or is reckless in not knowing) that the information selectively disclosed was both material and nonpublic.

We have modified several of the key terms in the regulation that serve to define its precise scope and effect. We discuss the key provisions of the regulation below.

1. **Scope of Communications and Issuer Personnel Covered by the Regulation**

As proposed, Regulation FD would have applied to any disclosure of material nonpublic information made by an issuer, or person acting on its behalf, to "any person or persons outside the issuer." A number of commenters stated that, as proposed, Regulation FD was too broad in its coverage of disclosures to "any person or persons outside the issuer," and in its definition of "person acting on behalf of an issuer." We are persuaded that these comments have merit, and thus we have modified the scope of the
regulation in several respects.

a. Disclosures to Enumerated Persons

Commenters stated that if Regulation FD applied to disclosures made to "any person" outside the issuer, it would inappropriately interfere with ordinary-course business communications with parties such as customers, suppliers, strategic partners, and government regulators.\textsuperscript{20} In addition, several media organizations and rating agencies commented that the regulation should not apply to disclosures made to the press, or to rating agencies for purposes of securities ratings.\textsuperscript{21} Overall, commenters suggested various ways to narrow the scope of the regulation, including providing specific exclusions for various types of recipients of information,\textsuperscript{22} or expressly limiting the regulation's coverage to persons such as securities analysts, market professionals, institutional investors, or others who regularly make or would reasonably be expected to make investment decisions involving the issuer's securities.\textsuperscript{23}

In response to these comments, we have narrowed the coverage of the final regulation. The regulation is designed to address the core problem of selective disclosure made to those who would reasonably be expected to trade securities on the basis of the information or provide others with advice about securities trading. Accordingly, Rule 100(a) of Regulation FD, as adopted, makes clear that the general rule against selective disclosure applies only to disclosures made to the categories of persons enumerated in Rule 100(b)(1).

Rule 100(b)(1) enumerates four categories of persons to whom selective disclosure may not be made absent a specified exclusion. The first three are securities market professionals -- (1) broker-dealers and their associated persons, (2) investment advisers, certain institutional investment managers\textsuperscript{24} and their associated persons, and (3) investment companies, hedge funds,\textsuperscript{25} and affiliated persons.\textsuperscript{26} These categories will include sell-side analysts, many buy-side analysts, large institutional investment managers, and other market professionals who may be likely to trade on the basis of selectively disclosed information. The fourth category of person included in Rule 100 (b)(1) is any holder of the issuer's securities, under circumstances in which it is reasonably foreseeable that such person would purchase or sell securities on the basis of the information. Thus, as a whole, Rule 100(b)(1) will cover the types of persons most likely to be the recipients of improper selective
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disclosure, but should not cover persons who are engaged in ordinary-course business communications with the issuer, or interfere with disclosures to the media or communications to government agencies.\textsuperscript{27}

Rule 100(b)(2) sets out four exclusions from coverage. The first, as proposed, is for communications made to a person who owes the issuer a duty of trust or confidence -- \textit{i.e.}, a "temporary insider" -- such as an attorney, investment banker, or accountant. The second exclusion is for communications made to any person who expressly agrees to maintain the information in confidence. \textsuperscript{28} Any misuse of the information for trading by the persons in these two exclusions would thus be covered under either the "temporary insider" or the misappropriation theory of insider trading. This approach recognizes that issuers and their officials may properly share material nonpublic information with outsiders, for legitimate business purposes, when the outsiders are subject to duties of confidentiality.\textsuperscript{29}

The third exclusion from coverage in Rule 100(b)(2) is for disclosures to an entity whose primary business is the issuance of credit ratings, provided the information is disclosed solely for the purpose of developing a credit rating and the entity's ratings are publicly available. As discussed by commenters, ratings organizations often obtain nonpublic information in the course of their ratings work. We are not aware, however, of any incidents of selective disclosure involving ratings organizations. Ratings organizations, like the media, have a mission of public disclosure; the objective and result of the ratings process is a widely available publication of the rating when it is completed. And under this provision, for the exclusion to apply, the ratings organization must make its credit ratings publicly available. For these reasons, we believe it is appropriate to provide this exclusion from the coverage of Regulation FD.

The fourth exclusion from coverage is for communications made in connection with most offerings of securities registered under the Securities Act. We discuss this exclusion in greater detail in Part II.B.6 below.

b. Disclosures by a Person Acting on an Issuer's Behalf

As proposed, Regulation FD defined any "person acting on behalf of an issuer" as "any officer, director, employee, or agent of an issuer, who discloses material nonpublic information while acting within the scope of his or her authority." A number of commenters stated that this definition was too broad and should be limited to "senior officials," to designated or
authorized spokespersons, or in some other manner. One commenter said that the definition should be broader to prevent evasion. One commenter stated that if the scope of Regulation FD were limited to disclosures to analysts and institutional investors, then the definition of "person acting on behalf of an issuer" would be appropriate.

We have modified slightly the definition of "person acting on behalf of an issuer" to make it more precise. We define the term to mean: (1) any senior official of the issuer; or (2) any other officer, employee, or agent of an issuer who regularly communicates with any of the persons described in Rule 100(b)(1)(i), (ii), or (iii), or with the issuer's security holders. By revising the definition in this manner, we provide that the regulation will cover senior management, investor relations professionals, and others who regularly interact with securities market professionals or security holders. Of course, neither an issuer nor such a covered person could avoid the reach of the regulation merely by having a non-covered person make a selective disclosure. Thus, to the extent that another employee had been directed to make a selective disclosure by a member of senior management, that member of senior management would be responsible for having made the selective disclosure. See Section 20(b) of the Exchange Act. In addition, as was proposed, the definition expressly states that a person who communicates material nonpublic information in breach of a duty to the issuer would not be considered to be acting on behalf of the issuer. Thus, an issuer is not responsible under Regulation FD when one of its employees improperly trades or tips.

2. Disclosures of Material Nonpublic Information

The final regulation, like the proposal, applies to disclosures of "material nonpublic" information about the issuer or its securities. The regulation does not define the terms "material" and "nonpublic," but relies on existing definitions of these terms established in the case law. Information is material if "there is a substantial likelihood that a reasonable shareholder would consider it important" in making an investment decision. To fulfill the materiality requirement, there must be a substantial likelihood that a fact "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." Information is nonpublic if it has not been disseminated in a manner making it available to investors generally.
The use of the materiality standard in Regulation FD was the subject of many comments. Some commenters supported the use of the existing definition of materiality, noting that attempts to define materiality for purposes of Regulation FD could have implications beyond this regulation. Other commenters, however, including securities industry representatives, securities lawyers, and some issuers or issuer groups, stated that using a general materiality standard in the regulation would cause difficulties for issuer compliance. These commenters claimed that materiality was too unclear and complex a standard for issuer personnel to use in making "real time" judgments about disclosures, and that this vagueness would lead to litigation and a chilling effect on corporate disclosure practices. These commenters offered a variety of recommendations to address this issue.

Some commenters suggested that the regulation include a bright-line standard or other limitation on what was material for purposes of Regulation FD, or identify in the regulation an exclusive list of types of information covered. While we acknowledged in the Proposing Release that materiality judgments can be difficult, we do not believe an appropriate answer to this difficulty is to set forth a bright-line test, or an exclusive list of "material" items for purposes of Regulation FD. The problem addressed by this regulation is the selective disclosure of corporate information of various types; the general materiality standard has always been understood to encompass the necessary flexibility to fit the circumstances of each case. As the Supreme Court stated in responding to a very similar argument: "A bright-line rule indeed is easier to follow than a standard that requires the exercise of judgment in the light of all the circumstances. But ease of application alone is not an excuse for ignoring the purposes of the securities acts and Congress' policy decisions. Any approach that designates a single fact or occurrence as always determinative of an inherently fact-specific finding such as materiality, must necessarily be over- or underinclusive."

Other suggestions from commenters included providing more interpretive guidance about types of information or events that are more likely to be considered material. While it is not possible to create an exhaustive list, the following items are some types of information or events that should be reviewed carefully to determine whether they are material: (1) earnings information; (2) mergers, acquisitions, tender offers, joint ventures, or changes in assets; (3) new products or discoveries, or developments regarding customers or suppliers (e.g., the acquisition or loss of a contract);
(4) changes in control or in management; (5) change in auditors or auditor notification that the issuer may no longer rely on an auditor's audit report; (6) events regarding the issuer's securities -- e.g., defaults on senior securities, calls of securities for redemption, repurchase plans, stock splits or changes in dividends, changes to the rights of security holders, public or private sales of additional securities; and (7) bankruptcies or receiverships.\textsuperscript{47}

By including this list, we do not mean to imply that each of these items is \textit{per se} material. The information and events on this list still require determinations as to their materiality (although some determinations will be reached more easily than others). For example, some new products or contracts may clearly be material to an issuer; yet that does not mean that all product developments or contracts will be material. This demonstrates, in our view, why no "bright-line" standard or list of items can adequately address the range of situations that may arise. Furthermore, we do not and cannot create an exclusive list of events and information that have a higher probability of being considered material.

One common situation that raises special concerns about selective disclosure has been the practice of securities analysts seeking "guidance" from issuers regarding earnings forecasts. When an issuer official engages in a private discussion with an analyst who is seeking guidance about earnings estimates, he or she takes on a high degree of risk under Regulation FD. If the issuer official communicates selectively to the analyst nonpublic information that the company's anticipated earnings will be higher than, lower than, or even the same as what analysts have been forecasting, the issuer likely will have violated Regulation FD. This is true whether the information about earnings is communicated expressly or through indirect "guidance," the meaning of which is apparent though implied. Similarly, an issuer cannot render material information immaterial simply by breaking it into ostensibly non-material pieces.

At the same time, an issuer is not prohibited from disclosing a non-material piece of information to an analyst, even if, unbeknownst to the issuer, that piece helps the analyst complete a "mosaic" of information that, taken together, is material. Similarly, since materiality is an objective test keyed to the reasonable investor, Regulation FD will not be implicated where an issuer discloses immaterial information whose significance is discerned by the analyst. Analysts can provide a valuable service in sifting through and extracting information that would not be significant to the ordinary investor to reach material conclusions. We do not intend, by Regulation FD, to
discourage this sort of activity. The focus of Regulation FD is on whether
the issuer discloses material nonpublic information, not on whether an
analyst, through some combination of persistence, knowledge, and insight,
regards as material information whose significance is not apparent to the
reasonable investor.

Finally, some commenters stated that greater protection would be afforded
to issuers if we made clear that the regulation's requirement for
"intentional" (knowing or reckless) conduct also extended to the judgment
of whether the information disclosed was material. \footnote{48} We agree that this
clarification is appropriate. As adopted, Rule 101(a) states that a person acts
"intentionally" only if the person knows, or is reckless in not knowing, that
the information he or she is communicating is both material and
nonpublic. \footnote{49} As commenters suggested, this aspect of the regulation
provides additional protection that issuers need not fear being second-guessed by the Commission in enforcement actions for mistaken judgments
about materiality in close cases.

3. Intentional and Non-intentional Selective Disclosures: Timing of
Required Public Disclosures

A key provision of Regulation FD is that the timing of required public
disclosure differs depending on whether the issuer has made an "intentional"
selective disclosure or a selective disclosure that was not intentional. For an
"intentional" selective disclosure, the issuer is required to publicly disclose
the same information simultaneously. \footnote{50}

ea. Standard of "Intentional" Selective Disclosure

Under the regulation, a selective disclosure is "intentional" when the issuer
or person acting on behalf of the issuer making the disclosure either knows,
or is reckless in not knowing, prior to making the disclosure, that the
information he or she is communicating is both material and nonpublic. \footnote{51} A
number of commenters thought that the distinction between intentional and
non-intentional disclosures was appropriate. \footnote{52} Others, however, stated that
the "intentional" standard should not include reckless conduct, because of
the risk that this standard, in hindsight, could be interpreted as close to a
negligence standard. \footnote{53} Some commenters suggested that there be a safe
harbor for good-faith efforts to comply with Regulation FD or for good-faith
determinations that information was not material. \footnote{54}
After considering these comments, we have determined to adopt the "intentional"/non-intentional distinction essentially as proposed. By creating this distinction, Regulation FD already provides greater flexibility as to the timing of required disclosure in the event of erroneous judgments than do other issuer disclosure provisions under the federal securities laws; it essentially incorporates the knowing or reckless mental state required for fraud into this disclosure provision. Since recklessness suffices to meet the mental state requirement even for purposes of the antifraud provisions,\textsuperscript{55} we believe it is appropriate to retain recklessness in Regulation FD's definition of "intentional" as well. Further, in view of the definition of recklessness that is prevalent in the federal courts,\textsuperscript{56} it is unlikely that issuers engaged in good-faith efforts to comply with the regulation will be considered to have acted recklessly.

As requested by several commenters, moreover, we emphasize that the definition of "intentional" in Rule 101(a) requires that the individual making the disclosure must know (or be reckless in not knowing) that he or she would be communicating information that was both material and nonpublic. Thus, in the case of a selective disclosure attributable to a mistaken determination of materiality, liability will arise only if no reasonable person under the circumstances would have made the same determination.\textsuperscript{57} As a result, the circumstances in which a selective disclosure is made may be important. We recognize, for example, that a materiality judgment that might be reckless in the context of a prepared written statement would not necessarily be reckless in the context of an impromptu answer to an unanticipated question.

b. "Prompt" Public Disclosure After Non-intentional Selective Disclosures

Under Rule 100(a)(2), when an issuer makes a covered non-intentional disclosure of material nonpublic information, it is required to make public disclosure promptly. As proposed, Rule 101(d) defined "promptly" to mean "as soon as reasonably practicable" (but no later than 24 hours) after a senior official of the issuer learns of the disclosure and knows (or is reckless in not knowing) that the information disclosed was both material and non-public. "Senior official" was defined in the proposal as any executive officer of the issuer, any director of the issuer, any investor relations officer or public relations officer, or any employee possessing equivalent functions.

Commenters expressed varying views on the definition of "promptly" provided in the rule. Some said that the time period provided for disclosure
was appropriate; others said it was too short, and still others said that it was too specific, and should require disclosure only as soon as reasonably possible or practicable. We believe that it is preferable for issuers and the investing public that there be a clear delineation of when "prompt" disclosure is required. We also believe that the 24-hour requirement strikes the appropriate balance between achieving broad, non-exclusionary disclosure and permitting issuers time to determine how to respond after learning of the non-intentional selective disclosure. However, recognizing that sometimes non-intentional selective disclosures will arise close to or over a weekend or holiday, we have slightly modified the final rule to state that the outer boundary for prompt disclosure is the later of 24 hours or the commencement of the next day's trading on the New York Stock Exchange, after a senior official learns of the disclosure and knows (or is reckless in not knowing) that the information disclosed was material and nonpublic. Thus, if a non-intentional selective disclosure of material, nonpublic information is discovered after the close of trading on Friday, for example, the outer boundary for making public disclosure is the beginning of trading on the New York Stock Exchange on Monday.

Commenters also expressed differing views on the definition of "senior official" contained in the regulation. We are adopting this definition as proposed. However, in response to comments, we have provided greater clarity as to when the duty to make "prompt" disclosure begins. The requirement to make prompt disclosure is triggered when a senior official of the issuer learns that there has been a non-intentional disclosure of information by the issuer or a person acting on behalf of the issuer that the senior official knows, or is reckless in not knowing, is both material and non-public. Similar to the language contained in the definition of "intentional," discussed above, this language is designed to make clear that the requirements of the regulation are only triggered when a responsible issuer official (1) learns that certain information has been disclosed, (2) knows (or is reckless in not knowing) that the information disclosed is material, and (3) knows (or is reckless in not knowing) that the information disclosed is nonpublic.

4. "Public Disclosure" Required by Regulation FD

Rule 101(e) defines the type of "public disclosure" that will satisfy the requirements of Regulation FD. As proposed, Rule 101(e) gave issuers considerable flexibility in determining how to make required public disclosure. The proposal stated that issuers could meet Regulation FD's
"public disclosure" requirement by filing a Form 8-K, by distributing a press release through a widely disseminated news or wire service, or by any other non-exclusionary method of disclosure that is reasonably designed to provide broad public access -- such as announcement at a conference of which the public had notice and to which the public was granted access, either by personal attendance, or telephonic or electronic access. This definition was designed to permit issuers to make use of current technologies, such as webcasting of conference calls, that provide broad public access to issuer disclosure events.

Commenters generally favored the flexible approach provided by Rule 101 (e). The American Society of Corporate Secretaries and the Financial Executives Institute, among others, agreed that the definition should not stipulate particular means of technology used for public disclosure. Individual investors supported the idea that issuers should open their conference calls to the public through means such as webcasting over the Internet. Some commenters, however, raised the concern that conference calls or webcasts should not be permitted to supplant the use of press releases as means of disclosing material information. Others suggested that we provide that an issuer's posting of information on its website should also be considered sufficient Regulation FD disclosure.

After considering the range of comments on this issue, we have determined to adopt a slightly modified definition of "public disclosure" that would provide even greater flexibility to issuers in determining the most appropriate means of disclosure. As adopted, Rule 101(e) states that issuers can make public disclosure for purposes of Regulation FD by filing or furnishing a Form 8-K, or by disseminating information "through another method (or combination of methods) of disclosure that is reasonably designed to provide broad, non-exclusionary distribution of the information to the public."

a. Form 8-K Disclosure

Commenters generally opposed the proposed new Item 10 of Form 8-K based, in large part, on a concern that people would construe a separate Item 10 filing as an admission that the disclosed information is material. In light of the timing requirements for making materiality judgments under Regulation FD, commenters wanted to be able to err on the side of filing information that may or may not be material, without precluding a later conclusion that the information was not material. Commenters recommended amending Item 5 of Form 8-K to include required Regulation
FD disclosures. Some commenters also suggested that Regulation FD submissions on Form 8-K should not be treated as "filed" for purposes of the Exchange Act.

In light of these comments, we provide that either filing or furnishing information on Form 8-K solely to satisfy Regulation FD will not, by itself, be deemed an admission as to the materiality of the information. In addition, while we retain a separate Item, we also are modifying Item 5 of Form 8-K to address commenters' concerns. As revised, issuers may choose either to "file" a report under Item 5 of Form 8-K or to "furnish" a report under Item 9 of Form 8-K that will not be deemed "filed." If an issuer chooses to file the information on Form 8-K, the information will be subject to liability under Section 18 of the Exchange Act. The information also will be subject to automatic incorporation by reference into the issuer's Securities Act registration statements, which are subject to liability under Sections 11 and 12(a)(2) of the Securities Act. If an issuer chooses instead to furnish the information, it will not be subject to liability under Section 11 of the Securities Act or Section 18 of the Exchange Act for the disclosure, unless it takes steps to include that disclosure in a filed report, proxy statement, or registration statement. All disclosures on Form 8-K, whether filed or furnished, will remain subject to the antifraud provisions of the federal securities laws.

b. Alternative Methods of Public Disclosure

We are recognizing alternative methods of public disclosure to give issuers the flexibility to choose another method (or a combination of methods) of disclosure that will achieve the goal of effecting broad, non-exclusionary distribution of information to the public.

As a general matter, acceptable methods of public disclosure for purposes of Regulation FD will include press releases distributed through a widely circulated news or wire service, or announcements made through press conferences or conference calls that interested members of the public may attend or listen to either in person, by telephonic transmission, or by other electronic transmission (including use of the Internet). The public must be given adequate notice of the conference or call and the means for accessing it. The regulation does not require use of a particular method, or establish a "one size fits all" standard for disclosure; rather, it leaves the decision to the issuer to choose methods that are reasonably calculated to make effective, broad, and non-exclusionary public disclosure, given the particular
circumstances of that issuer. Indeed, we have modified the language of the regulation to note that the issuer may use a method "or combination of methods" of disclosure, in recognition of the fact that it may not always be possible or desirable for an issuer to rely on a single method of disclosure as reasonably designed to effect broad public disclosure.

We believe that issuers could use the following model, which employs a combination of methods of disclosure, for making a planned disclosure of material information, such as a scheduled earnings release:

- First, issue a press release, distributed through regular channels, containing the information;\textsuperscript{70}

- Second, provide adequate notice, by a press release and/or website posting, of a scheduled conference call to discuss the announced results, giving investors both the time and date of the conference call, and instructions on how to access the call; and

- Third, hold the conference call in an open manner, permitting investors to listen in either by telephonic means or through Internet webcasting.\textsuperscript{71}

By following these steps, an issuer can use the press release to provide the initial broad distribution of the information, and then discuss its release with analysts in the subsequent conference call, without fear that if it should disclose additional material details related to the original disclosure it will be engaging in a selective disclosure of material information. We note that several issuer commenters indicated that many companies already follow this or a similar model for making planned disclosures.\textsuperscript{72}

In the Proposing Release, we stated that an issuer's posting of new information on its own website would not by itself be considered a sufficient method of public disclosure. As technology evolves and as more investors have access to and use the Internet, however, we believe that some issuers, whose websites are widely followed by the investment community, could use such a method. Moreover, while the posting of information on an issuer's website may not now, by itself, be a sufficient means of public disclosure, we agree with commenters that issuer websites can be an important component of an effective disclosure process. Thus, in some circumstances an issuer may be able to demonstrate that disclosure made on its website could be part of a combination of methods, "reasonably designed to provide broad, non-exclusionary distribution" of information to the
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public.\(^73\)

We emphasize, however, that while Rule 101(e) gives an issuer considerable flexibility in choosing appropriate methods of public disclosure, it also places a responsibility on the issuer to choose methods that are, in fact, "reasonably designed" to effect a broad and non-exclusionary distribution of information to the public. In determining whether an issuer's method of making a particular disclosure was reasonable, we will consider all the relevant facts and circumstances, recognizing that methods of disclosure that may be effective for some issuers may not be effective for others. If, for example, an issuer knows that its press releases are routinely not carried by major business wire services, it may not be sufficient for that issuer to make public disclosure solely by submitting its press release to one of these wire services; the issuer in these circumstances should use other or additional methods of dissemination, such as distribution of the information to local media, furnishing or filing a Form 8-K with the Commission, posting the information on its website, or using a service that distributes the press release to a variety of media outlets and/or retains the press release.

We also caution issuers that a deviation from their usual practices for making public disclosure may affect our judgment as to whether the method they have chosen in a particular case was reasonable. For example, if an issuer typically discloses its quarterly earnings results in regularly disseminated press releases, we might view skeptically an issuer's claim that a last minute webcast of quarterly results, made at the same time as an otherwise selective disclosure of that information, provided effective broad, non-exclusionary public disclosure of the information.\(^74\) In short, an issuer's methods of making disclosure in a particular case should be judged with respect to what is "reasonably designed" to effect broad, non-exclusionary distribution in light of all the relevant facts and circumstances.

5. Issuers Subject to Regulation FD

Regulation FD will apply to all issuers with securities registered under Section 12 of the Exchange Act, and all issuers required to file reports under Section 15(d) of the Exchange Act, including closed-end investment companies, but not including other investment companies, foreign governments, or foreign private issuers.

As written, proposed Regulation FD would have applied to foreign sovereign debt issuers required to file reports under the Exchange Act. Today's Regulation FD excludes these issuers from coverage. Proposed
Regulation FD also would have applied to foreign private issuers. However, the Commission has determined to exempt foreign private issuers at this time as it has in the past exempted them from certain U.S. reporting requirements such as Forms 10-Q and 8-K. Today’s global markets pose new regulatory issues. In recognition of this fact, the Commission will be undertaking a comprehensive review of the reporting requirements of foreign private issuers. In the interim, we remind foreign private issuers of their obligations to make timely disclosure of material information pursuant to applicable SRO rules and policies, and our expectation that the markets will enforce these obligations. Also, while Regulation FD will not apply, foreign issuers in their disclosure practices remain subject to liability for conduct that violates, and meets the jurisdictional requirements of, the antifraud provisions of the federal securities laws.

6. Securities Act Issues

a. The Operation of Regulation FD During Securities Offerings

As proposed, Regulation FD would have applied to disclosures made by a reporting company in connection with an offering under the Securities Act. Commenters expressed a number of concerns about tensions they perceived in the interplay of the disclosure requirements of Regulation FD and those of the Securities Act.

With respect to public offerings, commenters worried that a public disclosure mandated by Regulation FD could violate Section 5 of the Securities Act. Section 5 places limitations on the type of disclosures that may be made at various intervals during a registered offering. Commenters were concerned that public disclosures mandated by Regulation FD would exceed those limitations. Commenters similarly raised concerns about proposed Regulation FD’s interrelationship with unregistered offerings of securities. Here, the principal concern was that public disclosure mandated by Regulation FD could conflict with the conditions of the exemption from registration on which the issuer was relying.

i. Registered Offerings Exemption

In light of the comments we have received and our own further consideration, we have determined that our concerns about selective disclosure in connection with registered offerings under the Securities Act should not be addressed by overlaying Regulation FD onto the system of
regulation provided by that Act. The mandated disclosure regime and the civil liability provisions of the Securities Act reduce substantially any meaningful opportunity for an issuer to make selective disclosure of material information in connection with a registered offering. We are satisfied that the Securities Act already accomplishes at least some of the policy imperative of Regulation FD within the context of a registered offering. Thus, with limited exceptions, Regulation FD as adopted does not apply to disclosures made in connection with a securities offering registered under the Securities Act. 

In reaching this conclusion, we also note that our Division of Corporation Finance is currently involved in a systematic review of the Securities Act disclosure system as it relates to communications during the offering process. To the extent selective disclosure concerns arise in connection with registered offerings of securities, we believe it would be more appropriate to consider that impact in the context of a broader Securities Act rulemaking.

In creating the exclusion for registered offerings, we have defined for purposes of Regulation FD when those offerings are considered to begin and end. Communications that take place outside the periods clearly specified would not be considered a part of the registered securities offering to which the exemption from Regulation FD applies. Communications that are not made in connection with a registered offering also are not exempt.

ii. Unregistered Offerings

Unregistered offerings are not subject to the full public disclosure and liability protections that the Securities Act applies to registered offerings. An issuer engaged in an unregistered securities offering does not have the same discipline imposed under the Securities Act to merge material information into its public disclosure. While we have carefully considered the concerns expressed by commenters, we believe that Regulation FD should not provide an exception for communications made in connection with an unregistered offering. We believe that reporting companies making unregistered offerings should either publicly disclose the material information they disclose nonpublicly or protect against misuse of that information by having those who receive it agree to maintain it in confidence.

If a reporting issuer releases material information nonpublicly during an unregistered offering with no such understanding about confidentiality, we believe that disclosure under Regulation FD is appropriate. We believe this
even if, as a result of such disclosure, the availability of the Securities Act registration exemption may be in question. Public companies undertaking unregistered offerings will need to consider the impact their selective disclosure could have on any exemption they use. Before an exempt offering begins, issuer's counsel should advise the client of the potential complications that selective disclosure of material nonpublic information could raise.

Issuers who undertake private unregistered offerings generally disclose the information to the investors on a confidential basis. Under Regulation FD, public companies will still have the ability to avoid premature public disclosure in those cases. A public company need not make public disclosure if anyone who receives the material, nonpublic information agrees to maintain that information in confidence.

b. Eligibility for Short-Form Registration and Rule 144

Commenters observed that a failure to file a Form 8-K under Regulation FD when no alternative qualifying public disclosure is made, would result in the loss of availability of short-form Securities Act registration on Forms S-2 and S-3. They pointed out that because the proposal did not contain any means to alter that ineligibility, the issuer would be disqualified from using Form S-2 or S-3 for at least a year from the date of the non-compliance with Regulation FD. Commenters also noted that a failure to file a required Form 8-K would render Rule 144 temporarily unavailable for resale of restricted and control securities, and Form S-8 temporarily unavailable for employee benefit plan offerings. They pointed out that the loss of Rule 144 would primarily penalize shareholders reselling or attempting to resell securities. They also noted that the loss of Form S-8 could have a detrimental effect on employees.

The reporting status requirements in Forms S-2, S-3 and S-8 and Rule 144, the commenters argued, were not intended to be linked to a system for dissemination of discrete information outside of the traditional periodic reporting obligations of companies. The commenters were concerned that these consequences for the issuer and investors may be unduly harsh and not in line with the purposes of Regulation FD.

We find merit in these concerns and are modifying this aspect of the regulation. The purpose of Regulation FD is to discourage selective disclosure of material nonpublic information by imposing a requirement to make the information available to the markets generally when it has been
made available to a select few: We agree that the purpose is not well served by negatively affecting a company's ability to access the capital markets. Nor is it well served by penalizing the shareholders or employees of the company. As discussed below, we have other adequate enforcement remedies that will provide a proportionate response for a violation and will have the desired effect on compliance. To implement our approach, Rule 103 of the regulation as adopted states that an issuer's failure to comply with the regulation will not affect whether the issuer is considered current or, where applicable, timely in its Exchange Act reports for purposes of Form S-8, short-form registration on Form S-2 or S-3 and Rule 144.

7. Liability Issues

We recognize that the prospect of private liability for violations of Regulation FD could contribute to a "chilling effect" on issuer communications. Issuers might refrain from some informal communications with outsiders if they feared that engaging in such communications, even when appropriate, would lead to their being charged in private lawsuits with violations of Regulation FD. Accordingly, we emphasized in the Proposing Release that Regulation FD is an issuer disclosure rule that is designed to create duties only under Sections 13(a) and 15(d) of the Exchange Act and Section 30 of the Investment Company Act. It is not an antifraud rule, and it is not designed to create new duties under the antifraud provisions of the federal securities laws or in private rights of action.85

Most commenters who addressed this point believed that our decision not to create private liability for Regulation FD violations was appropriate. Several suggested, however, that the language in the Proposing Release offered insufficient protection from private lawsuits. In response to these comments, we have added to Regulation FD a new Rule 102, which expressly provides that no failure to make a public disclosure required solely by Regulation FD shall be deemed to be a violation of Rule 10b-5.86 This provision makes clear that Regulation FD does not create a new duty for purposes of Rule 10b-5 liability. Accordingly, private plaintiffs cannot rely on an issuer's violation of Regulation FD as a basis for a private action alleging Rule 10b-5 violations.

Rule 102 is designed to exclude Rule 10b-5 liability for cases that would be based "solely" on a failure to make a public disclosure required by Regulation FD. As such, it does not affect any existing grounds for liability under Rule 10b-5. Thus, for example, liability for "tipping" and insider trading under Rule 10b-5 may still exist if a selective disclosure is made in
circumstances that meet the Dirks "personal benefit" test.\textsuperscript{87} In addition, an issuer's failure to make a public disclosure still may give rise to liability under a "duty to correct" or "duty to update" theory in certain circumstances.\textsuperscript{88} And an issuer's contacts with analysts may lead to liability under the "entanglement" or "adoption" theories.\textsuperscript{89} In addition, if an issuer's report or public disclosure made under Regulation FD contained false or misleading information, or omitted material information, Rule 102 would not provide protection from Rule 10b-5 liability.

Finally, if an issuer failed to comply with Regulation FD, it would be subject to an SEC enforcement action alleging violations of Section 13(a) or 15(d) of the Exchange Act (or, in the case of a closed-end investment company, Section 30 of the Investment Company Act) and Regulation FD. We could bring an administrative action seeking a cease-and-desist order, or a civil action seeking an injunction and/or civil money penalties.\textsuperscript{90} In appropriate cases, we could also bring an enforcement action against an individual at the issuer responsible for the violation, either as "a cause of" the violation in a cease-and-desist proceeding,\textsuperscript{91} or as an aider and abetter of the violation in an injunctive action.\textsuperscript{92}
§ 4.03 Fair Disclosure, Free Writing, The Unanswered Questions

The Fair Disclosure Regulation as proposed dealt with one aspect of the issues surrounding restrictions on communications while in registration — to wit, the freedom and obligation of reporting companies to publicly distribute material information disclosed in the course of a road show. Proposed Rule 181 provided that it is not a violation of Section 5(b)(1) if a written communication is made "only as required by Rule 100(a) of Regulation FD." Regulation FD as proposed would have required such communications when the issuer or someone acting on its behalf "discloses any material nonpublic information." Thus, if an issuer in the course of a road show orally disclosed material non-public information, it would have had to simultaneously have made a general public disclosure of such information and such disclosure would not constitute a violation of Section 5(b) of the Securities Act. Proposed Rule 181, however, would not have provided absolution from Section 5(c) of the Securities Act. Accordingly, it would not have been applicable to communications, written or oral, before the filing of the registration statement. In the limited area in which it would have liberalized communications and permitted free writing imposed a catch-22. Proposed Rule 181 protected communications only if the information disclosed in the course of the road show relates to "material non-public information." The issuer would have run the risk of violating Regulation FD by not immediately making the information public if it concluded that the information was not material nonpublic information. Alternatively, if the issuer took the conservative approach and made the disclosure required by Regulation FD, it risked a violation of Section 5(b)(1) if Rule 181 was not available because the information was not deemed material nonpublic information. Although it is unlikely that on the Commission level this type of catch-22 was intended, staff members reviewing the filing of a registration statement might have seen public disclosure of information that tends to stimulate interest in the offering.
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under the guise of Rule 181 as an attempt to avoid the restriction on free writing while in registration.

The Commission in the Fair Disclosure Proposing Release raised more questions than it answered about the free writing while in registration aspects of the proposal. The Fair Disclosure Proposing Release included the following revealing soliloquy: 82

If the Commission were to adopt an exemption from Section 5(c) for Regulation FD-required disclosure, however, companies could abuse that exemption to make public communications that hype an offering before filing a registration statement with the Commission. In that event, the balanced full disclosure, against which to test the hyping information, would not be available. The protections of Section 5 could thus be eroded. While we have published proposals that, if adopted, would allow offers to be made prior to the filing of a registration statement in some offerings, those proposals did not extend to offerings by unseasoned companies to less sophisticated investors. We proposed to retain the pre-filing prohibition on offers in those cases because of the continued need for this aspect of investor protection.

We request comment on whether we should also adopt an exemption from liability under Section 5(c) of the Securities Act for communications made before the filing of a registration statement. If we do so, should the exemption apply only to non-intentional disclosures? Do the same reasons for providing a Section 5(b)(1) exemption also apply to Section 5(c), either for all issuers, or for offerings made by very large issuers or to more sophisticated investors? Or could a Section 5(c) exemption provide issuers with such freedom to make public disclosures prior to filing a registration state-

ment that issuers could engage in the hyping of an offering that Section 5(c) is designed to prevent?

With respect to the interplay between Regulation FD and the Securities Act, we request comment on the proposed approach described above. Should the Regulation also apply to issuers engaged in IPOs? Alternatively, given the liability questions under the Securities Act for these disclosures and the pending proposals in the Securities Act Reform release, should the Regulation not cover communications made as part of securities offerings under the Securities Act?

When the Commission adopted Regulation FD on August 15, 2000, it elected to punt. Regulation FD as adopted does not include that part of the proposed regulation that related to selective disclosure while in registration. Regulation FD provides that it is not applicable to communications made in connection with substantially all offerings registered under the Securities Act. Accordingly, selective disclosure can be made orally in the course of a road show without violating Regulation FD whether made by a reporting company or in connection with an IPO. If such disclosure is made, the registrant does not have the alternative of disclosing the information in a press release or other written communication without violating Section 5(b)(1). The Commission in the Regulation FD Adopting Release justified not going part-way down this slippery slope because “[w]e are satisfied that the Securities Act already accomplishes at least some of the policy imperative of Regulation FD within the context of a registered offering.” This does not exactly square with the Aircraft Carrier Release view of road shows as an egregious example of selective disclosure. See § 4.11. The Release does note that the Division of Corporation Financing SARP reproposal is forthcoming and that may be a more

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appropriate way of dealing with selective disclosure and free writing issues, stating: "To the extent selective disclosure concerns arise in connection with registered offerings of securities, we believe it would be more appropriate to consider that impact in the context of a broader Securities Act rulemaking." The questions posed in the Commission's soliloquy will have to answer in the broader context of a repurposed Securities Act Reform Proposal. Interpretative Release III relating to the Use of Electronic Media discussed below at § 4.05 could have, but does not, answer those questions. This does not mean that the staff does not have alternatives to deal with selective disclosure made orally while the company is in registration. See § 4.05[4]-[5]. The Fair Disclosure regulation is discussed at § 11.01.

§ 4.04 Interpretative Release III on Use of Electronic Media — Web Site Content and Free Writing

On April 28, 2000, the Commission issued an Interpretative Release dealing, among other things, with one aspect of issues raised by restrictions on free writing while in registration — information

66 Id.


68 The Release defines "in registration" as "the entire registration process under the Securities Act, at least from the time an issuer reaches an understanding with the broker-dealer which is to act as managing underwriter [before] the filing of a registration statement, until the end of the period during which dealers must deliver a prospectus," quoting from Sec. Act Release No. 5180 (Aug. 20, 1971). 1971 WL 11224. Interpretative Release III adds the following: "An issuer will not be considered to be "in registration" at any particular point in time solely because it has filed one or more registration statements on Form S-8, 17 CFR 239.16b, or it has on file a registration statement for a delayed shelf offering on Form S-3, S-4, F-3 or F-4, 17 CFR 239.13, 239.25, 239.33 or 239.34, and has not commenced or is not in the process of offering or selling securities "off of the shelf."" Sec. Act Release No. 7836 (Apr. 28. 2000), 2000 WL 502290, at *3 n.10.
I. Background

On June 17, 2002, we proposed to increase the number of events required to be disclosed on Form 8-K.\textsuperscript{20} Form 8-K is the Exchange Act form for current reports. Prior to the amendments being adopted today, Form 8-K required disclosure regarding nine different specified events.\textsuperscript{21} At the time, the proposals would have increased the number of reportable events under the form to 22. The proposals also would have shortened the form's filing deadline from five business days or 15 calendar days, depending on the particular event, to two business days with an automatic two business day extension upon a company's filing of a Form 12b-25. In response to these proposals, we received approximately 85 comment letters from various constituencies, including investors, issuers, accounting firms, law firms and associations representing the interests of such constituencies.

Under the previous Form 8-K regime, companies were required to report very few significant corporate events. The limited number of Form 8-K disclosure items permitted a public company to delay disclosure of many significant events until the due date for its next periodic report. During such a delay, the market was unable to assimilate such undisclosed information into the value of a company's securities. The revisions that we adopt today will benefit markets by increasing the number of unquestionably or presumptively material events that must be disclosed currently. They will also provide investors with better and more timely disclosure of important corporate events.

On July 29, 2002, Congress enacted the Sarbanes-Oxley Act of 2002.\textsuperscript{22} Section 409 of this Act requires public companies to disclose "on a rapid and current basis" material information regarding changes in a company's financial condition or operations as we, by rule, determine to be necessary or useful for the protection of Investors and in the public Interest. These amendments also further the goals of Section 409 of the Sarbanes-Oxley Act.

At the same time, we have taken into account a number of important comments on the proposals by adopting a modified version of the proposed Form 8-K amendments. We have addressed the commenters' concern regarding potential premature disclosure in a number of respects. We also have addressed the concerns raised by several commenters regarding the length of the Form 8-K filing period by extending it beyond the originally proposed two business day period and significantly reducing the amount of analysis required by the specific items of the form. Our general rules, however, prohibiting material omissions that make the contents of the disclosure misleading, of course, continue to apply.\textsuperscript{23} We have also taken into account the concerns expressed by commenters regarding the liabilities that could arise for failure to make current disclosure of some events in what are still tight timeframes. In response to these comments, we have replaced the proposed safe harbor that would have afforded protection from potential Exchange Act Section 13(a) or 15(d) liability stemming from a company's failure to file a required Form 8-K to instead afford protection from potential liability arising under Exchange Act Section 10(b) and Rule 10b-5 thereunder.

II. Discussion of Amendments
A. Shortened Form 8-K Filing Deadline and Availability of Form 12b-25

The amendments to Form 8-K require issuers that are subject to the reporting requirements of Section 13(a) and Section 15(d) of the Exchange Act, other than foreign private issuers that file annual reports on Form 20-F or 40-F to file required current reports on Form 8-K within four business days of a triggering event. These amendments do not affect the filing deadline for disclosures under Regulation FD (Item 7.01), voluntary disclosures (Item 8.01) and certain exhibits.

In the proposing release, we proposed a two business day deadline for Form 8-K, with provision for an automatic two business day extension upon a company's filing of Form 12b-25. Thus, the proposals would have permitted a four business day filing period whenever a company filed a Form 12b-25.

We received numerous comments and recommendations regarding appropriate filing deadlines. The comments ranged from support of the two business day deadline to recommendations of as much as ten business days. Similarly, we received mixed comments on the Form 12b-25 proposal. Some commenters noted that the Form 12b-25 proposal would complicate the process and that increased filings would reduce the significance of a Form 12b-25 filing. We are persuaded by these commenters that modifications to the proposals are warranted. Thus, we are not adopting the proposal to extend the Form 8-K filing deadline via Form 12b-25. Rather, we are adopting a four business day deadline for Form 8-K, with no provision for extension under Rule 12b-25. We believe that this change addresses commenters' concerns regarding the sufficiency of the filing period and simplifies the logistics of filing the four business day period.

B. Reorganization of Form 8-K Items

Because we are adding a number of new items to the form, we believe it is appropriate to organize the required reportable items into topical categories. Commenters generally supported such reorganization. The amendments organize the Form 8-K items under the following section headings and with the following new numbering system:

Section 1 - Registrant's Business and Operations

Item 1.01 Entry into a Material Definitive Agreement

Item 1.02 Termination of a Material Definitive Agreement

Item 1.03 Bankruptcy or Receivership

Section 2 - Financial Information

Item 2.01 Completion of Acquisition or Disposition of Assets

Item 2.02 Results of Operations and Financial Condition
Item 2.03 Creation of a Direct Financial Obligation or an Obligation under an Off-Balance Sheet Arrangement of a Registrant

Item 2.04 Triggering Events That Accelerate or Increase a Direct Financial Obligation or an Obligation under an Off-Balance Sheet Arrangement

Item 2.05 Costs Associated with Exit or Disposal Activities

Item 2.06 Material Impairments

Section 3 - Securities and Trading Markets

Item 3.01 Notice of Delisting or Failure to Satisfy a Continued Listing Rule or Standard; Transfer of Listing

Item 3.02 Unregistered Sales of Equity Securities

Item 3.03 Material Modifications to Rights of Security Holders

Section 4 - Matters Related to Accountants and Financial Statements

Item 4.01 Changes in Registrant’s Certifying Accountant

Item 4.02 Non-Reliance on Previously Issued Financial Statements or a Related Audit Report or Completed Interim Review

Section 5 - Corporate Governance and Management

Item 5.01 Changes in Control of Registrant

Item 5.02 Departure of Directors or Principal Officers; Election of Directors; Appointment of Principal Officers

Item 5.03 Amendments to Articles of Incorporation or Bylaws; Change in Fiscal Year

Item 5.04 Temporary Suspension of Trading Under Registrant’s Employee Benefit Plans

Item 5.05 Amendments to the Registrant’s Code of Ethics, or Waiver of a Provision of the Code of Ethics

Section 6 - [Reserved]

Section 7 - Regulation FD

Item 7.01 Regulation FD Disclosure

Section 8 - Other Events

Item 8.01 Other Events
Section 9 - Financial Statements and Exhibits

Item 9.01 Financial Statements and Exhibits

This new numbering system avoids re-use of the former single-digit item numbering system previously used in Form 8-K to avoid confusion about the subject of particular items. For example, the Form 8-K item permitting voluntary disclosure of "other events" that was formerly designated as Item 5 now appears as Item 8.01. Thus, anyone searching the EDGAR database for such filings made before and after the change will need to search for both Items 5 and 8.01. In addition, a company amending a Form 8-K that it filed before the effective date of the rules we are adopting today must file the amendment using the form’s new numbering system. For example, a company amending a Form 8-K previously filed under former Item 2, Acquisition or Disposition of Assets, to add the required financial statements must reference new Item 9.01, Financial Statements and Exhibits, when filing the amendment.

C. Expansion of Form 8-K Items

We are adding eight new items to the list of events that require a company to file a current report on Form 8-K and transferring, in part, two items from the periodic reports. In addition, we are expanding two pre-existing Form 8-K items. Based on our review of Form 8-K filings, as well as public comment letters, we believe that these items represent events that unquestionably or presumptively have such significance that current disclosure should be required. These amendments will operate prospectively only. The following is a discussion of the individual items in the revised Form 8-K.

Section 1 - Registrant's Business and Operations

Item 1.01 Entry into a Material Definitive Agreement.

New Item 1.01 requires the disclosure of material definitive agreements entered into by a company that are not made in the ordinary course of business. The item parallels Items 601(b)(10) of Regulation S-K with regard to the types of agreements that are material to a company, a standard already familiar to reporting companies.

Under Item 1.01, a company must also disclose any material amendment to a material definitive agreement. Disclosure of a material amendment may be required under Item 1.01 even if the underlying agreement previously has not been disclosed by the company. This could occur if, for example, the agreement was entered into prior to the effective date of this Item 1.01, or the amendment results in the agreement becoming a material definitive agreement of the company.

A company must disclose the following information upon entry into, or material amendment of, a material definitive agreement:

- The date on which the agreement was entered into or amended, the identity of the parties to the agreement and a brief description of any material relationship between the company or its affiliates and any of
the parties, other than in respect of the material definitive agreement or amendment; and

- A brief description of the terms and conditions of the agreement or amendment that are material to the company.

We received substantial comment on this item at the proposing stage. In particular, many commenters opposed our proposal to require disclosure of letters of intent and other non-binding agreements in addition to disclosure of definitive agreements that are material to the company.\textsuperscript{35} They noted that disclosure of non-binding agreements could cause significant competitive harm to the company and create excessive speculation in the market.\textsuperscript{36} Several companies also stated that they use letters of intent extensively, but that few such letters culminate in a completed transaction.\textsuperscript{37}

In response to the commenters, we eliminated the requirement that companies disclose their entry into non-binding agreements from this item.\textsuperscript{38} We have further replaced the proposed definition of "agreement" with a definition of "material definitive agreement" and have moved this definition from a proposed instruction into Item 1.01(b). We have clarified that only agreements which provide for obligations that are material to and enforceable against a company, or rights that are material to the company and enforceable by the company against one or more other parties to the agreement by the company, are required to be disclosed pursuant to Item 1.01, regardless of whether the material definitive agreement is enforceable subject to stated conditions.\textsuperscript{39}

We have also eliminated the specific requirements to disclose each party's rights and obligations under the material definitive agreement and the duration and termination provisions of the agreement. To the extent that any of these provisions is material to the company, it must be briefly described under paragraph (a)(2) of the item.

**Filing of Exhibits**

The proposals would have required a company to file a material agreement required to be disclosed under Item 1.01 as an exhibit to its Form 8-K. We received numerous comments on this proposal. A primary concern of commenters was that companies would not always be able to prepare and submit requests for confidential treatment of sensitive terms of the agreement within the short Form 8-K filing period.\textsuperscript{40} They recommended several alternatives, including streamlined treatment of such requests, such as by creating a short-form confidential treatment request process,\textsuperscript{41} and delaying the company's obligation to file the exhibit until it files its next periodic report.\textsuperscript{42} In addition, some commenters were concerned that the process of preparing to submit such lengthy documents in proper EDGAR format would hinder the ability of a company to report the event promptly.

In response to these comments, we have eliminated the proposed requirement to file the material agreement as a Form 8-K exhibit. Prior to these amendments, material agreements did not need to be filed until the company's next periodic report as there was no Form 8-K item requiring disclosure of the event. Thus, the amendments do not change current
requirements with regard to filing material agreements as exhibits, not do they affect the process for requesting confidential treatment of terms of those agreements. Given the initial disclosure of the agreement and its material terms, delayed filing of the exhibit should have minimal effect on the utility of the Item 1.01 disclosure. Pursuant to amended Item 601 of Regulation S-K, a company will have to file such agreement as an exhibit to the company's next periodic report or registration statement.43 However, we encourage companies to file the exhibit with the Form 8-K when feasible, particularly when no confidential treatment is requested.

**Considerations Regarding Business Combinations**

New Item 1.01 requires disclosure of all material definitive agreements specified by the item, including business combination agreements and other agreements that relate to extraordinary corporate transactions. The filing of the Form 8-K may constitute the first "public announcement" for purposes of Rule 16544 under the Securities Act and Rule 14d-2(b)45 or Rule 14a-1246 under the Exchange Act47 and thereby trigger a filing obligation under those rules.

In the proposing release, we solicited comment on whether Form 8-K should include boxes on the cover page to enable the filer to indicate that the Form 8-K filing also satisfies a separate filing obligation under Rule 165, Rule 14d-2(b) and/or 14a-12.48 We received favorable comments on this issue.49 Thus, to avoid duplicative filings, we are amending Form 8-K to enable a company to check one or more boxes on the cover page to indicate that it is simultaneously satisfying its filing obligations under these rules, provided that the Form 8-K contains all of the information required by those rules.50

**Item 1.02 Termination of a Material Definitive Agreement.**

We are adopting a new Form 8-K item requiring disclosure if a material definitive agreement not made in the ordinary course of business to which a company is a party is terminated, other than by expiration of the agreement on a stated termination date or as a result of all parties completing their obligations under such agreement, and such termination of the agreement is material to the company. In such an event, the company must disclose the following information:

- The date of the termination of the material definitive agreement, the identity of the parties to the agreement and a brief description of any material relationship between the company or its affiliates and any of the parties other than in respect of the material definitive agreement;

- A brief description of the terms and conditions of the agreement that are material to the company;

- A brief description of the material circumstances surrounding the termination; and

- Any material early termination penalties incurred by the company.51

Several commenters believed that an agreement that terminates "by its
terms" should not trigger disclosure. We have addressed these concerns by excluding termination as a result of expiration of the agreement on its stated termination date or as a result of completion by all parties of their obligations.

Commenters also were concerned that one party to an agreement may use this item as a negotiation tool to induce another party to the agreement to modify the agreement on terms more favorable to the first party, or else potentially suffer a negative market reaction to disclosure about termination of the agreement. We believe these comments are addressed by Instruction 1 to Item 1.02 which states that no disclosure is required under the item during negotiations or discussions regarding termination of a material definitive agreement unless and until the agreement has been terminated.

In addition, in response to commenters' concerns, we have further clarified in Instruction 2 to Item 1.02 that no disclosure is required under the item if the company believes, in good faith, that the agreement has not been terminated, unless the company has received a notice of termination pursuant to the terms of the agreement. If a company believes in good faith that a material definitive agreement has not been terminated, but determines nevertheless to make disclosure under Item 1.02, the company could disclose under this item a statement of its good faith belief as to any relevant matter, including, for example, that not all conditions to termination have been satisfied or that a termination has otherwise not occurred. In such event, an amendment under this Item 1.02 may be required if the company's conclusion as to termination changes due to a loss of, or change in, its good faith belief.

Other commenters were concerned about the proposed requirement to disclose management's analysis of the effect of the termination, which some referred to as a "mini-MD&A." We agree with the commenters that in some cases such analysis may be difficult to provide within the abbreviated Form 8-K filing period and may be more relevant and complete when discussed in the context of full financial statements. Thus, we have removed this proposed requirement from specific required terms of the final rule. Nevertheless, any disclosure made in a report on Form 8-K must include all other material information, if any, that is necessary to make the required disclosure, in the light of the circumstances under which it is made, not misleading.

Item 1.03 Bankruptcy or Receivership

This item retains the basic substantive requirements formerly included in Item 3 of Form 8-K regarding a company's entry into bankruptcy or receivership. As proposed, however, we are adopting minor changes to make the item more readable, such as breaking out embedded lists from the text and moving some language currently included in the text into an Instruction to the item.

Section 2 - Financial Information

Item 2.01 Completion of Acquisition or Disposition of Assets
under the conditions for use of the free writing prospectus in Rule 433, the offering participant is required to file the free writing prospectus with us pursuant to Rule 433.\textsuperscript{340}

The Rule, as revised, also provides that a person will not be considered to offer or sell securities by means of a free writing prospectus solely because another person has used or referred to the free writing prospectus or filed the free writing prospectus with us.

As a result of these provisions, we believe that offering participants will be able to determine when they will be considered to have offered or sold securities by means of any particular free writing prospectus.

c. Interaction of New Communications Rules with Regulation FD

i. Amendments to Regulation FD

As a consequence of our new rules to liberalize communications during the offering process and encourage continuing ongoing regular communications by reporting issuers, we are revisiting the exclusions from Regulation FD for communications made during a registered offering of securities.\textsuperscript{341} The communications regime that we are adopting today contemplates that, in connection with an offering, certain material non-public issuer information can be made public through the prospectus filed as part of a registration statement or the issuer’s filing of free writing prospectuses. Oral communications of an issuer made in connection with a registered offering after the registration statement is filed will continue not to be subject to any filing or public disclosure requirement. As we stated in the Proposing Release, we continue to believe

\textsuperscript{340} The Rule does not address when an issuer offers or sells “by means of” a free writing prospectus. The Rule does address when an issuer is considered to be a seller for purposes of Securities Act Section 12(a)(2). See discussion in Section IV.B below under “Issuer as Seller.”
that subjecting oral communications that occur in connection with a registered offering in a capital formation transaction to a public disclosure requirement could adversely affect the capital formation process.

We are amending Regulation FD substantially as proposed to specify the circumstances, both in terms of the type of offering and the means of communication, in which issuer communications will be excluded from the operation of that Regulation in connection with a registered securities offering.

First, as amended, Regulation FD will not apply to disclosures made in the following communications in connection with a registered securities offering that is of the type excluded from the Regulation:

- a registration statement filed under the Securities Act, including a prospectus contained therein;
- a free writing prospectus used after filing of the registration statement for the offering or a communication falling within the exception to the definition of prospectus contained in clause (a) of Securities Act Section 2(a)(10);
- any other Section 10(b) prospectus;
- a notice permitted by Securities Act Rule 135;
- a communication permitted by Securities Act Rule 134; or
- an oral communication made in connection with the registered securities offering after filing of the registration statement for the offering under the Securities Act.

Second, prior to our actions today, Regulation FD applied to offerings of the types described in Rule 415(a)(1)(i) through (vi).\textsuperscript{342} Rule 415(a)(1)(i) provides for offering by

\textsuperscript{341} See 17 CFR 243.100(b)(2).

\textsuperscript{342} The types of offerings under these provisions of Rule 415 are delayed or continuous offerings that are (1) securities to be offered or sold solely by or on behalf of selling security holders other than the issuer or its subsidiaries; (2) securities offered pursuant to dividend or interest reinvestment plans or an
serving security holders. We are amending Regulation FD to clarify that, as to offerings
of the type described in Rule 415(a)(1)(i) where the registered offering also includes a
registered offering, whether or not underwritten, for capital formation purposes for the
account of the issuer, Regulation FD does not apply, unless the issuer’s offering is
included for the purpose of evading Regulation FD.\textsuperscript{343} The amendments do not otherwise
change the types of registered offerings that are excluded from, or subject to, the
operation of the Regulation.

In view of our new rules to expand permissible communications, we believe it is
appropriate to clarify that the communications excluded from the operation of Regulation
FD are, in fact, those communications that are directly related to a registered securities
offering. Communications not contained in our enumerated list of exceptions from
Regulation FD – for example, the publication of regularly released factual business
information or regularly released forward-looking information or pre-filing
communications – are subject to Regulation FD.

ii. Comments on Amendments to Regulation FD

Most commenters on the proposed changes to Regulation FD supported the
inclusion of the specific enumeration of communications in connection with offerings
that are not subject to the provisions of Regulation FD.\textsuperscript{344} Commenters expressed

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\textsuperscript{343} This provision will cover the situation, for example, where a \textit{de minimis} issuer
participation is included in what is otherwise entirely a selling security holder
offering for the purpose of excluding communications in the offering from the
application of Regulation FD.

\textsuperscript{344} See, \textit{e.g.}, letters from Cleary; Fried Frank; and NYCBA.

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Impact of Recent Regulatory and Legal Developments on US Listings by Non-US Companies

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With the passage of the US Sarbanes-Oxley Act and the heightened scrutiny of listed companies by US regulatory authorities, the number of non-US companies willing to undertake or maintain a US listing and to deal with the consequent regulatory and legal requirements and risks seems to have decreased. This trend looks likely to continue at least into next year, as US-listed foreign companies become subject to even more requirements under the Sarbanes-Oxley Act and the risk of US private class action litigation continues to rise. In addition, in response to mounting calls from legal commentators and industry groups, the US Securities and Exchange Commission (SEC) is considering making it more feasible for non-US companies to deregister a class of securities under the US Securities Exchange Act of 1934 (the ‘Exchange Act’).

This article examines the impact of the Sarbanes-Oxley Act and other regulatory and legal developments (some of which may be more significant than the Sarbanes-Oxley Act) on US listings by foreign companies and what other factors may now or in the future be relevant for foreign companies evaluating US listings.

Sarbanes-Oxley and section 10A investigations

The Sarbanes-Oxley Act was enacted on 30 July 2002 and was followed by a series of new SEC rules. Historically, non-US issuers have been exempt from certain of the requirements of the US federal securities law (primarily relating to reporting, US GAAP, proxy statements and the ‘section 16’ insider trading rules), so long as such issuers

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1 Cravath Swaine & Moore LLP represented the issuers or underwriters in certain of the offerings referred to herein (Prudential plc, Tema Sp A, Tata Consultancy Services Limited and National Thermal Power Corporation Limited), and has been advising the Royal Dutch/Shell Group of Companies in connection with its restatements and reorganisation and Vivendi Universal, SA in connection with its securities litigation referred to herein. The authors would like to thank Mark R Hageman of Cravath Swaine & Moore LLP for his input.
complied with their home country requirements. However, while the fundamental differences in the treatment of non-US issuers remain unchanged, most of the new disclosure-related and governance-related requirements imposed by the Sarbanes-Oxley Act apply equally to both US and non-US issuers.

Briefly, the new principal requirements are:

(a) certifications by the CEO and CFO in each registration statement and annual report on Form 20-F filed with the SEC (with the risk of civil and criminal liability attaching to such certifications);
(b) reports by the issuer and its outside auditors on its internal controls over financial reporting (the so-called ‘section 404 reports’);
(c) the introduction and maintenance of adequate disclosure controls and procedures;
(d) an audit committee entirely made up of independent directors (with independence determined according to SEC standards), disclosure regarding an ‘audit committee financial expert’ and specific audit committee duties and responsibilities;
(e) new auditor independence standards, including a prohibition on the provision of specified non-audit services by outside auditors and pre-approval by the audit committee of all audit and permitted non-audit services;
(f) limitations on the use of non-GAAP financial measures and enhanced disclosure requirements for the ‘Management’s Discussion and Analysis’ section (MD&A);
(g) a prohibition on personal loans (broadly defined) by the issuer to its executive officers and directors;
(h) enhanced penalties, whistleblower protections and up-the-ladder attorney reporting of violations;
(i) disclosure regarding a code of ethics and regular SEC review of the issuer’s SEC filings; and
(j) regulation of the outside auditors by the Public Company Accounting Oversight Board (PCAOB), requiring, among other things, non-US auditors to provide their ‘work papers’ to the SEC upon request.

The Sarbanes-Oxley Act also introduced amendments to Section 10A under the Exchange Act. Section 10A, as an increasing number of issuers are learning, now requires, among other things, an issuer’s outside auditors to determine and consider the possible effects of ‘illegal acts’ on the issuer’s financial statements and to determine that the audit committee has been ‘adequately informed’ of such illegal acts and that ‘timely and appropriate remedial actions’ have been implemented.

In practice, Section 10A means that when an irregularity is discovered, an investigation by independent US counsel on behalf of the audit committee may need to be undertaken. In addition, outside auditors and the SEC are increasingly scrutinising whether

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2 The MD&A section is referred to as ‘Operating and Financial Review and Prospects’ in the Annual Report on Form 20-F required to be filed by foreign private issuers with the SEC.
restatements of financial statements are required and whether issuers have appropriately disclosed and dealt with illegal acts and other problems. The vigorousness and severity of the SEC’s current criminal and civil enforcement programme has generated substantial media coverage and much controversy, and does not show any signs of abating. Several non-US companies, including Adecco SA, Royal Ahold NV, Nokia Corporation, Nortel Networks Corporation and the Royal Dutch/Shell Group of Companies, have recently undergone high-profile investigations. The consequences of investigations, restatements and enforcement actions can obviously be severe for a company and its board of directors, management and share price and typically also result in US private class action litigation.

Other regulatory and legal developments

Recent US cases suggest that foreign issuers whose shares are principally traded outside the United States but who are concurrently registered and listed in the United States may be forced to defend securities class actions in US courts brought not only on behalf of the US purchasers of their US-listed securities, but also on behalf of foreign shareholders who purchased shares outside the United States (indeed, in the foreign issuer’s home country) in transactions having no connection to the United States. The possibility that class action suits may include such foreign purchasers could vastly increase the risk posed by such suits, because the class, if certified, would include the much greater number of shares traded outside the United States.

The listing requirements of the New York Stock Exchange (NYSE) and NASDAQ in general continue to defer to a non-US issuer’s home country requirements and practice, instead of imposing the same requirements that otherwise apply to US domestic issuers. However, other advantages that non-US issuers used to enjoy with the SEC have been

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3 In the first nine months of 2004, at least nine non-US companies were the subject of investigation by the SEC or the US Department of Justice, closely followed by private class action litigation. At least eight other non-US issuers have been subject to US class action claims where no accompanying investigation has yet been announced.

4 In In re Vivendi Universal, SA Securities Litigation, 2003 WL 22489764 (S.D.N.Y. 3 November 3 2003), a federal court in New York refused to dismiss securities fraud class action claims brought on behalf of non-US purchasers of shares of Vivendi, even though their purchases had no nexus to the United States. Vivendi argued unsuccessfully that the US court did not have subject matter jurisdiction to adjudicate such claims. The court held that the activities in the US of Vivendi’s top executives, who ‘move[d] to the United States, allegedly to better direct corporate operations and more effectively promote misleading perceptions on Wall Street,’ were sufficient for the court to assert subject matter jurisdiction over the claims that US federal securities laws were violated. After the case was reassigned to another federal judge, Vivendi sought reconsideration of this decision. The new judge declined to change the ruling, 2004 WL 2375830 (S.D.N.Y. 22 October 2004).

5 In the United States, issuers are subject to separate regulation by both the SEC and the listing authorities.
eroded over the last few years. Registration statements for non-US issuers are no longer reviewed confidentially by the SEC (except for first-time filers, such as in the case of an IPO). SEC comment and response letters are also now being made publicly available (subject to limited exceptions), whereas before they remained confidential except in the infrequent event of successful requests by third parties (eg journalists) under the US Freedom of Information Act (FOIA). In addition, non-US issuers now must make all their filings via the SEC’s EDGAR (Electronic Data Gathering, Analysis and Retrieval system) electronic document system.

Finally, other US legislative and regulatory developments are in many cases disproportionately affecting non-US companies. For example, the US Patriot Act of 2001 has resulted in a major expansion of US anti-money laundering laws, which are broadly defined, impose new compliance obligations on US and non-US financial institutions and can lead to criminal liability. The US Office of Foreign Assets Control (OFAC) has increased its scrutiny of dealings by issuers with ‘blacklisted’ countries (currently Cuba, Iran, Myanmar (Burma) and Sudan). Although non-US entities are not required to comply with the US economic sanctions administered by OFAC, US persons such as underwriters may be at risk of illegally ‘facilitating’ transactions with OFAC-sanctioned entities, to the extent that they engage in capital markets transactions with non-US entities that do business with OFAC-sanctioned entities. The SEC also appears to have stepped up its enforcement of the US Foreign Corrupt Practices Act (FCPA), an anti-bribery law that has historically received little attention from many companies, but that applies to all SEC registrants.

New listings

Historically, non-US companies have sought listings on the NYSE or NASDAQ for a variety of reasons, including for enhanced research analyst coverage, increased visibility and public awareness, a more attractive US acquisition currency, share-based compensation plans for US employees, an enhanced company image, and, depending on the company’s trading profile and home market, improved access to capital markets and trading efficiency. For some foreign issuers (usually from emerging markets), a US listing becomes their ‘primary’ listing, whereas for other issuers (such as those from Europe), a US listing is intended to be and has typically remained a ‘secondary’ listing. Since 2002, various companies such as Benfield Group Limited (UK), Porsche AG (Germany), Daiwa Securities Group Inc (Japan) and Fuji Photo Film Co, Ltd (Japan) have publicly abandoned plans to list on the NYSE or NASDAQ.

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6 There are also OFAC-administered sanctions against dealings with North Korea and Syria, although these sanctions do not normally bar financial or securities transactions involving the US capital markets.
In many cases, the impact of the Sarbanes-Oxley Act has been a factor in the decision not to list. In contrast to past years, of the 107 companies that listed on the NYSE in 2003, only 16 were non-US companies. In 2003, only one non-US company listed on NASDAQ. So far in 2004, 11 non-US companies have listed on the NYSE and four non-US companies have listed on NASDAQ. Most recently, Air China ruled out a NYSE listing ostensibly for technical accounting reasons, although some press reports suggest that the Sarbanes-Oxley Act may have been a factor.

Another indicator of the reticence of non-US companies to list in the United States is the increasing reliance on Rule 144A under the US Securities Act of 1933 (the ‘Securities Act’), which provides an exemption from the registration requirements of the Securities Act for certain private resales of securities to qualified institutional buyers. In 2003, non-US companies issued almost half of the US$4.5 billion of equity securities placed pursuant to Rule 144A. In Europe’s second-largest IPO of 2004 to date, Terna Sp A, Italy’s largest electricity transmission company, listed on the Borsa Italiana and relied on Rule 144A for sales into the United States.

Likewise, many Chinese and Indian companies have recently opted to list only on domestic stock exchanges and rely on Rule 144A for sales into the United States. Nine of the ten largest IPOs in China from 1 January 2003 to 20 October 2004 included Rule 144A placements but no US listing. This trend seems to be even more significant in light of the difficulties experienced by China Netcom Group Corporation (which has warned that it may not be able to comply with Section 404 of the Sarbanes-Oxley Act) and China Life Insurance Company Limited (which is now the subject of private class action litigation in the United States), both of which have pursued high-profile US listings. The nine equity offerings with US tranches completed in India to date in 2004 have utilised Rule 144A or another exemption from registration, instead of a US listing. In fact, only two Indian companies (Tata Motors Limited and Sify Limited) have listed in the United States since 2002, in spite of the recent substantial gains in the Indian economy and equity capital markets.

**Delistings and deregistrations**

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7 For example, 33 and 51 non-US companies (excluding those that moved their listing to the NYSE from NASDAQ) listed on the NYSE in 2002 and 2001, respectively.

4 The foregoing excludes non-US companies who moved their listing to the NYSE from NASDAQ.

9 Rule 144A is not available for securities that are fungible with securities listed in the United States. For securities that already have a US listing, section 4(2) under the Securities Act affords a similar, but somewhat more restrictive, private placement exemption to Rule 144A. For example, Prudential plc, in its recent £1 billion rights offering, utilised section 4(2) to privately place rights to certain qualified institutional buyers in the United States.

10 Source: Thomson Financial.
The impact of US regulatory and legal developments may also be evidenced by the increased interest of foreign companies in delisting and deregistering in the United States. By delisting a class of securities from the NYSE or NASDAQ and subsequently deregistering the class under the Exchange Act, an issuer can free itself of the Sarbanes-Oxley Act and the other reporting and governance requirements applicable under US federal securities law.11

Various European companies listed in the United States have explicitly cited the impact of the Sarbanes-Oxley Act on their decisions to terminate their US listings and, in some cases, to deregister under the Exchange Act. To date in 2004, at least ten foreign issuers have reportedly voluntarily delisted from NASDAQ, including lastminute.com PLC (UK), which has delisted from NASDAQ and announced its intention to deregister; Intershop Communications AG (Germany), which has delisted from NASDAQ and deregistered; and TeliaSonera AB (Sweden), which has delisted from NASDAQ. At least four foreign issuers have voluntarily delisted from the NYSE to date in 2004 (Boardwalk Equities Inc (Canada), Tenon Limited (New Zealand), Internacional de Cerámica, SA de CV (Mexico) and Telefónica del Perú SAA (Peru)).

Importantl, although delisting from the NYSE or NASDAQ is not particularly difficult, deregistering under the Exchange Act is not possible for most companies. An issuer is only eligible to terminate registration of its securities once its securities are held of record by fewer than 300 persons resident in the United States or fewer than 300 persons worldwide13 (or, for issuers with assets worth below US$10 million, fewer than 500 persons worldwide)14. Holders of both ADRs and ordinary shares are counted towards the foregoing thresholds. Even for an issuer with ADRs that are thinly traded, it can rarely be established with sufficient comfort and headroom that the issuer has, and will continue to have, less than the requisite number of securityholders.

Since the more burdensome US regulatory requirements apply to all SEC registrants, whether or not listed on the NYSE or NASDAQ, delisting without deregistering does not accomplish much (other than reducing US liquidity and thereby increasing the likelihood that eventually fewer than 300 US residents will own the issuer’s shares), and leaves the

11 Note that issuers remain subject to the registration requirements under the Securities Act for any subsequent offer and sale of securities.

12 Terminating or unwinding an ADR programme may involve significant out-of-pocket costs for an issuer, depending on the terms of the issuer’s ADR deposit agreement.

13 The ‘look-through’ requirements for the 300 worldwide holders alternative are different from those for the 300 US resident holders test.

14 Moreover, if after deregistering, the securities are held by more than 300 US residents on the last day of a subsequent fiscal year, the issuer must re-register the class of securities under the Exchange Act. (If the issuer had never registered the class of securities in the first place, the issuer could have utilised Rule 12g3-2(b) under the Exchange Act to avoid registration.)
issuer with basically all the burdens of SEC registration without the primary benefits of a US listing. Needless to say, the difficulty in deregistering has come as an unpleasant surprise to many (most?) non-US issuers. By way of contrast, in many European countries, a company can terminate a secondary listing by providing notice to the relevant regulatory authorities and observing a waiting period or complying with certain limited undertakings.

In light of the difficulties that issuers face in deregistering, proposals have been submitted to the SEC advocating modernisation of the deregistration requirements, including allowing an issuer to terminate its SEC registration two years after a US public offering or listing if US trading does not represent at least five per cent of its worldwide trading volume (subject to the issuer continuing to furnish home country reports that meet certain disclosure and financial reporting standards). Another proposal would allow deregistration if the percentage of US resident holders relative to the issuer's total number of securityholders is below a certain threshold (such as ten per cent). Alternatively, the current deregistration threshold of 300 US resident securityholders may be increased. The SEC is currently considering such proposals and at least some changes to the deregistration requirements are expected, although the extent and timing of such changes are uncertain. Ultimately, perhaps some sort of mutual recognition regime between the United States and other jurisdictions will be feasible and indeed necessary.

Analysis

Given the foregoing data, it seems clear that the Sarbanes-Oxley Act and other US regulatory and legal developments have had at least some impact on the willingness of foreign companies to seek or maintain US listings. However, it should be noted that there are other factors at work as well. Perhaps most important has been the declining or at least stagnant equity markets, especially for IPOs, and the fact that many companies have been internally focused, dealing with restructurings and reorganisations and ensuring that their own 'house' is in order first. Relatedly, the level of cross-border acquisitions of US companies has been fairly low over the last few years, meaning that fewer non-US companies have needed to seek US listings to create acquisition currency. The value of a US acquisition currency has also come under greater scrutiny, given the recent negative experience of some non-US acquirers with shares 'flowing back' from the US market to their home market and the overhang effect on their share price that the risk of such flowback creates. In addition, share-based compensation plans for US employees are less attractive than before, given new accounting rules in some jurisdictions that require

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15 The proposals would also modify the rules so that a company would not become permanently unable to use Rule 12g3-2(b) under the Exchange Act as a result of the original registration. See note 14 above.
issuers to recognise (or at least disclose) stock options as an upfront compensation expense.\textsuperscript{16}

US investors can more easily than ever directly buy shares of foreign companies, as markets become more global, technologically advanced and liquid, information is more readily available and investors are more at ease dealing with local legal restrictions and currency risk. For example, India has relaxed many of its foreign ownership rules. Limited liquidity in most ADR programmes, especially since the enactment of Rule 144A in 1990, further compounds the unattractiveness of US listings. Many non-US exchanges are also more liquid than ever before,\textsuperscript{17} and Rule 144A (and Section 4(2)) under the Securities Act are viable alternatives for accessing at least the institutional portion of the US capital markets. Furthermore, it seems that most of the significant US investment banks, mutual funds and other financial institutions now have a home in the significant European and Asian markets, helping to reduce or eliminate the need for a non-US company to list on the NYSE or NASDAQ to ensure adequate US analyst coverage.\textsuperscript{18} But, given the now more restrictive regulatory environment for research analysts and their potentially diminished role, some financial institutions are reportedly beginning to cut back on the number and location of their analysts.

Non-US stock exchanges, such as the London Stock Exchange and Singapore Stock Exchange, appear to have stepped up their efforts of late to compete more directly with the NYSE and NASDAQ. To varying degrees, the non-US exchanges may either advocate their own governance and disclosure standards, or even highlight more relaxed standards, to attract issuers. In addition, the prestige and favourable publicity that some non-US companies have coveted with a US listing is presumably diminished in the post-Enron era. However, issuers in industries such as media and technology may benefit

\textsuperscript{16} See, eg, US Statement of Financial Accounting Standards No 148 (SFAS No 148), Accounting for

Stock-Based Compensation – Transition and Disclosure, and International Financial Reporting Standard 2
Share-based Payment (IFRS 2).

\textsuperscript{17} Tata Consultancy Services Limited, India’s largest information technology services company,

launched a US$1.1 billion IPO in August 2004 and received a then-record US$5.6 billion worth of

applications from retail buyers, a total of US$10 billion of orders overall, and placed 38 per cent of the

offering with international funds, including pursuant to Rule 144A. The US$1.2 billion IPO in November

2004 by National Thermal Power Corporation Limited, India’s largest power generating company, fared

similarly, with total orders of US$1.6 billion and an international allocation of 38 per cent, including

pursuant to Rule 144A.

Between 1983 and 2003, average daily trading volume on the principal market of the Paris Stock

Exchange increased from the equivalent of £206 million to over £3.4 billion, and on the London Stock

Exchange increased from £208 million to over £14 billion.

\textsuperscript{18} The foregoing factors have been cited as reasons for not seeking a US listing by, among others, adidas-Salomon AG (Germany), BMW AG (Germany), Greencore Group plc (Ireland), Rexam PLC (UK), Roche Holding Ltd (Switzerland) and Samsung Electronics Co, Ltd (South Korea).
more than others from a valuation on the NYSE or NASDAQ benchmarked against US competitors.

Last but certainly not least, companies are increasingly aware of and focused on the risk of US liability and regulatory scrutiny, whether as a result of SEC enforcement proceedings, private class action litigation (both inside and outside the United States) or other proceedings. Historically, class action litigation was directed almost entirely at US companies, but more non-US companies are now the subject of class action litigation in the United States (including potentially for claims by non-US purchasers19) and even increasingly outside the United States. The Sarbanes-Oxley Act has also focused the attention of senior management and board members on the burdens of a US listing and on the question of whether the benefits outweigh the cost and risk of the listing. Even the ‘ordinary’ costs of a US listing can be significant with not only accountants’, lawyers’ and filing fees, but also costs to establish an ADR or ‘global share’ programme.

Conclusions

Of course, as indicated above, at least some foreign companies still consider US listings attractive, especially those that view their US listing more as a ‘primary’, as opposed to a ‘secondary’, listing. There are several other factors, which in the short term may also impact the attitude of non-US companies towards US listings. The pending move to IFRS may make European companies less willing to tackle the US GAAP reconciliation that a US listing would require. On the other hand, convergence between US GAAP and IFRS may make a US listing less daunting20. The European Union’s Prospectus Directive also now requires companies to prepare disclosure documents in accordance with the recommendations of the International Organization of Securities Commissions (IOSCO). The Prospectus Directive and other EU regulations seem likely to result in a larger and deeper pan-European market with more uniform standards, further dampening any enthusiasm for an additional listing in the United States.

Pursuant to Section 404 of the Sarbanes-Oxley Act, non-US companies will be required, beginning with fiscal years ending on and after 15 July 2005, to report specifically on their internal controls over financial reporting. The outside auditors must also ‘attest’ to such reports. The cost and workload required for section 404 reports is substantial in most cases. A recent report estimates that large US companies (defined as having annual revenues in excess of US$5 billion) will spend on average US$8 million for the first year of section 404 reports. Total estimated ‘year one’ costs for all surveyed US companies

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19 See note 4 above.

20 Harmonisation between US GAAP and IFRS remains a significant challenge, including, for example, in the accounting for leases, insurance and pensions. According to a report in the Financial Times on 9 November 2004, the current target for convergence is 2007-2008, although there will be ‘blood all over the streets’ before convergence finally occurs.
(with average annual revenues of US$2.5 billion) is on average US$3 million. The foregoing excludes indirect costs such as slower decision-making and lower productivity, although some of the section 404 direct costs would have presumably been incurred by issuers anyway (such as for IT systems). Although most non-US companies have already begun undertaking the work necessary to comply with section 404, the cost and workload for section 404 means that such companies are examining the value of their US listings even more closely.

The attitude and approach of the SEC and other US regulators and legal authorities to non-US companies will also be closely watched in boardrooms and among advisers to gauge the level of difficulty and risk that US listings entail. Ironically, by making it more feasible for foreign companies to deregister under the Exchange Act, the SEC could actually help attract more US listings, since foreign issuers would not have to view a US listing and registration as practically permanent and also might more generally be encouraged that the SEC will accommodate the particular needs of non-US companies.

The SEC should want to accommodate non-US issuers, since the alternative is to watch such issuers increasingly utilise Rule 144A (or section 4(2)) under the Securities Act and remain free of the Sarbanes-Oxley Act and direct SEC oversight. Other pending reform of certain provisions of the US federal securities law may make it easier for issuers, especially 'well-known seasoned issuers' to access the US capital markets without some of the more unnecessary and outdated restrictions currently imposed in an SEC-registered offering. In addition, for better or worse, the Sarbanes-Oxley Act seems to have become something of a 'model' for governance and disclosure reform in certain other jurisdictions. As such governance and disclosure standards converge, a US listing...

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21 See Financial Executives International (FEI), July 2004: 'Special Survey on Sarbanes-Oxley Section 404 Implementation Executive Summary' (www.fei.org). The FEI survey found that estimated section 404 'year one' compliance costs had increased 62 per cent since its initial survey in January 2004. For large companies, the estimated costs had nearly doubled (from US$4.6 million in January 2004).

22 According to the SEC's proposal, a 'well-known seasoned issuer' generally has a market capitalisation of at least US$700 million (or, in limited circumstances, has issued US$1 billion in SEC-registered debt in the last three years), has been public for at least one year, is current with all its SEC filings, has not defaulted in the current fiscal year on any of its preferred stock or debt instruments and is not otherwise an 'ineligible issuer' as defined by the SEC. An ineligible issuer includes any issuer that within the past three years has entered into a settlement or consent decree with the US federal government to resolve allegations of violation of the US federal securities laws (the language of the proposed exclusion would generally track the existing exclusion from the forward-looking statement safe harbour provisions).

23 See www.sec.gov/rules/proposed/33-8501.pdf. The proposed reforms were announced by the SEC on 26 October 2004, and are pending public comment and final adoption. The proposals involve, among other things, significant changes to registration procedures, communication requirements and prospectus delivery mechanics under the Securities Act. In particular, the proposals would (i) liberalise the rules relating to pre-offering communications (often called 'gun jumping') and (ii) create revised offering procedures, including automatic registration without the delay of possible SEC review, for certain 'shelf' registrations for offerings by 'well-known seasoned issuers'.
may not be perceived to be as burdensome as it is currently. It is likely that there will remain, however, the increased risk of liability and regulatory scrutiny in the United States. New high-profile investigations and legal proceedings against either US or non-US listed companies could further negatively influence attitudes towards US listings.

Given the various factors at work and the seeming trend away from US listings by foreign issuers, it will be most revealing to see how such issuers respond when there is a more sustained uptick in US inbound M&A activity and in equity capital markets. Will it indeed be true that a rising tide lifts all boats...?
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The New Federalism of the American Corporate Governance System:
Preliminary Reflections of Two Residents of One Small State

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proposal was apparently dropped in view of the outright ban on audit committee participation by such owner-directors contained within Sarbanes-Oxley, but the original recommendation is unlikely to be easily forgotten by shareholder activists or plaintiffs’ lawyers. Indeed, the NASDAQ still requires that if the director is to serve on the Audit committee, he or she must meet the requirements under the Act, be independent as described above, and not own or control 20% or more of the issuer’s voting securities, or such lower measurement as may be established by the SEC under § 301 of Sarbanes-Oxley.49

C. The Clearest Example of the New Federalism: The New Substantive and Procedural Checks on Director And Officer Compensation

In one subject area, the 2002 Reforms are easy to see as intrusions on the domain of the states.50 In § 402 of Sarbanes-Oxley, Congress explicitly

49 NASDAQ PROPOSED AMENDMENTS RULE 4350(d)(2)(A)(i).

50 Although director and officer compensation is one clear example of federal intrusion into a traditional state domain, it is by no means the only example. For example, establishing and enforcing standards for attorney professional conduct is another area traditionally left to the states. But Section 307 of the Sarbanes-Oxley Act directs the SEC to “issue rules, in the public interest and for the protection of investors, setting forth minimum standards of professional conduct for attorneys.” Accordingly, the SEC recently adopted rules governing attorneys’ professional responsibilities. These proposed “minimum standards” include controversial reporting requirements imposed upon attorneys who come across evidence of an issuer’s violation of securities laws or fiduciary duties. In these circumstances, the attorney must report the evidence to the chief legal counsel or chief executive officer (or the equivalent, including an optional qualified legal compliance committee) of the issuer, and then to the audit committee, another committee of independent directors, or even the full board of directors, if the recipient of
bans corporations from making loans to directors and officers, with certain limited exceptions.51 This is a direct federal limitation on the power of state-chartered corporations to engage in a particular type of transaction explicitly authorized by state statutory law,52 a type of limitation that more traditional minds might think should flow from the chartering states, rather than from the federal government. The ban inspired a group of prominent law firms to write a joint memorandum articulating their shared view of the appropriate scope of the ban.53 In particular, the law firms addressed whether the ban on loans would deny companies the ability to advance litigation costs to directors and officers, in accordance with Delaware law.54

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51 Sarbanes-Oxley § 402 (codified at 15 U.S.C.A. § 78m(k)).
52 See DEL. CODE ANN. tit. 8, § 143 (2001) (authorizing loans to employees and officers of a corporation whenever "in the judgment of the directors, such loan, guarantee or assistance may reasonably be expected to benefit the corporation.").
54 Id. (discussing advancement of litigation costs as possibly implicating Sarbanes-Oxley's prohibition on personal loans); see also DEL. CODE ANN. tit. 8, § 145(e) (2001) (enabling corporations to advance litigation costs under certain conditions).
The Exchanges have also delved into the compensation area in a manner that would more typically find its manifestation in a state corporate code. The proposed NYSE and NASDAQ Rules require stockholder approval for certain equity-compensation plans. In this way, the Exchanges have demonstrated a willingness to go beyond state requirements for stockholder votes when they believe that those requirements are insufficient to protect stockholder interests.

Notably, the Exchanges’ more aggressive regulation of the internal affairs of their listed companies is not necessarily limited to the subject of compensation. An interesting NASDAQ proposal requires all related party transactions to be “approved by the company’s audit committee or a comparable body of the board of directors.” In contrast, Delaware law allows proof of fairness or stockholder ratification to substitute for use of a special committee in validating an interested transaction. This protection of interested transactions that are either fair or shareholder-approved is an allowance not afforded under the NASDAQ proposal.

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57 DEL. CODE. ANN. tit. 8, § 144 (2001).
With these basic features of the 2002 Reforms in mind, we now turn to some of the implications they have for state corporate law.

II. Are the 2002 Reforms a Shadow Corporate Law?

The most striking feature of the Reforms is a pervasive and general one: the extent to which they can be seen as a shadow corporation law that requires public company boards to comply with a very specific set of procedural prescriptions. This aspect of the Reforms represents a departure from the general spheres in which the three principal sources of corporate governance guidance in the American system have operated. Stated in very rough terms, the division between the two governmental authorities has given primary responsibility for fair disclosure and securities market regulation to the federal government (principally through the SEC). State law retained the substantive regulation of corporate transactions and board conduct. The Exchanges have played a more mixed role, through listing requirements and rules of some diversity, but had generally non-burdensome effects. These include requirements for stockholder votes on

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58 For recently released articles that express (in stronger terms) some of the same sentiments and concerns we raise here, the interested reader should consult the provocative and well-written articles by Stephen M. Bainbridge, A Critique of the NYSE’s Director Independence Listing Standards, 30 SEC. REG. L.J. 370 (2002) and Simon Lorne, Sarbanes-Oxley: The Pernicious Beginnings of Usurpation?, 6 WALL ST. LAWYER 1 (Sept. 2002).
certain transactions that do not require such approval under state law, and, perhaps most notably, for audit committees comprised of independent directors.

This division of responsibilities has never been marked by bright borders. To the contrary, many federal disclosure requirements have had the natural (and presumably) intended consequence of influencing boardroom practices. Similarly, the state law of fiduciary duties has been an important tool in evolving better disclosure practices, particularly in the context of mergers and acquisitions requiring a stockholder vote or tendering decision. The tug and pull among the various policy actors has occurred in a civil manner, manifesting a sincere concern for the creation of an overall system that functions fairly and efficiently and that avoids whipsawing corporate officials with contradictory or unworkable mandates from different sources of legitimate authority.

In several respects, however, the 2002 Reforms can be seen as different in kind from previous incursions across the rough borders of policy responsibility that have characterized the American system of corporate

59 The NYSE has long required a stockholder vote on any transaction that would result in an increase in the listed company's outstanding shares by 20% or more. See N.Y. Stock Exch., Listed Company Manual § 312.03(c). This requirement has often influenced the dynamics of M&A cases arising under Delaware corporate law. See, e.g., Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1146-48 (Del. 1989).

60 See N.Y. Stock Exch., Listed Company Manual § 303.01(B)(2).
governance to date. The isolated provision of Sarbanes-Oxley that bans most loans from public corporations to their directors and officers is the most obvious example. By this method, Congress took upon itself responsibility for delimiting the range of permissible transactions that corporations chartered by state law could consummate. In itself, the mandate is relatively trivial, but its precedential significance may not be. What's next? A ban on going private transactions? Or options-based compensation of executives? Or on interested transactions? The proposed Exchange Rule that requires a stockholder vote on equity compensation plans and plan amendments has a similar quality. Under this rule shareholders must approve all equity compensation plans, other than exempt plans, and brokers may not vote on stock option plans without client instructions. What is the next class of transactions that the

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61 At various times during the past century or so, the federal government and the Exchanges have considered a more full-bodied intrusion into the states' primary role in governing the internal relations of corporations. There is no doubt that federal statutes exist that vest in the federal government primary or co-equal governance of corporate conduct that might seem to fall principally within the purview of state law (for example, regulation of the corporate proxy solicitation and ballot process). For a provocative and incisive examination of the interaction between the federal government and the states in corporate law policymaking, see Mark J. Roe, Delaware's Competition passim (Nov. 25, 2002) (unpublished manuscript, on file with authors).

62 As noted, the NASDAQ Proposed Rule Change to its Rule 4350 requires all related party transactions to be approved by the company's audit committee or a comparable body of the board of directors. SEC Proposed Rule Change, File No. SR-NASD-2002-80. This diminishes the range of options available to corporations under state law, which have typically been able to use proof of fairness or a ratification by disinterested stockholders to validate an interested transaction.

63 NYSE PROPOSED RULES, supra note 5, at § 303A(8).
Exchanges believe should receive stockholder approval, irrespective of the fact that state law empowers directors to consummate them without stockholder approval? In recent years, for example, there has been a great deal of controversy about whether stockholders may adopt a bylaw that requires a board of directors to dismantle a shareholder rights plan or poison pill. See generally John C. Coffee, Jr., *The Bylaw Battlefield: Can Institutions Change the Outcome of Corporate Control Contests?*, 51 U. M I A M I L. R E V. 605 (1997); Jeffrey N. Gordon, "Just Say Never?" Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffett, 19 CARDOZO L. R E V. 511 (1997); Lawrence A. Hamermesh, Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back the Street?, 73 T U L. L. R E V. 409 (1998). As Professor Thompson commented to us, these examples raise two distinct, albeit related, issues. That is, the distinction between what board decisions stockholders must approve, and what decisions stockholders may make themselves (e.g., through bylaws). For our purposes, this distinction is less important than the potential that the answers to these traditionally state law questions may be dictated by the Exchanges or the federal government.

64 The Sarbanes-Oxley Act lacks any specific section expressing an intention to expand the SEC’s reach into corporate internal affairs through Stock Exchange listing requirements. As a result, the SEC’s authority to command state-chartered corporations to comply with those aspects of the proposed Exchange Rules that require the formation of certain types of committees with particular members is unclear. An important decision pre-dating Sarbanes-Oxley casts doubt on the ability of the SEC, through its oversight of Exchange Rules, to regulate the internal affairs of corporations.

In *Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990), the United States Court of Appeals for District of Columbia Circuit held that the SEC did not have the statutory authority to promulgate a rule barring national securities exchanges and associations from listing stock of corporations which nullify, restrict or disparately reduce per share voting rights of existing common stockholders. Id. at 407. In so ruling, the court held that the provision of the Exchange Act authorizing exchange rules had to be read as addressing certain specified congressional
We have no reason to believe that the Exchanges will in fact enter the poison pill debate anytime soon. But this illustration does highlight the potential problems that could arise if the federal government and the Exchanges are not sensitive to the states' primary role in the formulation of substantive corporation law.\textsuperscript{66}

Whether everyone is entirely happy with the resulting product, Delaware does have a carefully thought-out model of corporation law — one which corporations and their constituencies are free to choose or to abandon by going to another state. Delaware takes an enabling approach, which broadly empowers corporate boards acting in conformity with their fiduciary purposes, and not as, sub silentio, an intention to supplant state corporation laws. Consistent with that holding, the D.C. Circuit Court found that "the Exchange Act cannot be understood to include regulation of an issue that is so far beyond matters of disclosure . . . and of the management and practices of self-regulatory organizations, and that is concededly a part of corporate governance traditionally left to the states." \textit{Id.}

The court also rejected the SEC's claim that it had authority to promulgate the rule because the 1975 amendments to the Exchange Act gave the Commission the authority to "facilitate the establishment of a national market system for securities." \textit{Id.} at 415. The court refused to read into those words broad-sweeping authority for the SEC to supplant all state corporate law. It stated that the SEC's "theory can easily federalize corporate law for all companies wishing access to the national capital markets. Yet nothing in the statute and legislative history suggests so broad a purpose." \textit{Id.} at 415. The court's reasoning was, in large part, grounded in the teaching of the United States Supreme Court, found in the landmark case of \textit{Santa Fe Industries, Inc. v. Green}, where the Court stated that corporations "are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation." 430 U.S. 462, 479 (1977) (emphasis in original).

\textsuperscript{66} See Bainbridge, supra note 68, at 397-99 (arguing that the nation will suffer if substantive corporate law is federalized through the SEC and Exchanges).
duties to cause their corporations to engage in virtually any lawful activity subject to compliance with relatively flexible statutory constraints.

The statutory constraints on unilateral action that exist in the Delaware General Corporation Law have been chosen with some care. They are designed to protect stockholders in situations when the importance or nature of a transaction seems to require support from the corporate electorate in order to prevent abuse and to fulfill the legitimate expectations of the investors. Thus, our law requires stockholder approval for important items such as charter amendments,\(^{67}\) increases in the corporation’s authorized shares,\(^{68}\) certain mergers,\(^{69}\) and a sale of substantially all of the corporation’s assets.\(^{70}\)

Enforcing these statutory safeguards is the common law of fiduciary duty. The preoccupation of that aspect of corporate law has been the deterrence and remediation of disloyal acts by fiduciaries who use their position of trust to extract private benefits at the expense of their corporations’ stockholders.\(^{71}\) The Delaware courts have deployed a variety

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\(^{68}\) § 242(a)(3).

\(^{69}\) E.g., § 251.

\(^{70}\) § 271.

\(^{71}\) E.g., Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983); Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939).
of tools for that purpose, including the entire fairness standard of review for conflict transactions and the heightened \textit{Revlon} \textsuperscript{72} and \textit{Unocal} \textsuperscript{73} standards that are applied to certain director actions in the M&A context. Within the framework of fiduciary duty review, the Delaware courts have provided strong incentives for corporate boards to use procedures that are designed to protect public stockholders. For instance, our law gives great liability-insulating effect to majority-of-the minority vote provisions and to the deployment of a special committee of independent directors. \textsuperscript{74} Indeed, it has long been the case that Delaware law provides a strong incentive for companies to comprise their boards with a majority of independent directors. \textsuperscript{75}

What Delaware law has resisted, however, is the recitation (by statute or case law) of a detailed set of particular measures that boards must take, or of certain transactions that boards must avoid, if they are to act equitably and lawfully. This reticence is not inspired by any reluctance to hold boards


\textsuperscript{73} Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

\textsuperscript{74} Kahn v. Lynch Communication Sys., Inc., 638 A.2d 1110, 1117-18 (Del. 1994); Rosenblatt v. Getty Oil Co., 493 A.2d 929, 937 (Del. 1985); \textit{Huizenga}, 751 A.2d at 891, 900-01; In re Gen. Motors Class H S'holders Litig., 734 A.2d 611, 617 (Del. Ch. 1999).

\textsuperscript{75} \textit{E.g.}, Aronson v. Lewis, 473 A.2d 805 (Del. 1984).
accountable for improper action, as our case law is replete with examples that refute any assertion of that kind.\textsuperscript{76} Rather, this cautious approach has rested on a belief that there must be room for creativity and innovation and that the law must accommodate the diversity that exists in corporate America. The restraints that might be useful and workable when applied to the largest fifty companies in America might be ill-suited to smaller public companies. The potency of fiduciary duty review (particularly under the entire fairness doctrine) and the statutory protections given to stockholders (\textit{e.g.}, appraisal rights) were seen as sufficient,\textsuperscript{77} especially when coupled with a corporate election process that gave stockholders an annual opportunity to elect directors.

The Delaware system takes the electoral process seriously and our courts have been vigilant about policing instances of electoral abuse.\textsuperscript{78} One natural outgrowth of our system’s view of corporate democracy has been a mindset on the part of Delaware policymakers that does not lightly deprive the stockholders’ chosen representatives of managerial authority. When the


\textsuperscript{77} This statement subsumes the idea that Delaware’s lawmakers and its judges adapt these protections to address new evolutions, such as the takeover boom of the last twenty-five years.
matter is debatable and no self-dealing exists, the decisions of elected boards have been respected. That is the essence of the business judgment rule.

From the perspective of Delaware and other states, the 2002 Reforms are somewhat problematic because they supplement our principles-based, substantive corporation laws with a variety of specific requirements that are not part of any overall system of corporate governance.\(^79\) This is not to say that the 2002 Reforms do not bespeak an overall philosophy of corporate governance: they do. That philosophy is based on the notion that strong and diligent oversight by independent directors who are required to focus on legal and accounting compliance will result in public companies behaving with integrity. Concomitantly, the Reforms reflect a belief in the behavior-influencing effect of process and disclosure (\textit{i.e.,} by requiring boards and officers to undertake certain tasks and to certify that they have done so (or explain why not). Thus, the Reforms hope to encourage responsible conduct and to deter wrongdoing and imprudent risk-taking.

To two Delaware judges, these beliefs are almost as familiar as the Lord's Prayer. What is not so familiar is the detail in which the Reforms


\(^{79}\) Academic and professional commentators have raised concerns about this aspect of the 2002 Reforms, as well as the large staff and advisor costs that will be required to implement them. \textit{E.g.,} Peter V. Letsou, Flaw and Folly, The Daily Deal (Oct. 11, 2002).
prescribe the precise means by which directors and officers are to pursue
certain ends. The Delaware approach has tended to create incentives for
particular good governance practices, while recognizing that what generally
works for most boards may not be the best method for some others. The
fiduciary duty form of accountability is well-suited to this sort of flexibility,
because it is context-specific in application.

But because the Reforms naturally take a more rule-based form, they
come with the risk of codifying (by statute or contract) an array of
procedures that, when fully implemented in their totality, might be less than
optimal. For present purposes, we highlight two risks of the Reforms that
seem to stand out. First, there is the hazard that corporate boards will have
very little time to concentrate on core business issues given the various tasks
and implementation deadlines mandated by the Reforms.80 Second, there is
a danger that the 2002 Reforms may be too costly for smaller firms to

80 Taken as a whole, the Reforms impose a host of new obligations on listed companies, which
come due at various times of the year. By way of example, auditor independence requirements
become effective in April, 2003, subject to transition periods. Notably, failure to comply with the
strict audit committee standards by this date could subject an issuer to delisting by the Exchanges,
as discussed supra at note 25. Provisions requiring enhanced disclosure for non-GAAP financial
measures and disclosure of earnings releases on Form 8-K become effective after March 28,
2003. Various other disclosures must be included in annual reports for fiscal years ending on or
after July 15, 2003 for most companies, such as Audit Committee “financial expert” disclosure,
Code of Ethics disclosure, and Off-Balance Sheet disclosure. Record retention requirements take
effect on October 31, 2003. With all of these compliance dates, and many more, contained within
the Act, boards will likely feel great pressure to merely meet the baseline requirements, especially
at smaller public corporations. A sophisticated law firm’s compilation of the required tasks fills a
chart spanning five pages and includes another page of proposed rules that still require final
implement efficiently. The intense focus of the Reforms on corporate compliance is both understandable and praiseworthy. What is a bit more questionable is the expansive reach of the Reforms and their attempt to spell out precisely the means through which each board will ensure the goal of legal compliance and accounting integrity.  

By their own terms, the proposed NYSE Rules require several committees comprised entirely of independent directors with specific mandates. Once the independent directors have carried out (or at least "checked the box" on) all their Reform mandated duties—on the audit committee, on the nominating/corporate governance committee, and the compensation committee—they may find it difficult to find time to ponder issues like: Does the company have a good strategic direction? If it does, how well is the company’s management doing in executing that strategy?

Finding the time to think about issues of this kind may be even harder for smaller public companies that may not be able to afford extra staff or a host of outside advisors simply to ensure implementation of the Reforms’ mandates. Likewise, these companies may have more difficulty finding independent directors at an affordable price. These time demands and cost rulemaking before their deadlines are established. See Patricia A. Vlahakis et al., Sarbanes-Oxley Act: Compliance Reminders (Wachtell, Lipton, Rosen & Katz, Feb. 7, 2003).
pressures on smaller public companies could lead to an increase in going private transactions, or to much lower net profitability, as increased advisor and staff costs eat into cash flow. Even at the largest of companies, it will be a challenge for boards to organize themselves in an efficient manner that leaves adequate time for the deep consideration of key business issues and that does not overly diminish the corporations’ coffers.  

III. Spillover Effects: State Courts Will Soon Face Fiduciary Duty Cases premised on the 2002 Reforms

Because public companies, as a practical matter, cannot opt out of the 2002 Reforms, their mandates can be seen as reducing the overall flexibility of the American system of corporate governance. Although our state has a strong market position, it still faces competition from other sources of corporate law, a factor which some scholars believe has contributed to a

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81 See Bainbridge, supra note 68, at 394 (expressing concern that the NYSE has “strap[ped] all listed companies into a single model of corporate governance”).

82 Even well-meaning efforts by the SEC to create flexibility under the new Act surface this challenge. For example, the SEC has given companies flexibility to have required reports by attorneys or accountants go to a Qualified Legal Compliance Committee (“QLCC”), rather than the chief legal counsel or the chief executive officer of the company. SEC Adopts Attorney Conduct Rule Under Sarbanes-Oxley Act, SEC Release 2003-13, available at http://www.sec.gov/news/press/2003-13.htm. But the QLCC must include a member of the audit committee and two other independent directors. This “flexibility” actually takes away the ability for a board to create a separate legal compliance committee comprised of independent directors to address legal compliance matters that do not related to financial or disclosure issues. Given the substantial burdens on audit committees and given the far-flung compliance obligations of some big companies, separate committees might make business sense, not only in terms of allocating scarce director resources but in terms of expertise (i.e., the director who is an expert at accounting might be clueless about CERCLA or Title VII). As now proposed, however, some very lucky independent director will get to serve on both the audit and legal compliance committee.
better product.\textsuperscript{83} It can be argued, we suppose, that this type of governance choice could be made available through competing Exchange requirements. We find this a bit doubtful. Furthermore, the congressional process is not designed to produce annual updates, such as have characterized state corporate law, at least in Delaware. Nor are the Exchanges likely to gin up the energy for an annual review of their listing requirements.

As a result, corporate America is likely to have to live with the 2002 Reforms for some time. Because the Reforms address boardroom practices traditionally governed by state law but do not, in themselves, constitute a comprehensive body of substantive corporation law, the Reforms will inevitably begin to influence state law adjudication. One of the important factors supporting this intuition is that Congress and the Exchanges did not supply forums for the resolution of implementation disputes at the instance of stockholders.

Unlike Delaware, for instance, the Exchanges do not have a judicial tribunal that regularly applies corporate governance requirements to real-world disputes through a fair process that results in written decisions, which in turn provide feedback to policymakers that stimulates later amendments to the rules. In addition, the Exchanges have only a very blunt tool to use to

\textsuperscript{83} See, \textit{e.g.}, \textsc{Roberta Romano}, \textsc{The Genius of American Corporate Law} (1993).
ensure compliance: the threat of delisting or suspending trading in a company’s stock. Delisting or suspending trading are remedies that do not punish the directors who are responsible for any failures (as fiduciary duty review does) alone; they also punish the stockholders themselves. Therefore, delisting or suspending trading are likely to be viewed as unsatisfactory remedies from the point of view of stockholders. And, under pre-existing law, stockholders have generally been denied the ability to enforce Exchange Rules by way of a private right of action under the Exchange Act. Sarbanes-Oxley contains no provision suggesting that

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64 Besides delisting, the NYSE would also wield the power of issuing a “public reprimand letter to any listed company that violates an NYSE listing standard.” NYSE PROPOSED RULES, supra note 5, § 303A(13); NYSE REPORT, supra note 5, at 24. If such a public reprimand fails to move a listed company toward compliance, then the NYSE is left only with a choice of blunt remedies—delisting or suspending trading. Indeed, Delaware judges are sure to hear from the plaintiffs’ bar that the significance of a public reprimand is that a company’s board of directors is “risking delisting.” In any case, NYSE Chairman Dick Grasso has said in public speeches (e.g., at the Duke University Director’s Institute in October 2002) that the NYSE will move to delist noncompliant companies for any material violation.

It is also true, of course, that the SEC may potentially enforce the listing standards of the Exchanges. The Exchange Act provides that the SEC can bring an action for violations of, or to command compliance with, the rules of a self-regulatory organization if the organization is unable or unwilling to take appropriate action or if the action is “otherwise necessary or appropriate in the public interest or for the protection of investors.” 15 U.S.C. § 78u(f). In addition, the SEC has recently proposed a rule that would require the Exchanges to prohibit the listing of securities of issuers that do not comply with Sarbanes-Oxley’s audit committee requirements. Proposed Rule 10A-3 of the Exchange Act, Rel. No. 34-47137, available at 68 Fed. Reg. 2638-01 (Jan. 17, 2003). This proposed rule puts teeth in Section 301 of the Sarbanes-Oxley Act.

As noted previously, see supra note 52, the extent of the SEC’s authority to act under this authority is, at the very least, uncertain when the Exchange Rule to be enforced addresses the internal affairs of corporations.

65 As a general matter, stockholders attempting to assert a right of action under the Exchange Act based on a violation of Exchange Rules have been denied standing to sue. E.g., Walck v. Am. Stock Exch., Inc., 687 F.2d 778, 786 (3d Cir. 1982) (noting that Congress expressly created a
Congress intends for stockholder-plaintiffs to now be permitted to press such claims.

In fact, Sarbanes-Oxley itself does not, with certain limited exceptions, create new causes of actions for stockholders. Rather, as a general matter, the provisions of Sarbanes-Oxley are to be codified in the Exchange Act and will be exclusively enforced by the SEC or by federal criminal authorities. The inadequacy of delisting as a remedy and the absence of a clear path for aggrieved shareholders to press claims.

private right of action in §§ 9(c), 16(b) and 18 of the Exchange Act, but did not create a private right of action in § 6. The court stated that “[t]he clear implication of the legislative history is that Congress has carefully studied and 'balanced' the competing considerations and enacted the statutory schema that in its view would best serve its various goals of promoting transactional efficiency, fair dealing, and investor protection, and of limiting expensive and ineffective federal intervention. We cannot infer in the face of all this evidence that Congress nonetheless authorized by implication authority in the federal courts to intervene in the self-regulatory system at the instance of an injured investor and grant redress in the form of a monetary award against an exchange, conditioned on its failure to enforce its own rules, for the purpose of coercing or encouraging enforcement.... We therefore conclude that application of the Cort v. Ash standards demonstrates a clear congressional intent not to create a private damages remedy in § 6.” (citations omitted).

86 Sarbanes-Oxley at § 3(b)(1) (“A violation by any person of this Act, any rule or regulation of the Commission issued under this Act, or any rule of the Board shall be treated for all purposes in the same manner as a violation of the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) or the rules and regulations issued thereunder, consistent with the provisions of this Act, and any such person shall be subject to the same penalties, and to the same extent, as for a violation of that Act or such rules or regulations.”); Patricia A. Vlahakis et al., Understanding the Sarbanes-Oxley Act of 2002, CORP. GOVERNANCE REFORM, Sept.–Oct. 2002, at 16 (“Except in the case of recovery of profits from prohibited sales during a blackout period and suits by whistleblowers, the Sarbanes-Oxley Act does not expressly create new private rights of action for civil liability for violations of the Act. The Sarbanes-Oxley Act, however, potentially affects existing private rights of action under the Exchange Act by: (1) lengthening the general statute of limitations applicable to private securities fraud actions to the earlier of two years after discovery of the facts constituting the violation or five years after the violation; and (2) expanding reporting and disclosure requirements that could potentially expand the range of actions that can be alleged to give rise to private suits under Section 10(b) and Section 18 of the Exchange Act and SEC Rule 10b-5.”).
themselves in the federal courts under the 2002 Reforms may, therefore, generate new types of state corporate law cases. In our experience, it is unlikely that stockholder-plaintiffs will be content to leave enforcement of the 2002 Reforms entirely to the SEC and the Exchanges. Rather, if history is any guide, the active corporate plaintiffs’ bar will be creative and aggressive in deploying the Reforms as a tool in shareholder litigation under state law.\(^87\)

After all, unlike the 2002 Reforms, state corporate laws come with a full-service commitment to enforcement at the behest of stockholders who file well-pleaded allegations of breach.\(^88\) State courts are expected to, and

\(^87\) In our experience, the effective adjudication of corporate law disputes requires a great deal of direct involvement by the trial judge. The factual records in such cases are often large and make demanding reading. Moreover, many of these matters are time-sensitive and involve the application of complex legal doctrines to the evidence in a very short timeframe—a reality that limits the capacity of judges to delegate very much of the work to law clerks.

As we understand it, the federal courts already face a stiff challenge in addressing their already formidable caseloads. Indeed, Chief Justice Rehnquist has regularly noted that the federal courts are overworked and has encouraged reforms (e.g., measures to diminish diversity suits) to reduce, rather than increase, their caseloads. See, e.g., Supreme Court of the United States, 2002 Year-End Report of the Federal Judiciary (last updated Jan. 2, 2003), available at http://www.supremecourts.gov/publicinfo/year-end/2002/year-endreport.html; Milo Geyelin & Arthur S. Hayes, Chief Justice Rehnquist Warns About Swamped Federal Courts, WALL ST. J., Jan. 2, 1992, available at 1992 WL-WSJ 671120. In view of that reality, it seems unlikely that the federal courts are well-positioned to absorb the burden of adjudicating corporate governance disputes now handled by state courts.

\(^88\) Some would note that Delaware courts do not provide a forum to enforce the fiduciary duty of care, leaving a gap for others to fill. This is, at best, partially true. Although it is the case that Delaware corporations can adopt charter provisions that immunize directors from damages liability for due care violations, see DEL. CODE ANN. tit. 8, § 102(b)(7), this does not preclude courts from enjoining transactions resulting from grossly negligent board action. More importantly, many exculpatory charter provisions were adopted at mature public companies with support from sophisticated and activist institutional investors. See Edward Rock and Michael Wachter, Dangerous Liaisons: Corporate Law, Trust Law, and Interdisciplinary Legal Transplants,
do, resolve all disputes under their codes, including suits alleging fiduciary misconduct by corporate directors and officers. Indeed, in the recent past, the Delaware courts have entertained claims touching on Exchange Rules. For example, our courts have held that plaintiffs stated a claim for breach of fiduciary duty when directors were alleged to have delisted the company’s

96 NW. U. L. REV. 651, 659-60 (2002) ("In the wake of section 102(b)(7), Delaware corporations quickly amended their certificates of incorporation, and thereby immunized directors from liability under Van Gorkom. These amendment were overwhelmingly approved by shareholders at a time when shareholding was already concentrated in the hands of institutions, and at the beginning of the rise of institutional investor activism. In the years since, as institutional investors have become increasingly active, there has been no pressure on firms to re-amend their charters to expose their directors to monetary liability for negligent breaches of the duty of care. This is strong evidence that a judicially enforced duty of care is not in the shareholders’ interests. At the very least, intelligent and sophisticated shareholders do not think it is in their interests."). E. Norman Veasey, The Role of Corporate Litigation in the Twenty-First Century, 25 DEL. J. CORP. L. 131, 147 (2000) ("The strongest support for the principle of self-governance came in the form of the liability limiting charter provisions that were first authorized in 102(b)(7) of the Delaware General Corporation Law. Similar provisions have been enacted in forty-three states and they have been routinely approved when presented to shareholders as charter amendments.") (internal citations omitted). If the federal government wishes to deprive investors of the right to provide such protection, it must consider whether that intrusion on private ordering makes principled sense, especially because it will tend to discourage board service. 89 One Delaware case illustrates the limited utility of Exchange Rules to plaintiffs’ lawyers as a direct route to obtaining relief. In Lennane v. Ask Computer Systems, Inc., 1990 Del. Ch. LEXIS 164 (Del. Ch. Oct. 11, 1990), former Chancellor Allen held that stockholder-plaintiffs were third-party beneficiaries of their corporation’s listing agreement and, therefore, had standing to enforce the agreement as a matter of contract law. He held that this was so because third party rights are a function of contract and federal regulation of the securities exchanges does not interfere with these rights. Id. ("I decide the current motion on the assumption that the federal regulation of securities exchanges does not itself preclude a shareholder from enforcing terms of a listing agreement intended to benefit shareholders. I assume also that shareholders are third party beneficiaries of at least some of the terms of a securities listing agreement."). But the right that Chancellor Allen recognized to sue was of dubious value, because he observed that a stockholder’s only remedies for a breach of the listing agreement as a contract were the same as those available to the direct party to the to the listing agreement, the Exchange—i.e., delisting. Id. ("What third party rights are created by a contract is obviously a function of the contract itself. Here the parties to the listing agreement have negotiated the remedy for breach of the terms of the agreement: delisting. It seems plain to me that the NASD itself could not specifically enforce by court order its shareholder voting by-law. Rather the remedy for its breach appears to be limited to delisting of the offending corporation’s securities . . . . If this is the case, as I now believe, then

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stock in order to further an inequitable purpose. For that reason, those of us who serve on state courts may be among the first to hear shareholder grievances based on the requirements of the 2002 Reforms.

One form that these cases may take could involve claims that directors are breaching their fiduciary duties by not complying with the Reforms. The plaintiffs' arguments will likely come in two varieties. The most straightforward will be that Delaware's common law ought to embrace the substance of a feature of the Reforms (e.g., the Reforms' definition of independent director or the Reforms' requirement for independent director

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96 A corporation's directors have the power to cause a corporation to withdraw its listing and registration with securities exchanges in their proper exercise of business judgment. Hamilton v. Nozko, 1994 Del. Ch. LEXIS 139 at *18 (Del. Ch. July 26, 1994); Lennane, 1990 Del. Ch. LEXIS 164. Such power may be exercised even if the delisting and deregistration may adversely affect the market for the corporation's securities. But when the power is exercised for an inequitable purpose, the fiduciary analysis becomes interesting. Id. In Hamilton v. Nozko, the Court of Chancery found that stockholder-plaintiffs stated a claim for breach of fiduciary duty because they alleged that the delisting, which eliminated the market for their stock and forced them to convey their stock at an unfair price, was undertaken for self-interested purposes. 1994 Del. Ch. LEXIS 139 at *18-*21. Similarly, in Seagraves v. Urrstadt Property Co., the plaintiff stockholders were able to withstand a motion to dismiss because they properly alleged a claim for unfair dealing in relation to the wrongful delisting of their stock. 1989 Del. Ch. LEXIS 155 at *11-*12 (Del. Ch. Dec. 4, 1989). Because the delisting was allegedly part of a scheme to lower the market price of the company's stock so the company could force a cash out merger at an unfair price, the court found that this inequitable purpose could form the basis for a breach of fiduciary duty claim. Id.

In another case, defendant directors threatened to delist the shares of the company's stock if a self-tender offer for the company's preferred stock proposed by the company's president did not succeed. This threat was held to be coercive of a stockholder's decision whether to tender. Eisenberg v. Chicago Milwaukee Corp., 537 A.2d 1051, 1061-62 (Del. Ch. 1987). When a corporation goes beyond simply informing the stockholders of the possibility of delisting and deregistration, and, instead, threatens that it "intends to request" a delisting of its shares, such a
approval of certain transactions). The more indirect route will be an allegation that directors breach their fiduciary duties by exposing the corporation (and, therefore, its stockholders) to an injurious sanction (e.g., delisting) by not adhering to the Reforms.

There will be some legitimate pressure on state courts to respond with a measure of receptivity to these arguments. After all, there is something to be said for harmonizing state standards with the 2002 Reforms, when that can be achieved fairly and efficiently. And why, plaintiffs’ lawyers will ask, shouldn’t state courts require directors to ensure that their companies do not run afoul of the Exchanges, when that is necessary to guarantee listing of the company’s shares? Isn’t there a fiduciary duty to avoid this kind of harsh penalty? Or, relatedly, to make sure that the corporation doesn’t engage in a transaction that violates Sarbanes-Oxley?

Through arguments of this kind, state courts may soon find themselves immersed in the implementation of the Reforms, even though their own state laws are not directly implicated. In this process, the gravitational effect of the Reforms’ existence will nudge state judges to align

disclosure “tips the balance and impels the Court to find that the Offer, even if benignly motivated, operates in an inequitably coercive manner.” 

Eisenberg, 537 A.2d at 1062.

91 Cf. Eisenberg v. Chicago Milwaukee Corp., 537 A.2d 1051, 1062 (Del. Ch. 1987) (finding actionable coercion when board threatened to seek delisting if transaction was not approved).
their own state corporate systems so as to avoid whipsawing corporate
directors with incompatible dictates. At the same time, this process will
generate opportunities for state judges to deepen the dialogue with
policymakers at the Exchanges and in the federal government. In particular,
the resolution of actual disputes may shed light on the utility of the Reforms
and reveal whether they are compatible, in their present form, with the
enabling systems of corporate law that are employed by Delaware and most
other states.

In the remaining sections of this essay, we examine a few specific
subjects that provide good examples of how the Reforms may require
adaptive responses by the states that may reflect pressure back on the
sources of Reforms to modify their initial scope and shape.

IV. Harmonic Convergence or Train Wreck?: The 2002 Reforms’
Definition of An Independent Director

The 2002 Reforms contain a relatively pristine definition of
independent director — one that builds on the best practice
recommendations of many shareholder activists. Although this definition is
not in all respects identical to preexisting state law, the concerns the
definition seeks to address are ones that state law has always considered

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92 Cf. DEL. CODE ANN. tit. 8, § 102(b)(7) (denying exculpation for acts or omissions involving a
knowing violation of law).
After the 2002 Reforms, it will be even more important for courts to bear all these realities in mind, and not to allow the necessarily nuanced and fact-driven consideration of whether particular human beings must pay damages to be replaced by an overly simple inquiry into status. Otherwise, well-qualified people may be dissuaded from serving on boards, to the resulting detriment of stockholders.

V. The Director Election Process: The Forgotten Element To Reform?

Another related issue provoked by the 2002 Reforms is whether or not it is time that state and federal policymakers examined the management-biased corporate election system. After the 2002 Reforms, it is unquestionable that Delaware, the Exchanges, and the federal government each have policies that express the belief that genuinely independent directors who owe their allegiances entirely to the corporation and its stockholders are valuable to investors. In particular, the proposed NYSE Rule that demands that the nominating process be exclusively the province of independent directors reflects this view.\(^\text{114}\)

If this philosophy is so central to our system of corporate governance, one can rightly ask why the current incumbent-biased corporate election process should be perpetuated. As of now, incumbent slates are able to

\(^{114}\) NYSE PROPOSED RULES, supra note 5, § 303A(4)(a); NYSE REPORT, supra note 5, at 9.
spend their companies' money in an almost unlimited way in order to get themselves re-elected. As a practical matter, this renders the corporate election process an irrelevancy, unless a takeover proposal is on the table and a bidder is willing to fund an insurgent slate. The aberrational cases in which shareholder activists have actually mounted proxy contests tend to prove the incumbent bias of the system, rather than cast doubt on it.\textsuperscript{115}

Although it would seem to promise more expense than protection to investors to create incentives for lively electoral disputes on an annual basis, it is equally questionable whether the current balance is optimal. Even with the advent of independent nominating committees, there will remain the danger that incumbent slates will become overly comfortable in their positions and that even putatively independent directors will become less than ideally sensitive to stockholder input. A balance of the efficient deployment of corporate resources (\textit{i.e.}, costs) against the utility of a genuinely open election process that generates increased accountability might be reflected in a biennial or triennial system of elections that require equal access to the proxy machinery between incumbents and insurgents with significant (\textit{e.g.}, five or ten percent) nominating support.

Through this means, Delaware could invigorate its system of corporate democracy without undue cost and create a more secure foundation for the 2002 Reforms. The very fact that an open process is created would influence independent directors to be more responsive on an ongoing basis and to consult with key stockholder constituencies in shaping the management slate. Put differently, by facilitating fair contests, the new rules of the game will cut down on the need for them.

This is, of course, not a novel proposal. Its implementation would also require a sensitive corresponding reaction by the SEC, to enable disaggregated investors to communicate in a non-burdensome manner in the electoral process. Reform along these lines needs to be carefully thought out, of course. The reality that thoughtful deliberation on this front is warranted cannot obscure an equally apparent reality: the rhetorical analogy of our system of corporate governance to republican democracy will ring hollow so long as the corporate election process is so tilted towards the self-perpetuation of incumbent directors.

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117 The adoption of this proposal might also be accompanied by another reform to make the analogy to traditional republican democracy even more precise. For years, corporations, stockholders, and the SEC have struggled over the proper role of so-called stockholder
To grasp why this is so, it is useful to consider the delicate subject of executive compensation. As we have explained, the American system of corporate governance involves a dialogue among the federal and state governments and the Exchanges, who each act on the basis of input from various interested constituencies. Policymakers at the state level must listen in this process, as well as speak. For example, it can argued fairly that Delaware’s common law did not react quickly or aggressively enough to changes in compensation practices during the last two decades that were so substantial quantitatively that they required a qualitatively more intense form of judicial review, through, for example, a reinvigorated application of the concept of waste. In the past, the Delaware courts had generally taken a hands-off approach to executive compensation based on the assumption that this was a matter of business judgment, which could also be factored into the electorate’s voting decisions. Before the last twenty years, the overall level of executive compensation did not seem to reflect any major defect in this policy choice. Empirical evidence of the huge Argentina-like inflation in executive compensation in more recent decades creates greater doubt.\footnote{Cf. Jerry Useem, \textit{The Winner-Steal-All Society: And the Persistence of the CEO-Market Myth}, AM. PROSPECT, Oct. 21, 2002, at 13-14 ("The statistics are simply too obscene: In 1999, the}
It will not surprise legal scholars that Delaware’s common law was perhaps slower than ideal in adapting to the new realities, which seem to many to cry out for a deeper and more skeptical judicial inquiry. The common law accretes knowledge, but not always at an optimal pace. The 2002 Reforms contain measures reflecting a policy judgment that the constraints of state law on executive compensation are, in themselves, inadequate to protect investors against abusive compensation practices. State law policymakers—including judges shaping the common law—will undoubtedly be responsive to this expression of concern and may use it as an opportunity to reflect more deeply on whether their own policies need adaptation to better protect stockholders.

In that process, a not unfamiliar policy question might arise: is it preferable to react to a potential need for greater restraints on executive compensation by tightening judicial review, or by increasing the ability of stockholders to displace directors who do not set responsible levels of pay? A potent electoral check on director conduct dampens the need for increased judicial intervention and encourages the resolution of corporate disputes within the corporate family.

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average chief executive earned 419 times more than his or her coworkers, up from 25 times in 1981, while the 10 highest-paid executives have seen their income soar an astonishing 4,300 percent between 1981 and 2000."}
SEC SETTLES ENFORCEMENT ACTION AGAINST PARMALAT

Settlement Continues SEC Trend of Imposing Corporate Governance Reform through Enforcement Actions

The Securities and Exchange Commission announced last week that it reached a settlement with Parmalat Finanziaria, S.p.A. ("Parmalat"). The settlement brings to a close an enforcement action in which the SEC alleged that Parmalat perpetrated a massive accounting fraud on institutional U.S. investors who bought over $1 billion in Parmalat bonds between 1997 and 2003. SEC v. Parmalat Finanziaria, S.p.A., Lit. Rel. No. 18803, 2004 SECLEXIS 1631 (July 28, 2004). The settlement, filed in the United States District Court for the Southern District of New York, is significant because Parmalat agreed to a variety of corporate governance reforms. As such, the Parmalat case marks the continuation of a trend in which corporate governance undertakings are becoming a common remedy in major SEC enforcement actions.

The SEC's Allegations

In its First Amended Complaint, the SEC alleges that, from 1997 through 2003, Parmalat "engaged in one of the largest financial frauds in history" though the efforts of its founder, chairman, and CEO Calisto Tanzi, and its CFO, Fausto Tonina. The complaint alleges three facets of the fraud: First, the company concealed losses and overstated assets through related entities including nominee companies. It used nominee companies, for example, to conceal uncollectible and impaired receivables; extend loans to Parmalat subsidiaries, which those subsidiaries used to hide expenses; and serve as counterparties to transactions from which Parmalat subsidiaries recorded inflated or fictitious revenue. Second, Parmalat allegedly understated debt by approximately $9.16 billion, or 123.4 percent. According to the SEC's complaint, for example, Parmalat eliminated about $3.8 billion in debt through a fictitious transaction in which a nominee entity purportedly acquired that debt, and falsely portrayed another $1.16 billion in debt as equity. Third, the SEC alleges that Parmalat unlawfully diverted about $400 million to members of the Tanzi family. The company allegedly concealed these payments by recording them as receivables to unrelated third parties.

The SEC's complaint alleges that, as a consequence of this scheme, Parmalat's financial statements were materially false and misleading. By means of these financial
statements—the complaint further alleges—Parmalat offered several classes of bonds to US institutional investors between 1997 and 2003. These offerings were exempt from SEC registration and the company’s financial statements accompanied private placement memoranda. Parmalat also allegedly misled investors during 2002 road shows during which its CFO, Tonna, met with potential investors, and the company provided investors with a 40 page booklet containing materially false data from the company’s financials.

**Parmalat’s Corporate Governance Undertakings**

Without admitting or denying the allegations, Parmalat settled to a Judgment of Permanent Injunction enjoining the company from violating antifraud provisions of the federal securities laws—Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 thereunder. The judgment, approved by the court on July 29, incorporates by reference Parmalat’s accompanying Consent and Undertakings (the “Consent”), pursuant to which Parmalat agreed to a variety of corporate governance reforms. The Consent explains that the reforms will go into effect upon the company’s reorganization in bankruptcy proceedings pending in Italy and in the United States. According to the Consent, the corporate reforms “are designed to ensure transparency and correctness in the company’s conduct of business and to protect the shareholders’ interests by providing for their substantial involvement in the company’s governance.” The corporate governance reforms include:

- **Selection and Composition of Board of Directors.** Pursuant to the Consent, Parmalat must adopt by-laws providing for governance by a shareholder-elected board, the majority of which must consist of independent directors. Each director may not serve longer than a specified term. According to the Consent, “[t]he by-laws will mandate that the positions of chairman of the board of directors and chief executive officer . . . be held by two separate individuals.”

- **Board Responsibilities.** The by-laws must specifically delineate the duties of the board, which will include reviewing and approving strategic company plans, reviewing and approving material transactions, assessing whether directors meet independence requirements, and appointing chief executive officers.

- **Code of Conduct.** The Consent provides that board must adopt a Code of Conduct governing its duties and activities. Among other things, the Code of Conduct will set forth the board’s responsibility for company reporting and disclosure. Concerning that responsibility, the board will be required to meet at least quarterly and receive quarterly reports on operations and material transactions.

- **Internal Control and Governance Committee.** The company will establish an Internal Control and Governance Committee—consisting of independent directors—to have oversight for the company’s internal controls systems.

- **Code of Insider Dealing and a Code of Ethics.** The company will adopt a Code of Insider Dealing limiting insider trades to particular time periods “following disclosure of operating and financial data” and setting forth disclosure requirements for insider transactions. The company also will adopt a Code of Ethics establishing standards of behavior for Parmalat officers and employees. The company will also adopt a scheme of penalties for violations of that Code: procedures for preventing, reporting, and investigating violations, and procedures for verifying compliance.

**Observations**

*Parmalat* is the latest chapter in a line of recent SEC settlements in which the Commission has sought measures reforming corporate governance procedures. The other recent settlements generally come within two categories: (1) settlements with issuers concerning accounting fraud and other financial reporting violations, and (2) settlements with
mutual fund advisers concerning allegations of market timing and late trading.

SEC v. WorldCom, Inc., Lit. Rel. No. 17866, 2002 SEC LEXIS 3043 (Nov. 26, 2002), exemplifies the first category. In that case, WorldCom consented to a partial judgment that required WorldCom’s special investigative committee to provide WorldCom’s corporate monitor with a report on WorldCom’s corporate governance procedures and required the corporate monitor, in turn, to review the adequacy of these procedures and summarize his recommendations in a report. The judgment further required that WorldCom’s board report to the court and the SEC on its progress in acting on the corporate monitor’s recommendations 60 days after receiving his report. The judgment also required WorldCom to hire a qualified independent consultant to monitor the company’s efforts to remedy its internal controls deficiencies. The result was the Corporate Monitor’s 150 page August 2003 report, Restoring Trust, which proposed 78 specific reforms to WorldCom’s corporate governance structure and procedures.

SEC v. Hollinger International, Inc., Lit. Rel. No. 18551, 2004 SEC LEXIS 131 (Jan. 21, 2004), is another example of a financial reporting case in which the Commission imposed corporate governance reforms on issuers through settlement. There, the SEC filed a civil injunctive action alleging that Hollinger’s SEC filings contained misstatements and omitted to state material facts regarding transfers of corporate assets to certain of Hollinger’s insiders and related entities. Hollinger International entered into a consent judgment in which it agreed to a “springing” corporate monitor. The SEC’s litigation release explained the relief as follows: “[u]nder the order, Hollinger International is required to maintain its Special Committee to, among other things, continue its investigation of alleged misconduct and its efforts to recover and maintain corporate assets. In the event the Special Committee’s authority were in any way impaired, including through a change in control of the company, Richard C. Breeden (the current Counsel to the Special Committee) would serve as a court-ordered Special Monitor to protect the interests of Hollinger International shareholders.” Id. Recently, the district court upheld the consent judgment, including the Special Monitor provision, over the objections of Hollinger International’s controlling shareholder. SEC v. Hollinger International, Inc., 2004 U.S. Dist. LEXIS 9097 *22-23 (N.D. Ill. May 17, 2004).

In the matter of Pilgrim Baxter & Associates, Ltd., Inv. Co. Act Rel. No. IC-26470, 2004 SEC LEXIS 1267 (June 21, 2004), is a recent example of the second category of cases—those involving governance reform for mutual fund complexes. In Pilgrim Baxter, the SEC brought a settled administrative proceeding against Pilgrim Baxter, a mutual fund adviser, charging it with violations of the federal securities laws for, among other things, permitting a select group of investors to trade rapidly in and out of the PBHG Funds, reaping profits and diluting the value of the funds to the detriment of long-term investors. Pilgrim Baxter agreed to undertake a series of compliance and mutual fund governance reforms, such as: (a) maintaining a Code of Ethics Oversight Committee having responsibility for all matters relating to issues arising under the Pilgrim Baxter Code of Ethics; (b) establishing an Internal Compliance Controls Committee; (c) requiring Pilgrim Baxter’s Chief Compliance Officer to report to the independent Trustees of the PBHG Funds any breach of fiduciary duty and/or the federal securities laws of which he becomes aware; and (d) retaining an Independent Compliance Consultant to review and recommend improvements to Pilgrim Baxter’s compliance and market timing departments. See also, e.g., In the matter of Franklin Adviser, Inc. Inv. Co. Act Rel. No. IC-26523 (Aug. 2, 2004) (settled administrative proceeding ordering similar measures).

Parmalat is a particularly expansive application of corporate governance reform as an SEC enforcement remedy. Parmalat imposes corporate governance reform on a company that is not a domestic issuer – or even a foreign private issuer filing
annual reports with the SEC on Form 20-F. Parmalat is an Italian company, whose stock traded on the Milan Stock Exchange. As mentioned above, the allegations concern fraud on institutional investors who bought debt securities pursuant to an exempt offering. Parmalat also sponsored ADRs which were sold over-the-counter and quoted on the “Pink Sheets.” The corporate governance reforms set forth in the settlement apparently mirror those to which the company agreed in its bankruptcy proceedings in Italy.

The settlement demonstrates just how broad a net the SEC is willing to cast to impose corporate governance reform through enforcement actions. Federal courts have authority to impose that type of relief pursuant to their general equitable powers to tailor-make remedies for the benefit of investors in SEC cases. Originally a creature of case law, this principle was codified by Section 305 of the Sarbanes-Oxley Act, which states: “In any action or proceeding brought or instituted by the Commission under any provision of the securities laws, the Commission may seek, and any Federal court may grant, any equitable relief that may be appropriate or necessary for the benefit of investors.” Whether a court in the context of contested litigation would award similar relief under the same facts is an issue for another day.

Foreign private issuers that raise funds in the U.S. capital markets need to be particularly mindful of the SEC’s increasing use of this enforcement remedy. Even foreign issuers that are not listed on U.S. exchanges, and that are not subject to the corporate governance, disclosure, and internal controls provisions of the Sarbanes-Oxley Act of 2002, can still be subject to SEC enforcement for exempt sales of securities in the U.S.

For more information, please call your regular Sidley Austin Brown & Wood LLP contact or any of the attorneys listed on the front. Please also visit our website, where we have posted prior client bulletins about securities enforcement, Sarbanes-Oxley Act developments, and corporate governance issues (www.sidley.com/corporategovernance).
Corporate Governance Rules

What follows are the final corporate governance rules of the New York Stock Exchange approved by the SEC on November 4, 2003, other than Section 303A.08, which was filed separately and approved by the SEC on June 30, 2003. These final rules will be codified in Section 303A of the NYSE's Listed Company Manual.

303A

General Application

Companies listed on the Exchange must comply with certain standards regarding corporate governance as codified in this Section 303A. Consistent with the NYSE's traditional approach, as well as the requirements of the Sarbanes-Oxley Act of 2002, certain provisions of Section 303A are applicable to some listed companies but not to others.

Equity Listings

Section 303A applies in full to all companies listing common equity securities, with the following exceptions:

Controlled Companies

A company of which more than 50% of the voting power is held by an individual, a group or another company need not comply with the requirements of Sections 303A.01, .04 or .05. A controlled company that chooses to take advantage of any or all of these exemptions must disclose that choice, that it is a controlled company and the basis for the determination in its annual proxy statement or, if the company does not file an annual proxy statement, in the company's annual report on Form 10-K filed with the SEC. Controlled companies must comply with the remaining provisions of Section 303A.

Limited Partnerships and Companies in Bankruptcy

Due to their unique attributes, limited partnerships and companies in bankruptcy proceedings need not comply with the requirements of Sections 303A.01, .04 or .05. However, all limited partnerships (at the general partner level) and companies in bankruptcy proceedings must comply with the remaining provisions of Section 303A.

Closed-End and Open-End Funds

The Exchange considers the significantly expanded standards and requirements provided for in Section 303A to be unnecessary for closed-end and open-end management investment companies that are registered under the Investment Company Act of 1940.
given the pervasive federal regulation applicable to them. However, closed-end funds must comply with the requirements of Sections 303A.06, .07(a) and (c), and .12. Note, however, that in view of the common practice to utilize the same directors for boards in the same fund complex, closed-end funds will not be required to comply with the disclosure requirement in the second paragraph of the Commentary to 303A.07(a), which calls for disclosure of a board’s determination with respect to simultaneous service on more than three public company audit committees. However, the other provisions of that paragraph will apply.

Business development companies, which are a type of closed-end management investment company defined in Section 2(a)(48) of the Investment Company Act of 1940 that are not registered under that Act, are required to comply with all of the provisions of Section 303A applicable to domestic issuers other than Sections 303A.02 and .07(b). For purposes of Sections 303A.01, .03, .04, .05, and .09, a director of a business development company shall be considered to be independent if he or she is not an “interested person” of the company, as defined in Section 2(a)(19) of the Investment Company Act of 1940.

As required by Rule 10A-3 under the Exchange Act, open-end funds (which can be listed as Investment Company Units, more commonly known as Exchange Traded Funds or ETFs) are required to comply with the requirements of Sections 303A.06 and .12(b).

Rule 10A-3(b)(3)(ii) under the Exchange Act requires that each audit committee must establish procedures for the confidential, anonymous submission by employees of the listed issuer of concerns regarding questionable accounting or auditing matters. In view of the external management structure often employed by closed-end and open-end funds, the Exchange also requires the audit committees of such companies to establish such procedures for the confidential, anonymous submission by employees of the investment adviser, administrator, principal underwriter, or any other provider of accounting related services for the management company, as well as employees of the management company. This responsibility must be addressed in the audit committee charter.

Other Entities

Except as otherwise required by Rule 10A-3 under the Exchange Act (for example, with respect to open-end funds), Section 303A does not apply to passive business organizations in the form of trusts (such as royalty trusts) or to derivatives and special purpose securities (such as those described in Sections 703.16, 703.19, 703.20 and 703.21). To the extent that Rule 10A-3 applies to a passive business organization, listed derivative or special purpose security, such entities are required to comply with Sections 303A.06 and .12(b).

Foreign Private Issuers

Listed companies that are foreign private issuers (as such term is defined in Rule 3b-4 under the Exchange Act) are permitted to follow home country practice in lieu of the provisions of this Section 303A, except that such companies are required to comply with the requirements of Sections 303A.06, .11 and .12(b).
Preferred and Debt Listings

Section 303A does not generally apply to companies listing only preferred or debt securities on the Exchange. To the extent required by Rule 10A-3 under the Exchange Act, all companies listing only preferred or debt securities on the NYSE are required to comply with the requirements of Sections 303A.06 and .12(b).

Effective Dates/Transition Periods

Except for Section 303A.08, which became effective June 30, 2003, listed companies will have until the earlier of their first annual meeting after January 15, 2004, or October 31, 2004, to comply with the new standards contained in Section 303A, although if a company with a classified board would be required (other than by virtue of a requirement under Section 303A.06) to change a director who would not normally stand for election in such annual meeting, the company may continue such director in office until the second annual meeting after such date, but no later than December 31, 2005. In addition, foreign private issuers will have until July 31, 2005, to comply with the new audit committee standards set out in Section 303A.06. As a general matter, the existing audit committee requirements provided for in Section 303 continue to apply to listed companies pending the transition to the new rules.

Companies listing in conjunction with their initial public offering will be permitted to phase in their independent nomination and compensation committees on the same schedule as is permitted pursuant to Rule 10A-3 under the Exchange Act for audit committees, that is, one independent member at the time of listing, a majority of independent members within 90 days of listing and fully independent committees within one year. Such companies will be required to meet the majority independent board requirement within 12 months of listing. For purposes of Section 303A other than Sections 303A.06 and .12(b), a company will be considered to be listing in conjunction with an initial public offering if, immediately prior to listing, it does not have a class of common stock registered under the Exchange Act. The Exchange will also permit companies that are emerging from bankruptcy or have ceased to be controlled companies within the meaning of Section 303A to phase in independent nomination and compensation committees and majority independent boards on the same schedule as companies listing in conjunction with an initial public offering. However, for purposes of Sections 303A.06 and .12(b), a company will be considered to be listing in conjunction with an initial public offering only if it meets the conditions of Rule 10A-3(b)(1)(iv)(A) under the Exchange Act, namely, that the company was not, immediately prior to the effective date of a registration statement, required to file reports with the SEC pursuant to Section 13(a) or 15(d) of the Exchange Act.

Companies listing upon transfer from another market have 12 months from the date of transfer in which to comply with any requirement to the extent the market on which they were listed did not have the same requirement. To the extent the other market has a substantially similar requirement but also had a transition period from the effective date of that market’s rule, which period had not yet expired, the company will have the same transition period as would have been available to it on the other market. This transition period for companies transferring from another market will not apply to the requirements
of Section 303A.06 unless a transition period is available pursuant to Rule 10A-3 under the Exchange Act.

References to Form 10-K

There are provisions in this Section 303A that call for disclosure in a company's Form 10-K under certain circumstances. If a company subject to such a provision is not a company required to file a Form 10-K, then the provision shall be interpreted to mean the annual periodic disclosure form that the company does file with the SEC. For example, for a closed-end fund, the appropriate form would be the annual Form N-CSR. If a company is not required to file either an annual proxy statement or an annual periodic report with the SEC, the disclosure shall be made in the annual report required under Section 203.01 of the NYSE Listed Company Manual.

1. Listed companies must have a majority of independent directors.

*Commentary:* Effective boards of directors exercise independent judgment in carrying out their responsibilities. Requiring a majority of independent directors will increase the quality of board oversight and lessen the possibility of damaging conflicts of interest.

2. In order to tighten the definition of "independent director" for purposes of these standards:

(a) No director qualifies as "independent" unless the board of directors affirmatively determines that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company). Companies must disclose these determinations.

*Commentary:* It is not possible to anticipate, or explicitly to provide for, all circumstances that might signal potential conflicts of interest, or that might bear on the materiality of a director's relationship to a listed company (references to "company" would include any parent or subsidiary in a consolidated group with the company). Accordingly, it is best that boards making "independence" determinations broadly consider all relevant facts and circumstances. In particular, when assessing the materiality of a director's relationship with the company, the board should consider the issue not merely from the standpoint of the director, but also from that of persons or organizations with which the director has an affiliation. Material relationships can include commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships, among others. However, as the concern is independence from management, the Exchange does not view ownership of even a significant amount of stock, by itself, as a bar to an independence finding.

The basis for a board determination that a relationship is not material must be disclosed in the company's annual proxy statement or, if the company does not file an annual proxy statement, in the company's annual report on Form 10-K.
filed with the SEC. In this regard, a board may adopt and disclose categorical standards to assist it in making determinations of independence and may make a general disclosure if a director meets these standards. Any determination of independence for a director who does not meet these standards must be specifically explained. A company must disclose any standard it adopts. It may then make the general statement that the independent directors meet the standards set by the board without detailing particular aspects of the immaterial relationships between individual directors and the company. In the event that a director with a business or other relationship that does not fit within the disclosed standards is determined to be independent, a board must disclose the basis for its determination in the manner described above. This approach provides investors with an adequate means of assessing the quality of a board’s independence and its independence determinations while avoiding excessive disclosure of immaterial relationships.

(b) In addition:

(i) A director who is an employee, or whose immediate family member is an executive officer, of the company is not independent until three years after the end of such employment relationship.

Commentary: Employment as an interim Chairman or CEO shall not disqualify a director from being considered independent following that employment.

(ii) A director who receives, or whose immediate family member receives, more than $100,000 per year in direct compensation from the listed company, other than director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service), is not independent until three years after he or she ceases to receive more than $100,000 per year in such compensation.

Commentary: Compensation received by a director for former service as an interim Chairman or CEO need not be considered in determining independence under this test. Compensation received by an immediate family member for service as a non-executive employee of the listed company need not be considered in determining independence under this test.

(iii) A director who is affiliated with or employed by, or whose immediate family member is affiliated with or employed in a professional capacity by, a present or former internal or external auditor of the company is not “independent” until three years after the end of the affiliation or the employment or auditing relationship.

(iv) A director who is employed, or whose immediate family member is employed, as an executive officer of another company where any of the listed company’s present executives serve on that company’s
compensation committee is not "independent" until three years after the end of such service or the employment relationship.

(v) A director who is an executive officer or an employee, or whose immediate family member is an executive officer, of a company that makes payments to, or receives payments from, the listed company for property or services in an amount which, in any single fiscal year, exceeds the greater of $1 million, or 2% of such other company's consolidated gross revenues, is not "independent" until three years after falling below such threshold.

Commentary: In applying the test in Section 303A.02(b)(v), both the payments and the consolidated gross revenues to be measured shall be those reported in the last completed fiscal year. The look-back provision for this test applies solely to the financial relationship between the listed company and the director or immediate family member's current employer; a listed company need not consider former employment of the director or immediate family member.

Charitable organizations shall not be considered "companies" for purposes of Section 303A.02(b)(v), provided however that a listed company shall disclose in its annual proxy statement, or if the listed company does not file an annual proxy statement, in the company's annual report on Form 10-K filed with the SEC, any charitable contributions made by the listed company to any charitable organization in which a director serves as an executive officer if, within the preceding three years, contributions in any single fiscal year exceeded the greater of $1 million, or 2% of such charitable organization's consolidated gross revenues. Listed company boards are reminded of their obligations to consider the materiality of any such relationship in accordance with Section 303A.02(a) above.

General Commentary to Section 303A.02(b): An "immediate family member" includes a person's spouse, parents, children, siblings, mothers and fathers-in-law, sons and daughters-in-law, brothers and sisters-in-law, and anyone (other than domestic employees) who shares such person's home. When applying the look-back provisions in Section 303A.02(b), listed companies need not consider individuals who are no longer immediate family members as a result of legal separation or divorce, or those who have died or become incapacitated. In addition, references to the "company" would include any parent or subsidiary in a consolidated group with the company.

Transition Rule. Each of the above standards contains a three-year "look-back" provision. In order to facilitate a smooth transition to the new independence standards, the Exchange will phase in the "look-back" provisions by applying only a one-year look-back for the first year after adoption of these new standards. The three-year look-backs provided for in Section 303A.02(b) will begin to apply only from and after November 4, 2004.
As an example, until November 3, 2004, a company need look back only one year when testing compensation under Section 303A.02(b)(ii). Beginning November 4, 2004, however, the company would need to look back the full three years provided in Section 303A.02(b)(ii).

3. To empower non-management directors to serve as a more effective check on management, the non-management directors of each company must meet at regularly scheduled executive sessions without management.

Commentary: To promote open discussion among the non-management directors, companies must schedule regular executive sessions in which those directors meet without management participation. “Non-management” directors are all those who are not company officers (as that term is defined in Rule 16a-1(f) under the Securities Act of 1933), and includes such directors who are not independent by virtue of a material relationship, former status or family membership, or for any other reason.

Regular scheduling of such meetings is important not only to foster better communication among non-management directors, but also to prevent any negative inference from attaching to the calling of executive sessions. There need not be a single presiding director at all executive sessions of the non-management directors. If one director is chosen to preside at these meetings, his or her name must be disclosed in the company’s annual proxy statement or, if the company does not file an annual proxy statement, in the company’s annual report on Form 10-K filed with the SEC. Alternatively, a company may disclose the procedure by which a presiding director is selected for each executive session. For example, a company may wish to rotate the presiding position among the chairs of board committees.

In order that interested parties may be able to make their concerns known to the non-management directors, a company must disclose a method for such parties to communicate directly with the presiding director or with the non-management directors as a group. Companies may, if they wish, utilize for this purpose the same procedures they have established to comply with the requirement of Rule 10A-3 (b)(3) under the Exchange Act, as applied to listed companies through Section 303A.06.

While this Section 303A.03 refers to meetings of non-management directors, if that group includes directors who are not independent under this Section 303A, listed companies should at least once a year schedule an executive session including only independent directors.

4. (a) Listed companies must have a nominating/corporate governance committee composed entirely of independent directors.

(b) The nominating/corporate governance committee must have a written charter that addresses:
(i) the committee's purpose and responsibilities – which, at minimum, must be to: identify individuals qualified to become board members, consistent with criteria approved by the board. and to select, or to recommend that the board select, the director nominees for the next annual meeting of shareholders; develop and recommend to the board a set of corporate governance principles applicable to the corporation; and oversee the evaluation of the board and management; and

(ii) an annual performance evaluation of the committee.

Commentary: A nominating/corporate governance committee is central to the effective functioning of the board. New director and board committee nominations are among a board's most important functions. Placing this responsibility in the hands of an independent nominating/corporate governance committee can enhance the independence and quality of nominees. The committee is also responsible for taking a leadership role in shaping the corporate governance of a corporation.

If a company is legally required by contract or otherwise to provide third parties with the ability to nominate directors (for example, preferred stock rights to elect directors upon a dividend default, shareholder agreements, and management agreements), the selection and nomination of such directors need not be subject to the nominating committee process.

The nominating/corporate governance committee charter should also address the following items: committee member qualifications; committee member appointment and removal; committee structure and operations (including authority to delegate to subcommittees); and committee reporting to the board. In addition, the charter should give the nominating/corporate governance committee sole authority to retain and terminate any search firm to be used to identify director candidates, including sole authority to approve the search firm's fees and other retention terms.

Boards may allocate the responsibilities of the nominating/corporate governance committee to committees of their own denomination, provided that the committees are composed entirely of independent directors. Any such committee must have a published committee charter.

5. (a) Listed companies must have a compensation committee composed entirely of independent directors.

(b) The compensation committee must have a written charter that addresses:

   (i) the committee's purpose and responsibilities – which, at minimum, must be to have direct responsibility to:

      (A) review and approve corporate goals and objectives relevant to CEO compensation, evaluate the CEO's performance in light of those goals
and objectives, and, either as a committee or together with the other independent directors (as directed by the board), determine and approve the CEO's compensation level based on this evaluation; and

(B) make recommendations to the board with respect to non-CEO compensation, incentive-compensation plans and equity-based plans; and

(C) produce a compensation committee report on executive compensation as required by the SEC to be included in the company's annual proxy statement or annual report on Form 10-K filed with the SEC;

(ii) an annual performance evaluation of the compensation committee.

Commentary: In determining the long-term incentive component of CEO compensation, the committee should consider the company's performance and relative shareholder return, the value of similar incentive awards to CEOs at comparable companies, and the awards given to the listed company's CEO in past years. To avoid confusion, note that the compensation committee is not precluded from approving awards (with or without ratification of the board) as may be required to comply with applicable tax laws (i.e., Rule 162(m)).

The compensation committee charter should also address the following items: committee member qualifications; committee member appointment and removal; committee structure and operations (including authority to delegate to subcommittees); and committee reporting to the board.

Additionally, if a compensation consultant is to assist in the evaluation of director, CEO or senior executive compensation, the compensation committee charter should give that committee sole authority to retain and terminate the consulting firm, including sole authority to approve the firm's fees and other retention terms.

Boards may allocate the responsibilities of the compensation committee to committees of their own denomination, provided that the committees are composed entirely of independent directors. Any such committee must have a published committee charter.

Nothing in this provision should be construed as precluding discussion of CEO compensation with the board generally, as it is not the intent of this standard to impair communication among members of the board.

6. Listed companies must have an audit committee that satisfies the requirements of Rule 10A-3 under the Exchange Act.

Commentary: The Exchange will apply the requirements of Rule 10A-3 in a manner consistent with the guidance provided by the Securities and Exchange Commission in SEC Release No. 34-47654 (April 1, 2003). Without limiting the
generality of the foregoing, the Exchange will provide companies the opportunity to cure defects provided in Rule 10A-3(a)(3) under the Exchange Act.

7. (a) The audit committee must have a minimum of three members.

Commentary: Each member of the audit committee must be financially literate, as such qualification is interpreted by the company’s board in its business judgment, or must become financially literate within a reasonable period of time after his or her appointment to the audit committee. In addition, at least one member of the audit committee must have accounting or related financial management expertise, as the company’s board interprets such qualification in its business judgment. While the Exchange does not require that a listed company’s audit committee include a person who satisfies the definition of audit committee financial expert set out in Item 401(e) of Regulation S-K, a board may presume that such a person has accounting or related financial management expertise.

Because of the audit committee’s demanding role and responsibilities, and the time commitment attendant to committee membership, each prospective audit committee member should evaluate carefully the existing demands on his or her time before accepting this important assignment. Additionally, if an audit committee member simultaneously serves on the audit committees of more than three public companies, and the listed company does not limit the number of audit committees on which its audit committee members serve, then in each case, the board must determine that such simultaneous service would not impair the ability of such member to effectively serve on the listed company’s audit committee and disclose such determination in the company’s annual proxy statement or, if the company does not file an annual proxy statement, in the company’s annual report on Form 10-K filed with the SEC.

(b) In addition to any requirement of Rule 10A-3(b)(1), all audit committee members must satisfy the requirements for independence set out in Section 303A.02.

(c) The audit committee must have a written charter that addresses:

(i) the committee’s purpose – which, at minimum, must be to:

(A) assist board oversight of (1) the integrity of the company’s financial statements, (2) the company’s compliance with legal and regulatory requirements, (3) the independent auditor’s qualifications and independence, and (4) the performance of the company’s internal audit function and independent auditors; and

(B) prepare an audit committee report as required by the SEC to be included in the company’s annual proxy statement;

(ii) an annual performance evaluation of the audit committee; and
(iii) the duties and responsibilities of the audit committee - which, at a minimum, must include those set out in Rule 10A-3(b)(2), (3), (4) and (5) of the Exchange Act, as well as to:

(A) at least annually, obtain and review a report by the independent auditor describing: the firm’s internal quality-control procedures; any material issues raised by the most recent internal quality-control review, or peer review, of the firm, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, respecting one or more independent audits carried out by the firm, and any steps taken to deal with any such issues; and (to assess the auditor’s independence) all relationships between the independent auditor and the company;

*Commentary:* After reviewing the foregoing report and the independent auditor’s work throughout the year, the audit committee will be in a position to evaluate the auditor’s qualifications, performance and independence. This evaluation should include the review and evaluation of the lead partner of the independent auditor. In making its evaluation, the audit committee should take into account the opinions of management and the company’s internal auditors (or other personnel responsible for the internal audit function). In addition to assuring the regular rotation of the lead audit partner as required by law, the audit committee should further consider whether, in order to assure continuing auditor independence, there should be regular rotation of the audit firm itself. The audit committee should present its conclusions with respect to the independent auditor to the full board.

(B) discuss the company’s annual audited financial statements and quarterly financial statements with management and the independent auditor, including the company’s disclosures under “Management’s Discussion and Analysis of Financial Condition and Results of Operations”;

(C) discuss the company’s earnings press releases, as well as financial information and earnings guidance provided to analysts and rating agencies;

*Commentary:* The audit committee’s responsibility to discuss earnings releases, as well as financial information and earnings guidance, may be done generally (i.e., discussion of the types of information to be disclosed and the type of presentation to be made). The audit committee need not discuss in advance each earnings release or each instance in which a company may provide earnings guidance.

(D) discuss policies with respect to risk assessment and risk management;
Commentary: While it is the job of the CEO and senior management to assess and manage the company's exposure to risk, the audit committee must discuss guidelines and policies to govern the process by which this is handled. The audit committee should discuss the company's major financial risk exposures and the steps management has taken to monitor and control such exposures. The audit committee is not required to be the sole body responsible for risk assessment and management, but, as stated above, the committee must discuss guidelines and policies to govern the process by which risk assessment and management is undertaken. Many companies, particularly financial companies, manage and assess their risk through mechanisms other than the audit committee. The processes these companies have in place should be reviewed in a general manner by the audit committee, but they need not be replaced by the audit committee.

(E) meet separately, periodically, with management, with internal auditors (or other personnel responsible for the internal audit function) and with independent auditors;

Commentary: To perform its oversight functions most effectively, the audit committee must have the benefit of separate sessions with management, the independent auditors and those responsible for the internal audit function. As noted herein, all listed companies must have an internal audit function. These separate sessions may be more productive than joint sessions in surfacing issues warranting committee attention.

(F) review with the independent auditor any audit problems or difficulties and management's response;

Commentary: The audit committee must regularly review with the independent auditor any difficulties the auditor encountered in the course of the audit work, including any restrictions on the scope of the independent auditor's activities or on access to requested information, and any significant disagreements with management. Among the items the audit committee may want to review with the auditor are: any accounting adjustments that were noted or proposed by the auditor but were "passed" (as immaterial or otherwise); any communications between the audit team and the audit firm's national office respecting auditing or accounting issues presented by the engagement; and any "management" or "internal control" letter issued, or proposed to be issued, by the audit firm to the company. The review should also include discussion of the responsibilities, budget and staffing of the company's internal audit function.

(G) set clear hiring policies for employees or former employees of the independent auditors; and

Commentary: Employees or former employees of the independent auditor are often valuable additions to corporate management. Such individuals' familiarity with the business, and personal rapport with the employees, may be attractive qualities when filling a key opening. However, the audit committee should set
hiring policies taking into account the pressures that may exist for auditors consciously or subconsciously seeking a job with the company they audit.

(H) report regularly to the board of directors.

Commentary: The audit committee should review with the full board any issues that arise with respect to the quality or integrity of the company’s financial statements, the company’s compliance with legal or regulatory requirements, the performance and independence of the company’s independent auditors, or the performance of the internal audit function.

General Commentary to Section 303A.07(e): While the fundamental responsibility for the company’s financial statements and disclosures rests with management and the independent auditor, the audit committee must review: (A) major issues regarding accounting principles and financial statement presentations, including any significant changes in the company’s selection or application of accounting principles, and major issues as to the adequacy of the company’s internal controls and any special audit steps adopted in light of material control deficiencies; (B) analyses prepared by management and/or the independent auditor setting forth significant financial reporting issues and judgments made in connection with the preparation of the financial statements, including analyses of the effects of alternative GAAP methods on the financial statements; (C) the effect of regulatory and accounting initiatives, as well as off-balance sheet structures, on the financial statements of the company; and (D) the type and presentation of information to be included in earnings press releases (paying particular attention to any use of “pro forma,” or “adjusted” non-GAAP, information), as well as review any financial information and earnings guidance provided to analysts and rating agencies.

(d) Each listed company must have an internal audit function.

Commentary: Listed companies must maintain an internal audit function to provide management and the audit committee with ongoing assessments of the company’s risk management processes and system of internal control. A company may choose to outsource this function to a third party service provider other than its independent auditor.

General Commentary to Section 303A.07: To avoid any confusion, note that the audit committee functions specified in Section 303A.07 are the sole responsibility of the audit committee and may not be allocated to a different committee.

8. Reserved.

9. Listed companies must adopt and disclose corporate governance guidelines.

Commentary: No single set of guidelines would be appropriate for every company, but certain key areas of universal importance include director qualifications and responsibilities, responsibilities of key board committees, and director compensation. Given the importance of corporate governance, each
listed company's website must include its corporate governance guidelines and
the charters of its most important committees (including at least the audit, and if
applicable, compensation and nominating committees). Each company's annual
report on Form 10-K filed with the SEC must state that the foregoing information
is available on its website, and that the information is available in print to any
shareholder who requests it. Making this information publicly available should
promote better investor understanding of the company's policies and procedures,
as well as more conscientious adherence to them by directors and management.

The following subjects must be addressed in the corporate governance guidelines:

- **Director qualification standards.** These standards should, at minimum, reflect
  the independence requirements set forth in Sections 303A.01 and .02. Companies
  may also address other substantive qualification requirements, including policies
  limiting the number of boards on which a director may sit, and director tenure,
  retirement and succession.

- **Director responsibilities.** These responsibilities should clearly articulate what is
  expected from a director, including basic duties and responsibilities with respect
  to attendance at board meetings and advance review of meeting materials.

- **Director access to management and, as necessary and appropriate, independent advisors.**

- **Director compensation.** Director compensation guidelines should include
  general principles for determining the form and amount of director compensation
  (and for reviewing those principles, as appropriate). The board should be aware
  that questions as to directors' independence may be raised when directors' fees
  and emoluments exceed what is customary. Similar concerns may be raised when
  the company makes substantial charitable contributions to organizations in which
  a director is affiliated, or enters into consulting contracts with (or provides other
  indirect forms of compensation to) a director. The board should critically
  evaluate each of these matters when determining the form and amount of director
  compensation, and the independence of a director.

- **Director orientation and continuing education.**

- **Management succession.** Succession planning should include policies and
  principles for CEO selection and performance review, as well as policies
  regarding succession in the event of an emergency or the retirement of the CEO.

- **Annual performance evaluation of the board.** The board should conduct a self-
  evaluation at least annually to determine whether it and its committees are
  functioning effectively.
10. Listed companies must adopt and disclose a code of business conduct and ethics for directors, officers and employees, and promptly disclose any waivers of the code for directors or executive officers.

**Commentary:** No code of business conduct and ethics can replace the thoughtful behavior of an ethical director, officer or employee. However, such a code can focus the board and management on areas of ethical risk, provide guidance to personnel to help them recognize and deal with ethical issues, provide mechanisms to report unethical conduct, and help to foster a culture of honesty and accountability.

Each code of business conduct and ethics must require that any waiver of the code for executive officers or directors may be made only by the board or a board committee and must be promptly disclosed to shareholders. This disclosure requirement should inhibit casual and perhaps questionable waivers, and should help assure that, when warranted, a waiver is accompanied by appropriate controls designed to protect the company. It will also give shareholders the opportunity to evaluate the board’s performance in granting waivers.

Each code of business conduct and ethics must also contain compliance standards and procedures that will facilitate the effective operation of the code. These standards should ensure the prompt and consistent action against violations of the code. Each listed company’s website must include its code of business conduct and ethics. Each company’s annual report on Form 10-K filed with the SEC must state that the foregoing information is available on its website and that the information is available in print to any shareholder who requests it.

Each company may determine its own policies, but all listed companies should address the most important topics, including the following:

- **Conflicts of Interest.** A “conflict of interest” occurs when an individual’s private interest interferes in any way – or even appears to interfere – with the interests of the corporation as a whole. A conflict situation can arise when an employee, officer or director takes actions or has interests that may make it difficult to perform his or her company work objectively and effectively. Conflicts of interest also arise when an employee, officer or director, or a member of his or her family, receives improper personal benefits as a result of his or her position in the company. Loans to, or guarantees of obligations of, such persons are of special concern. The company should have a policy prohibiting such conflicts of interest, and providing a means for employees, officers and directors to communicate potential conflicts to the company.

- **Corporate opportunities.** Employees, officers and directors should be prohibited from (a) taking for themselves personally opportunities that are discovered through the use of corporate property, information or position; (b) using corporate property, information, or position for personal gain; and (c) competing with the
company. Employees, officers and directors owe a duty to the company to advance its legitimate interests when the opportunity to do so arises.

- **Confidentiality.** Employees, officers and directors should maintain the confidentiality of information entrusted to them by the company or its customers, except when disclosure is authorized or legally mandated. Confidential information includes all non-public information that might be of use to competitors, or harmful to the company or its customers, if disclosed.

- **Fair dealing.** Each employee, officer and director should endeavor to deal fairly with the company's customers, suppliers, competitors and employees. None should take unfair advantage of anyone through manipulation, concealment, abuse of privileged information, misrepresentation of material facts, or any other unfair-dealing practice. Companies may write their codes in a manner that does not alter existing legal rights and obligations of companies and their employees, such as "at will" employment arrangements.

- **Protection and proper use of company assets.** All employees, officers and directors should protect the company's assets and ensure their efficient use. Theft, carelessness and waste have a direct impact on the company's profitability. All company assets should be used for legitimate business purposes.

- **Compliance with laws, rules and regulations (including insider trading laws).** The company should proactively promote compliance with laws, rules and regulations, including insider trading laws. Insider trading is both unethical and illegal, and should be dealt with decisively.

- **Encouraging the reporting of any illegal or unethical behavior.** The company should proactively promote ethical behavior. The company should encourage employees to talk to supervisors, managers or other appropriate personnel when in doubt about the best course of action in a particular situation. Additionally, employees should report violations of laws, rules, regulations or the code of business conduct to appropriate personnel. To encourage employees to report such violations, the company must ensure that employees know that the company will not allow retaliation for reports made in good faith.

11. **Listed foreign private issuers must disclose any significant ways in which their corporate governance practices differ from those followed by domestic companies under NYSE listing standards.**

*Commentary:* Foreign private issuers must make their U.S. investors aware of the significant ways in which their home-country practices differ from those followed by domestic companies under NYSE listing standards. However, foreign private issuers are not required to present a detailed, item-by-item analysis of these differences. Such a disclosure would be long and unnecessarily complicated. Moreover, this requirement is not intended to suggest that one country's corporate governance practices are better or more effective than another. The Exchange
believes that U.S. shareholders should be aware of the significant ways that the
governance of a listed foreign private issuer differs from that of a U.S. listed
company. The Exchange underscores that what is required is a brief, general
summary of the significant differences, not a cumbersome analysis.

Listed foreign private issuers may provide this disclosure either on their web site
(provided it is in the English language and accessible from the United States)
and/or in their annual report as distributed to shareholders in the United States in
accordance with Sections 103.00 and 203.01 of the Listed Company Manual
(again, in the English language). If the disclosure is only made available on the
web site, the annual report shall so state and provide the web address at which the
information may be obtained.

12. (a) Each listed company CEO must certify to the NYSE each year that he or she
is not aware of any violation by the company of NYSE corporate governance
listing standards.

Commentary: The CEO’s annual certification to the NYSE that, as of the date of
certification, he or she is unaware of any violation by the company of the NYSE’s
corporate governance listing standards will focus the CEO and senior
management on the company’s compliance with the listing standards. Both this
certification to the NYSE, and any CEO/CFO certifications required to be filed
with the SEC regarding the quality of the company’s public disclosure, must be
disclosed in the company’s annual report to shareholders or, if the company does
not prepare an annual report to shareholders, in the companies annual report on
Form 10-K filed with the SEC.

(b) Each listed company CEO must promptly notify the NYSE in writing after
any executive officer of the listed company becomes aware of any material non-
compliance with any applicable provisions of this Section 303A.

13. The NYSE may issue a public reprimand letter to any listed company that
violates a NYSE listing standard.

Commentary: Suspending trading in or delisting a company can be harmful to the
very shareholders that the NYSE listing standards seek to protect; the NYSE must
therefore use these measures sparingly and judiciously. For this reason it is
appropriate for the NYSE to have the ability to apply a lesser sanction to deter
companies from violating its corporate governance (or other) listing standards.
Accordingly, the NYSE may issue a public reprimand letter to any listed
company, regardless of type of security listed or country of incorporation, that it
determines has violated a NYSE listing standard. For companies that repeatedly
or flagrantly violate NYSE listing standards, suspension and delisting remain the
ultimate penalties. For clarification, this lesser sanction is not intended for use in
the case of companies that fall below the financial and other continued listing
standards provided in Chapter 8 of the Listed Company Manual or that fail to
comply with the audit committee standards set out in Section 303A.06. The
processes and procedures provided for in Chapter 8 govern the treatment of companies falling below those standards.
company is required to file SARs, the company should establish procedures for filing and educate its employees as part of the anti-money laundering compliance program.

IX. The Foreign Corrupt Practices Act Books and Records: Enforcing Corporate Integrity

With the accelerating pace of internationalization, an ever growing number of companies engaged in foreign markets are also raising capital in the United States public markets, and thus are subject to U.S. disclosure requirements, including the Foreign Corrupt Practices Act. The growth has occurred both in the number of U.S. companies investing in operations abroad and through foreign companies raising

bank or a trust company; private bankers; an agency or branch of a foreign bank in the United States; any credit union; a thrift institution; a broker or dealer registered with the SEC under the Securities Exchange Act of 1934; a broker or dealer in securities or commodities whether or not registered; an investment banker or investment company; a currency exchange; an issuer, redeemer or cashier of traveler's checks, checks, money orders or similar instruments; an operator of a credit card system; an insurance company; a dealer in precious metals, stones or jewels; a pawnbroker; a loan or finance company; a travel agency; a licensed sender of money or any other person who engages as a business in the transmission of funds, formally or informally; a telegraph company; a business engaged in vehicle sales; persons involved in real estate closings and settlements; the United States Postal Service; an agency of the federal or any state or local government carrying out a duty or power of business described in the definition of a “financial institution”; a state-licensed or Indian casino with annual gaming revenue of more than $1,000,000; and certain other businesses designated by Treasury.
capital on the U.S. market. In the latter category, over 500 foreign companies from 36 countries have entered the U.S. public securities market since the beginning of 1992 (bringing the total to more than 800).

The Securities and Exchange Commission has responded to the demand for access to the U.S. market by simplifying procedural requirements and removing technical barriers to entry. At the same time, however, as discussed below, it has redoubled its efforts to enhance the integrity of the U.S. markets. Thus, the SEC is increasing its scrutiny of the foreign operations (and associated disclosures) of both domestic issuers and foreign companies filing reports, with the Commission. The application of one of the SEC’s most effective weapons for requiring full and fair disclosure by foreign and domestic companies alike, the Foreign Corrupt Practices Act ("FCPA" or "the Act"), is a powerful tool in the era of multi-national corporate initiatives, However, it is subject to serious challenge in the United States Courts. See discussion of American Rice at § F.[8]. As discussed infra at § F.[8][c], these challenges have the potential to drastically alter the manner in which the statute is enforced, as well as the United States international status with regard to policing corruption in international transactions.

A. Background

The FCPA has two substantive prongs: the anti-bribery provisions and the books and records provisions:

The Anti-Bribery (or foreign payments) provision tend to be the part of the act to which most attention is paid. It makes it illegal to make payments directly or indirectly to foreign officials, officials of foreign political parties, or any other person acting as a conduit for payments to foreign officials or political parties, for the purpose of obtaining or retaining business. See 15 U.S.C. §§ 78dd-1 (Exchange Act § 30A) and 78dd-2.

The Books and Records provisions, under section 13 of the Exchange Act, although less well-known, give the SEC a far more potent and easily applied tool for requiring full and fair disclosure. The Books and Records provisions require companies who file reports with the SEC to maintain records that accurately reflect transactions and the nature and quantity of corporate assets and liabilities

B. Accounting/Books and Records Provisions and Rules

Sections 13(b)(2)(A) and (B), the accounting provisions of the Act, are designed to provide assurances that corporations make and keep their books, records, and accounts in a fashion which will enable them to fulfill their disclosure obligations.

[1] Section 13(b)(2)(A)

This section requires issuers to "make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer."

Rule 13b-1 provides that "[n]o person shall, directly or indirectly, falsify or cause to be falsified, any book, record, or account..."
Rule 13(b)(2)-2 provides that "no director or officer shall, directly or indirectly, make or cause to be made a materially false or misleading statement, or omit to state, or cause another person to omit to state, any material fact necessary in order to make statements made, in light of the circumstances under which such statements were made, not misleading to an accountant in connection with (1) any audit or examination of the financial statements of the issuer required to be made pursuant to this subpart, or (2) the preparation or filing of any documents or report required to be filed with the Commission."  

[2] Section 13(b)(2)(B)  

This section requires issuers to devise and maintain a system of internal accounting controls aimed at providing assurances that such issuers have reliable financial information from which to prepare financial statements and other disclosure documents.

Among other things, the purpose of internal controls is to enable a company to detect and prevent illicit payments to foreign officials by being capable of highlighting irregularities which conceal disguised payments. Such a system, for instance; would detect payments made through conduits by verifying (or assuring that there has been verification of) the value of consulting services received relative to the amount paid. Where a bribe is made and unaccounted for, this provision can provide an almost automatic enforcement vehicle, or charging as a separate offense, for any situation where there are indications of an accounting irregularity and/or an illegal foreign payment. It is therefore vital that companies demonstrate their commitment at the highest levels to the implementation of effective controls to assure accurate books and to prevent illegal foreign payments.

C. The Foreign Corrupt Practices Act

Although there is a materiality requirement in Rule 13(b)(2)-2, the SEC specifically rejected such a standard for Rule 13(b)(2)-1. See SEC Release No. 34-15570 (Feb. 15, 1979) (citing a "concern that a limitation concerning material falsity would unduly narrow the scope of the Rule and result in an unwarranted diminution of investor protection"). Obviously, those responsible for generating the sorts of records that are eventually incorporated into a company's financials should be made aware of the scope of their liability.

Section 13(b)(2)(B) provides that the issuer must maintain a system of internal accounting controls sufficient to provide reasonable assurances that:
Amendments of 1988

The Foreign Corrupt Practices Act Amendments of 1988 ("The 1988 Amendment") to the FCPA created a new criminal standard for application of the books, records, and internal accounting provisions of the statute applicable to persons or entities that knowingly falsify a book or record, or knowingly circumvent or fail to implement a system of internal accounting controls. With regard to subsidiaries, domestic or foreign, where a company has an equity interest of 50% or less, the Act requires only that the company use its "good faith" efforts to influence the subsidiary to maintain adequate internal controls. Such efforts would create a presumption of compliance by the company.

D. Jurisdiction

[1] The SEC

The SEC has broad civil enforcement power over "issuers" (companies with a class of securities registered pursuant to § 12 of the Securities Act or which are required to file reports with the SEC under § 15(d)), their directors, officers, employees, agents and shareholders where acting on behalf of the issuer. The SEC can even prosecute officers and directors who are not U.S. citizens, nationals or residents; officers and directors of foreign issuers thus become liable in the United States for the FCPA violations of the company merely by virtue of their employment by an "issuer." The expansiveness of the SEC's jurisdiction is intended to increase the pressure on management - whether foreign or U.S. nationals - to take the necessary steps to implement augmented internal controls systems. The SEC can enforce both the books and records/internal control and the anti-bribery provisions against these parties.

If the Commission determines that there have been violations of these provisions of the Exchange Act, it may file a civil action in federal district court to seek an injunction against further violations of the statute, and a penalty. Moreover, where fraud is involved, the court may bar a person from acting as an officer or director of a public corporation. With respect to the books, records, and internal controls provisions of the Exchange Act, the Commission can also bring an Administrative Enforcement Proceeding and issue an agency order directing compliance with those sections of the law.

[2] The Department of Justice

DOJ has jurisdiction to bring criminal proceedings for knowing violations of the anti-bribery provision against the same entities as the SEC and additionally to bring civil or criminal proceedings against "domestic concerns" (those who are not "issuers"), their officers, directors, employees, agents or shareholders (acting on behalf of the concern). Of course, the potential for individual and corporate criminal liability only increases the pressure on management to implement effective controls and employee education programs.

E. Accounting Requirements and Practices for Companies Under the FCPA

By mandating certain accounting practices, the FCPA adds a powerful weapon to the SEC's enforcement arsenal, whose purpose is the deterrence of illegal payments and the assurance that shareholder disclosures remain accurate. Recent SEC enforcement activity illustrates the two-track approach that the SEC will take to addressing disclosure requirements for foreign payments under the FCPA. The fact that an independent auditor is not able to detect a bribe, or that there may be difficulties encountered in prosecuting a particular scheme for the ultimate payment of a bribe, does
not mean that those who make questionable payments go unpunished. Corporate officials face not only potential criminal charges for paying bribes, but also charges for maintaining inaccurate corporate books and records and inadequate internal accounting controls which permitted illegal payments - even those made unbeknownst to management - to be made. For these reasons, the specter of an enforcement action under the books and records provisions of the FCPA should cause management to create committees not only to undertake searching one-time reviews but also to periodically re-review internal controls systems and employee education and to deal quickly and appropriately with any issues which arise.

[1] Corporate Record-keeping

The purpose of the corporate record keeping provisions is to create a duty in a company’s management to ensure that the company’s books and records are accurate and that its annual financial statements can be prepared and independently audited. Moreover, management is charged with developing accounting control systems to ensure that the company has the ability to record economic events, safeguard assets and conform transactions to management’s authorization. Management may find it appropriate or effective to issue special guidelines to employees dealing with accounting for all company transactions. Judgment should be exercised in designing systems of accounting controls that are appropriate, for example, to the company’s size, the diversity of company operations, the degree of centralization of financial and operating management, and the amount of contact by top management with day-to-day operations. These issues should be revisited regularly to address the effectiveness of the implementation and the possible need for adjustment to changing circumstances. Indeed, most public companies have concluded that an independent audit committee of the board of directors can play a role in providing oversight to management’s efforts to create and maintain effective internal accounting controls. To facilitate this process, management may wish to seek assistance from accounting and auditing literature or from consultants.

[2] Role of Management and Boards

Imposing the corporate record-keeping obligations (to maintain accurate books and records and to implement effective internal controls) on companies does not necessarily require boards of directors or senior management to be involved in the minutiae of recording and accounting for every transaction that the companies may make. But such obligations probably do require both management and boards to monitor and evaluate the adequacy of companies’ books, records and internal accounting controls. While requirements to maintain accurate books and records and an adequate system of internal accounting controls does not mean that the management and board will be liable for every small, isolated error or irregularity, a system that permits frequent breaches and is unable to uncover or remedy those breaches in a timely fashion should be the subject of immediate management and board attention.

[3] The Auditor’s Role

The internal accounting controls that public companies are required to maintain under the Exchange Act are always considered by independent auditors in doing an audit. For example, U.S. Generally Accepted Auditing Standards (“GAAS”) require auditors to understand a company’s internal control structure in planning and performing an audit. Auditors must also provide advice to...
management regarding whether the internal accounting controls devised by management are adequate.131

Additionally, auditors are required to design their audits to provide reasonable assurance of detecting material errors or irregularities (intentional misstatements) that are material to the financial statements, including illegal acts such as bribery. When risk factors indicate, auditors should make appropriate inquiries of management concerning a company’s compliance with laws against bribery. The SEC has adopted a rule that makes it illegal for corporate management and directors to lie to or mislead its internal accountants or external auditors in any way in connection with the preparation of any report required to be filed with the SEC.

[4] Recent Legislation - Deputizing the Auditor

Perhaps one of the most important developments since the passage of the FCPA is the recent congressional enactment of legislation that imposes expanded obligations on auditors in connection with their review of corporate financial statements. Among other things, the Private Securities Litigation Reform Act of 1995 ("Litigation Reform Act") amended the Exchange Act to require auditors to report in a timely manner certain uncorrected illegal acts that have a material effect on the financial statements, which may include the payment of bribes, to the board of directors of issuers. See Litigation Reform Act, tit. iii, Publ. L. No. 104-67 (adding section 10A to the Exchange Act). The provision further requires the company, or if the company fails to do so then the auditor, to provide information regarding the illegal act to the SEC. By requiring the auditor to inform on his client, subjecting him to penalties if he should fail, this legislation extends U.S. generally accepted auditing standards that require auditors only to report illegal acts to a company’s management. Essentially, the Litigation Reform Act mandates third party oversight of corporate management. Moreover, the requirement that these irregularities be reported to the SEC enforces the SEC potentially to begin its own investigation more quickly than might otherwise be possible.

On March 13, 1997, new rules implementing the reporting requirements in section 10A of the Exchange Act became effective. See 17 C.F.R. § 210.1-02 and 240. 10A-1. The rules stipulate the required contents for the company notices and auditors’ reports filed with the SEC under the amended section 10A. The notice to the Commission (to be made to the Office of the Chief Accountant) must identify the company and the auditor, state the date the auditor made its report to the board regarding the illegal act, and provide a summary of the auditor’s report to the board. The required summary must describe the act and the potential impact of that act on the registrant’s financial statements.

In response to commentary received during the comment period, the rule explicitly provides that the section 10A notice and report are to be treated as exempt under FOIA in the same fashion as the SEC’s investigative records because they are intended to assist the SEC in its enforcement efforts. (Previously, the rule had only provided that the reports were to be treated as non-public). The SEC has acknowledged the importance of preserving the confidentiality of these reports to protect its own ability to investigate, the issuers’ right to a fair adjudication, the issuer’s privacy interests as well as the confidential source. The information itself, however, is not entirely shielded from

131 A recent amendment to Regulation S-X (17 C.F.R. § 210.1-02(d)) authorizes the SEC to supplement an auditors’ duties under GAAS.
disclosure since the rule does not affect an issuer’s obligation to file Forms 8-K or NSAR. While the confidential, FOIA-exempt treatment is important, it bears emphasizing that these auditor reports are being furnished directly to the enforcement division.

F. Recent SEC Enforcement Actions

[1] Montedison SpA

On November 21, 1996, the SEC instituted a civil enforcement action against Montedison SpA ("Montedison"), an Italian company, alleging that violations of the Exchange Act’s anti-fraud provision and the FCPA books and records provisions. This was the first case the SEC had ever brought against a foreign private issuer of securities in the U.S. Montedison, an Italian corporation with headquarters in Milan, had interests in the agro-industry, chemical, energy, and engineering sectors. Since July, 1987, American Depositary Receipts ("ADRs"), each representing ten shares of the company’s common stock, have been listed on the New York Stock Exchange. The ADRs are registered under Section 12(b) of the Exchange Act, Montedison filed reports with the SEC in Washington, D.C. pursuant to Section 13(a) of the Exchange Act. It filed annual reports with the SEC on Form 20-F.

In its complaint, the SEC alleged that Montedison violated the antifraud provisions of the Exchange Act by engaging in a fraudulent scheme to materially misstate it’s financial condition and results of operations on its books and records and in its reports filed with the Commission and disseminated to the investing public. According to the complaint, the scheme began in approximately 1988 and operated through the first half of 1993. The complaint alleges that the scheme was designed to conceal hundreds of millions of dollars of payments that, among other things, were used to bribe politicians in Italy and other persons. Moreover, the scheme concealed losses of at least $398 million. As a result, Montedison’s assets allegedly were materially overstated on its books and records and in its financial statements for its 1988, 1989, 1990, and 1991 fiscal years.

The SEC’s complaint alleged two examples of Montedison’s fraudulent conduct, the “Exilar Loan” and the “ENIMONT Affair.” According to the complaint, the Exilar Loan was a fraudulent accounting entry used to disguise and aggregate as an asset on the company’s balance sheet numerous questionable payments or bribes that had been made from at least December, 1988 and through May, 1993. In the latter half of 1993, Montedison determined that the Exilar loan was uncollectible, and took a write-down in the amount of 435 billion lire (approximately $272 million, at $1 - 1,600 lire) for the company’s 1992 fiscal year. The complaint alleges that the ENIMONT Affair involved fraudulent accounting entries that overstated real estate values to disguise numerous bribes on the company’s books and records from at least 1990 through 1992. The fraudulent entries resulted in a write-down on the company’s 1993 financial statements of 202 billion lire (approximately $126,250,000.00).

The complaint alleged that the fraudulent conduct continued undetected for several years because of a “seriously deficient internal control environment at Montedison.” The complaint notes that Montedison’s internal controls “were so deficient that, according to Montedison, neither the company itself, nor its auditors, have been able to reconstruct precisely what occurred and who was
responsible.” The fraudulent conduct was discovered after new management was appointed when Montedison disclosed that it was unable to service its bank debt. Many members of the former senior management responsible for the fraud were convicted by Italian criminal authorities and were sued by the company.

In its complaint the Commission requested that the court: (i) enter findings that Montedison violated Exchange Act Sections 10(b), 13(a), 13(b)(2)(A), and 13(b)(2)(B) and Rules 10b-5, 12b-20, and 13a-1 thereunder; (ii) grant a permanent injunction restraining and enjoining Montedison from violating such provisions; and (iii) order Montedison to pay a civil penalty pursuant to Exchange Act Section 21(d)(3).

While the prosecution of an Italian company for payments presumably made by Italian employees to Italian officials may appear to be an aggressive jurisdictional posture by the SEC, it is actually fairly conservative. Section 13 imposes penalties on issuers for submitting inaccurate financial records to the SEC and for maintaining an inadequate system of controls which permits those inaccuracies. As an issuer which has exploited the U.S. capital markets, Montedison was submitting false reports to the SEC and causing the false information to be disseminated to the U.S. market. It remains possible, though considerably more tenuous, that the SEC could prosecute a company like Montedison and its officials under the foreign payments provision, which proscribes any “use of the mails or any means of instrumentality of interstate commerce” to make an illegal payment. Apparently, the SEC was unwilling to test the question whether the use of the capital markets and the issuance of a report in the U.S. inaccurately reflecting an illegal foreign payment was a sufficient “use” of the means of interstate commerce to support the application of Section 30A to conduct occurring and having effect wholly outside the U.S.. Potentially, the SEC could attempt the prosecution of a foreign company or even foreign officers or directors of a foreign issuer under such circumstances in the future.

In a March 30, 2001 Litigation Release (Lit. Rel. No. 16948/March 30, 2001) the SEC announced that pursuant to a settlement agreement, the company was ordered to pay a civil penalty of $300,000 for violating the anti-fraud, financial reporting and books and records provisions of the U.S. federal securities laws. The company was acquired by Compalt, S.p.A. in late 2000 and its ADRs were delisted. Compalt then changed its name to Montedison. No securities of Compalt are listed for sale by U.S. stock exchanges.

[2] The Triton Case

On February 27, 1997, Triton Energy Corporation (“Triton Energy”), a U.S. company, entered into a settlement acknowledging violations of the anti-bribery, books and records, and internal control provisions. Simultaneously, two former senior officers of Triton Energy’s subsidiary, Triton Indonesia, Inc. (“Triton Indonesia”), Richard L. McAdoo and Philip W. Keever, also consented to the entry of orders concerning these offenses (the two consented to an order enjoining future violations of the foreign payments provision).

The Commission’s complaint alleges that during the years 1989 and 1990, McAdoo and Keever authorized numerous improper payments to Roland Siouffl, Triton Indonesia’s business agent. Siouffl acted as an intermediary...

between Triton Indonesia and Indonesian government agencies. It was alleged that in authorizing these payments, McAdoo and Keever knowingly or recklessly disregarded the high probability that Siouffi either had or would pass them along to Indonesian government employees for the purpose of influencing their decisions affecting the business of Triton Indonesia. The complaint alleges that these payments were made in violation of the Foreign Corrupt Practices Act. According to the complaint, McAdoo and Keever, together with other Triton Indonesia employees, also concealed these payments by falsely documenting and recording the transactions as routine business expenditures. The complaint states that Triton Energy did not expressly authorize or direct these improper payments and misbookings.

During the relevant time period, the SEC alleged that Triton Energy failed to devise and maintain an adequate system of internal accounting controls to detect and prevent improper payments by Triton Indonesia to government officials and to provide reasonable assurance that transactions were recorded as necessary to permit preparation of financial statements in conformity with generally accepted accounting principles. In particular, the complaint alleges that Triton Indonesia recorded other false entries in its books and records, including, for example, falsely documenting and recording case payments totaling $1,000 per month to clerical employees of the Indonesian national oil company made for the purpose of expediting payment of monthly crude oil invoices.

Simultaneous with the filing of the complaint, Triton Energy consented, without admitting or denying the allegations, to the entry of a Final Judgment that permanently enjoins it from violating the books and records and internal controls provisions of the Securities Exchange Act of 1934 ("Exchange Act"), and orders Triton Energy to pay a $300,000 penalty. In its press release announcing the settlement the SEC noted that its acceptance of the settlement was based upon its consideration of the fact that the violations occurred under former management and that certain remedial actions have been implemented by the current board of directors and senior management. Keever consented, without admitting or denying the allegations, to the entry of a Final Judgment that permanently enjoins him from violating the foreign corrupt practices and books and records provisions of the Exchange Act, and orders Keever to pay a $50,000 penalty. The action against McAdoo is pending.

As part of these proceedings, the SEC also instituted cease and desist proceedings against former employees of Triton Energy, David Gore, Robert Puettz, William McClure, and Robert P. Murphy. These proceedings were based upon those individuals' conduct in connection with the improper payments and misbookings. The SEC found that, as a result of the falsely documented payments and other false entries, Triton Indonesia maintained books and records that did not accurately or fairly reflect the underlying disposition of assets. It also made a finding that Murphy, Triton Indonesia's Controller, knowingly participated in creating and recording false entries in Triton Indonesia's books and records. According to the Order, McClure, Triton Indonesia's Commercial Manager, failed to assure that the entries prepared by Murphy accurately reflected the underlying transactions. The Commission's Order also found that Gore, formerly Triton Energy's president and a director, and Puettz, formerly Triton Energy's senior vice president of finance and chief financial officer, each received information indicating that Triton Indonesia was engaged in conduct that was potentially unlawful, but took no action to initiate an investigation of the serious issues raised by Triton Energy's internal auditor.
Without admitting or denying the Commission's findings, the respondents each consented to the entry of a cease and desist order. McClure and Murphy consented to cease and desist from committing or causing any violation of, and committing or causing any future violation of the books and records provision of the Exchange Act. Gore and Puetz consented to cease and desist from committing or causing any violation of, and committing or causing any future violation of, the foreign payments provision of the Exchange Act. In addition, Gore, Puetz, McClure, and Murphy consented to cease and desist from causing any violation of, and causing any future violation of, the record keeping provision of the Exchange Act. See, In the Matter of David Gore, Robert Puetz, William McClure, and Robert P. Murphy, Administrative Proceeding 3-9262 (February 27, 1997).

Unlike the Montedison case, the illegal payments (made to an intermediary to obtain favorable tax and regulatory treatment) were recorded as expenses albeit mischaracterized as legitimate expenses, so that the overall financial condition was not misstated. Although this is a more conventional exercise of jurisdiction than the Montedison case (a US company was prosecuted for the conduct of its employees - apparently all American nationals - in foreign subsidiaries) it is notable as only the fourth prosecution by the SEC under the foreign payments provision.


In this matter, the foreign subsidiary of International Business Machines Corporation ("IBM") went to great lengths to conceal the illicit payments made to foreign officials from IBM, including the creation of false invoices and other documentation. Nevertheless, the SEC pursued IBM for violations of the books and records provisions of the FCPA. The matter ultimately settled with the filing of a consent cease and desist order and a settled civil action. IBM agreed to pay a penalty of $300,000.

The complaint alleged that IBM's wholly-owned foreign subsidiary, IBM-Argentina, S.A., made approximately $4.5 million in payments to bank officials in its efforts to secure the contract to modernize a government-owned bank. The contract was worth $250 million. Senior management at IBM-Argentina subcontracted with Capacitacion Y Computacion Rural, S.A. and paid the subcontractor $22 million. The $4.5 million in illicit payments came from that $22 million.

This case, as well as the Chiquita Brands International matter discussed below, demonstrate that corporations can incur liability under the FCPA without knowledge of the underlying misconduct. Indeed, the books and records and internal controls provisions of the FCPA permitted findings against IBM and Chiquita in circumstances where the subsidiaries actively concealed evidence of illicit payments from the parents.


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In October of 2001, the SEC and Chiquita Brands International, Inc., entered into a settled cease and desist order and settled a civil action related to a payment to foreign customs officials in Columbia. This case demonstrates the importance of internal controls as a tool for corporations to protect themselves from liability under the FCPA, and also the importance of prompt, remedial action when potential violations are uncovered. The illicit payments at issue in this matter were made by C.I. Bananos de Exportacion S.A. (“Banadex”), a wholly owned, foreign subsidiary of Chiquita Brands International, Inc. (“Chiquita”). The parties agreed, and the administrative order reflected, that Banadex acted without the knowledge or consent of any Chiquita employees outside of Colombia and that the subsidiary’s conduct was in violation of the policies of both Chiquita and Banadex.

According to the order, Banadex made payments in 1996 and 1997 totaling $30,000 to local customs agents in an effort to have two prior citations for customs violations ignored so that Banadex could renew its license to maintain incoming inventory awaiting inspection at its Colombia port facility. If the prior citations had resulted in a denial of Banadex’ renewal application, the company would have incurred a cost of approximately $1 million to replace the holding facility. Banadex identified the payments as discretionary payments on its books and records. The initial payment was identified on the company’s books as a maritime donation. The second payment was identified as relating to a maritime agreement. Both of these characterizations were false.

When Chiquita became aware of questionable books and records entries relating to 1996, it conducted an internal

investigation which ultimately resulted in the termination of Banadex employees responsible for the payments.

The civil penalty in this case, $100,000, is reflective of Chiquita’s proactivity, including the thorough investigation, remedial measures and overhaul of the subsidiary’s internal controls.


This matter relates to illicit payments made to Saudi Arabian officials through a Swiss bank account in an effort to secure a contract to produce holograms for the Saudi Arabian government. According to the complaint, then chairman and CEO Morris Weissman and then executive vice president and general manager Joshua Cantor directed an employee of American Bank Note Holographics, Inc. to wire approximately $239,000 to the Swiss account to serve as a bribe for one or more Saudi officials. The corporation then recorded the $239,000 payment as a consulting fee.

The company discovered and questioned the transaction during its audit process, and instituted an internal
investigation. At the conclusion of the investigation, the corporation terminated the responsible officers and notified the SEC of the circumstances. Without admitting or denying the SEC’s findings, American Bank Note Holographics agreed to an order to cease and desist from violating the FCPA’s anti-bribery provisions and books and records and internal control provisions. The corporation also agreed to a $75,000 penalty in the civil action.

On April 10, 2003, the Commission filed a settled action against Joshua C. Cantor. The Complaint underlying the action included the FCPA violations described above, as well as significant financial fraud allegations. Without admitting or denying the allegations in the Complaint, Mr. Cantor consented to an order permanently enjoining him from violating and/or aiding and abetting violations of the antifraud, reporting, record keeping, internal controls, and lying to auditors provisions of the federal securities laws, as well as from violating the FCPA. In addition, Mr. Cantor consented to a ten year prohibition from acting as an officer or director of a public company.


154 On August 6, 2003, following a jury trial before the U.S. District Court for the Southern District of New York, Morris Weissman was convicted of conspiracy, securities fraud, falsifying books and records and making false statements to auditors. See Lit. Rel. No. 18283/August 12, 2003.
The injunction related to Baker Hughes also included illicit payments to agents in Brazil and India authorized by senior management in 1995 and 1998.

Eric Mattson and James Harris have moved to dismiss the charges. In addition to maintaining that they did not engage in the conduct alleged, they have argued that the favorable tax treatment did not satisfy the “obtain or retain business” prong of the FCPA. SEC v. Mattson, No. 01-CV-3106 (S.D. Tex., Sept. 11, 2001). See discussion of American Rice, infra. Relying on United States v. Kay, the court held that the payments did not violate the FCPA because they did not help Baker Hughes “obtain or retain business.” The SEC appealed the decision to the United States Court of Appeals for the Fifth Circuit. The appeal has been stayed pending the decision by the Fifth Circuit of the Department of Justice’s appeal of the decision in United States v. Kay.


On January 15, 2002, the SEC filed a settled civil action in federal court. Pursuant to the settlement agreement BellSouth agreed to pay a $150,000 civil penalty. In its complaint, the SEC alleged that BellSouth violated certain provisions of the Foreign Corrupt Practices Act (FCPA). The SEC alleged that BellSouth violated the books and records and internal controls provisions of the Securities Exchange Act of 1934. The matter stemmed from payments made by BellSouth’s Venezuelan and Nicaraguan subsidiaries.

According to the complaint, between September 1997 and August 2000, former senior management of BellSouth’s Venezuelan subsidiary, Telcel, C.A., authorized payments totaling approximately $10.8 million to six offshore companies and improperly recorded the disbursements in Telcel’s books and records, based on fictitious invoices, as services received. Telcel’s internal controls failed to detect the unsubstantiated payments for a period of at least two years. As a result of these failures, BellSouth was unable to reconstruct the circumstances surrounding the payments and could not identify the recipients of the payments.

The complaint also alleges that, between October 1998 and June 1999, BellSouth’s Nicaraguan subsidiary, Telefonia Celular de Nicaragua, S.A.’s (“Telefonia”), improperly recorded payments to the wife of the Nicaraguan legislator who was the chairman of the Nicaraguan legislative committee with oversight of Nicaraguan telecommunications. The alleged improper payments related to BellSouth’s purported efforts to accomplish the repeal by the Nicaraguan legislature of a foreign ownership restriction in effect in the telecommunications industry. BellSouth owned 49% of Telefonia and had an option to purchase an additional 40%. The foreign ownership restriction prohibited foreign companies from acquiring a majority interest in Nicaraguan telecommunications companies.

According to the complaint, in October 1998, Telefonia retained the wife of a Nicaraguan legislator to provide regulatory and legislative services, including lobbying for the repeal of the foreign ownership restriction. The legislator whose wife Telefonia retained chaired the legislative committee with jurisdiction over the foreign ownership restriction. The legislator’s wife had no

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155 The argument that seeking favorable tax treatment does not satisfy the “obtain or retain business” prong of the FCPA is discussed infra, at § IX.F.[8].

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legislative experience, although she did have experience in the financial and operational aspects of the telecommunications industry. BellSouth International knew that payments to the lobbyist could implicate the FCPA, yet a BellSouth International attorney approved the payments.

The complaint alleges that the legislator drafted the text of a proposed repeal of the foreign ownership restriction and held hearings on the issue. In May of 1999 BellSouth terminated the lobbyist, providing her with a severance payment in June of 1999. Total payments to the lobbyist amounted to $60,000. In September, 1999, the legislative committee referred the proposed repeal to the Nicaraguan National Assembly. In December, 1999 the Assembly voted to repeal the restriction and BellSouth exercised its 40% option in June, 2000, thereby increasing its ownership interest in Telefonia to 89%.

On January 15, 2002 the SEC issued a related, settled cease and desist order against BellSouth finding violations of the books and records provisions and the internal controls provisions of the Securities Exchange Act of 1934. The Order cites BellSouth’s cooperation with the SEC and the several remedial measures undertaken by BellSouth, including disciplining and terminating various employees. The Order also notes that BellSouth has initiated an enhanced compliance program.

The §13 provisions of the FCPA, taken together, require that publicly held corporations devise and maintain a system of accountability, i.e., internal controls, pursuant to which the corporation’s books and records are accurately maintained and fairly reflect the company’s business. While these provisions grew out of a desire to address foreign bribery, their application is far more pervasive and is applied to all aspects of a company’s accounting for its operations. In this regard, a manufacturing concern must maintain a system by which it records revenues from the sale of its products only when such sales actually occur and the purchaser is obligated to pay for the products in question. Where revenue from a purported sale of a product is prematurely recognized because the company is issuing invoices to a customer, but “holding” the product in question for some indeterminate amount of time, the company would run afoul of these provisions of the state and would not be in compliance with Generally Accepted Accounting Principles ("GAAP") in the preparation of its financial statements. See e.g., SEC v. Electro-Catheter Corp., et al, Civ. Act. 87-0267 (NAJ) (D.D.C. July 15,1986).


The American Rice case constitutes a significant challenge to the broad interpretation afforded the “obtain or retain business” element of the FCPA. The criminal indictment against former corporate officers Douglas Murphy and David Kay was dismissed by the United States District Court for the Southern District of Texas on the ground that the FCPA did not apply to bribes to gain better tax treatment. The Department of Justice has appealed the decision and the SEC has pursued civil remedies against Murphy and Kay in a parallel proceeding alleging the same conduct. While the decision in the criminal matter is pending appeal, however, the future scope of the FCPA is very much in question.
[a] The SEC enforcement matter

In July of 2002, the SEC filed suit in the United States District Court for the Southern District of Texas against two former officers of American Rice Co., Inc. who allegedly authorized more than $500,000 in bribery payments to Haitian officials. The SEC alleged that Douglas Murphy and David Kay authorized payments during 1998 and 1999 in order to reduce American Rice's import taxes by approximately $1.5 million. American Rice was a public company headquartered in Houston, Texas.

The SEC alleges that Mr. Murphy was American Rice's President and one of its directors, and Mr. Kay was the company's vice president of Caribbean operations, during the relevant period. According to the complaint, Kay directed an American Rice employee to prepare false shipping records and underreport the tonnage of rice arriving on certain vessels. Customs officials in Haiti used the false records to clear the vessels through customs. At Kay's direction, American Rice employees paid cash bribes to customs officials after the vessels cleared customs. Kay allegedly directed the American Rice controller in Haiti to record the payments as routine business expenditures in order to conceal the nature of the payments. The complaint alleges that American Rice employees made at least 12 bribery payments totaling approximately $500,000 in order for the company to avoid $1.5 million in import taxes.

The commission charged that Murphy was aware of the bribery scheme but took no action to stop the payments and that Lawrence Theriot, formerly the Caribbean operations consultant for American Rice, allegedly assisted Kay and Murphy by monitoring the bribery scheme and exploring alternative arrangements.

The SEC noted in its Litigation Release that the indictment in the criminal matter had been dismissed, but that the Department of Justice had appealed the decision. SEC Litigation Release No. 17651 (August 1, 2002).

On January 30, 2003, American Rice, Joseph A. Schwartz, Jr., Joel R. Malebranche and Allen W. Sturdivant consented to the issuance of an order requiring that the cease and desist from committing or causing any future violations of the Securities Exchange Act of 1934. The order included a finding that Schwartz, the former controller for Haitian operations, and employees Malebranche and Sturdivant, had participated in a scheme to bribe Haitian customs officials in violation of the FCPA. The order included a finding that American Rice had violated the books and records component of the FCPA.

[b] The criminal matter

The United States District Court for the Southern District of Texas dismissed the indictments against Murphy and Kay on the grounds that the challenged payments were not covered by the FCPA because they were not made to obtain or retain business in Haiti. In ruling on defendants' motion to dismiss for failure to state an offense under 15 U.S.C. §§ 78dd-1(a), 78dd-2(a), the court held that neither the language of the statute nor the legislative history supported the Government's argument that the FCPA encompassed payments made to reduce customs duties or tax obligations. Defendants argued that the alleged payments to Haitian officials if made, could not have been for the purpose of obtaining or retaining new business, since American Rice had already established its business in Haiti. Instead, the

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156 The SEC complaint in this matter is available via the Internet at www.sec.gov/litigation/complaints/comp17651.htm.
payments, if made, were made to reduce customs duties and taxes on incoming goods. The government responded that Defendants' payments to reduce customs duties "were essential for [American Rice] to be able to conduct business in Haiti and, thus, the payments constituted prohibited payments made to retain business." United States v. Kay, 200 F. Supp. 2d at 682.

In holding that "Congress has considered and rejected statutory language that would broaden the scope of the FCPA to cover the conduct in question here," id. at 683, the court noted that Congress considered and rejected two bills that would have broadened the scope of the Act's prohibited activities. The House bill prohibited corrupt payments to foreign officials used to influence "any act of decision of such foreign official in his official capacity." Id. at 684, citing H.R. 3815, 95th Cong. §2 (1977). The Senate bill prohibited any payments made for the purpose of "obtaining or retaining business . . . or directing business to, any person or influencing legislation or regulations of [the foreign government] . . ." Id., citing S. 305, 95th Cong. §103 (1977). The court noted that Congress rejected these proposals in favor of the "obtain or retain business" language, and referenced the 1977 Conference Committee Report that stated that "the purpose of the payment must be to influence any act or decision of a foreign official (including a decision not to act) or induce such official to use his influence to affect a government act or decision so as to assist an issuer in obtaining, retaining or directing business to any person." Id., citing H.R. Conf. Rep. No. 95-831, at 12 (1977). The court also noted that Congress rejected subsequent efforts to amend the "obtain or retain business" language.

[c] The ramifications of American Rice

The holding that the Act encompasses only payments to foreign government officials designed to obtain business contracts constituted a departure from the traditionally held belief that the Act covers any corrupt payment made to a foreign government official. The impact of an affirmance in United States v. Kay is twofold. First, it would call into question the traditional, expansive interpretation afforded the "obtain or retain business" element of the statute. In the absence of legislative intervention, this would impede domestic efforts to police actions traditionally targeted as foreign corrupt practices. Second, it would tarnish the United States image in the international regulatory system. For example, a decision that activities such as bribing foreign officials to obtain beneficial tax treatment is not covered by the Act would potentially place the United States in violation of the Organisation for Economic Co-operation and Development Convention on Combating Bribery of Foreign Officials in International Business Transactions ("the OECD Convention"). The OECD Convention provides that members will criminalize payments made to foreign officials "in order to obtain or retain business or other improper advantage in the conduct of international business." OECD Convention, art. 1(1) (emphasis added).

157 Of course, government agencies are still likely to pursue enforcement actions against defendants alleged to have made corrupt payments to foreign government officials on the basis of the expansive application of the Act in place prior to United States v. Kay.
No. 17887 (December 10, 2002).

On December 10, 2002, the SEC filed two settled enforcement proceedings, a complaint and an administrative order, charging Syncor International Corporation ("Syncor") with violating the FCPA. In addition, Syncor entered a guilty plea in the criminal matter.

The SEC charged Syncor with violating the anti-bribery provisions of the FCPA as well as the books and records and internal controls provisions of the FCPA. Pursuant to its agreement with Syncor, consented to a final judgment requiring it to pay a $500,000 civil penalty and to the issuance of the administrative order. As part of its agreement, Syncor was required to retain an independent consultant to review and make recommendations concerning the company's FCPA compliance policies and procedures.

The SEC alleged that Syncor's foreign subsidiaries in Taiwan, Mexico, Belgium, Luxembourg and France made a total of at least $600,000 in illicit payments to doctors employed by hospitals controlled by foreign authorities. The motive for the payments, according to the SEC, was to obtain or retain business with them and with the hospitals. The SEC alleged that the payments, which began in the mid-1980's, where made with the knowledge and approval of senior officers of the relevant Syncor subsidiaries, and in some cases with the knowledge and approval of Syncor's founder and chairman of the board. SEC Litigation Release No. 17887 (December 10, 2002). According to the complaint, the payments were improperly recorded as promotional and advertising expenses.

The SEC noted in its Litigation Release that the settlement arrangement was affected by Syncor's full cooperation with the Commission staff. The SEC also noted that Syncor brought the matter to the attention of the SEC and the U.S. Department of Justice promptly upon becoming aware of the problem when notified by another company conducting due diligence in anticipation of a merger with Syncor.

In the criminal matter, Syncor Taiwan, Inc., a subsidiary of Syncor, agreed to plead guilty to one count of violating the anti-bribery provision of the FCPA and to pay a $2 million fine. According to the Department of Justice, Syncor Taiwan made payments amounting to at least $344,110 between January 1, 1997 and November 6, 2002 in order to obtain and retain business from hospitals owned by the legal authorities in Taiwan. The payments were allegedly authorized by the company's board chairman while in the Central District of California, and paid in cash in Taiwan via hand-delivered, sealed envelopes. See U.S. Department of Justice Release 02-CRM-707 (December 10, 2002). In addition, the U.S. Department of Justice alleged, Syncor Taiwan made at least $113,007 in illicit payments to physicians employed by hospitals owned by the legal authorities in Taiwan in exchange for patient referrals to Syncor Taiwan's medical imaging centers.

While the nature of the alleged activity in the Syncor matter clearly qualifies as conduct for the purpose of obtaining and retaining business, the case is significant in two respects. First, the case demonstrates the intent of United States authorities to aggressively pursue allegations of FCPA violations in the wake of the United States District Court decision in American Rice. Second, it demonstrates that, at least in the short term, American Rice has not altered the approach of the SEC or the Department of Justice in taking an expansive view of the scope of the statute. The alleged recipients of the payments from Syncor and its subsidiaries were doctors at hospitals run by government agencies. The SEC and the DOJ treated these recipients as "foreign officials, officials of foreign political parties, or any
other person acting as a conduit for payments to foreign officials or political parties designated by the statute. Because both the civil and criminal matters were negotiated to resolution, the interpretation of the statute as covering payments to doctors working in hospitals operated by government agencies was not challenged.

G. Implications

Traditionally, when thinking about foreign corrupt practices, or the application of the FCPA, attention was focused solely on “domestic concerns” - in other words, individuals who are citizens, nationals, or residents of the United States, or corporations, partnerships, associations, etc., which have their principal places of business in the United States or are organized under the laws of a state of the United States. The FCPA, however, has always provided the potential to reach beyond “domestic concerns” to foreign private issuers of securities in the U.S. Internationalization of the world’s securities markets, and the equity provided by the U.S. securities markets, have now brought that additional class of covered entities - foreign private issuers of securities - into U.S. jurisdiction. Thus, whereas in the past focus has been principally on efforts of U.S. companies to ensure that controls could be applied to their far flung operations, today as increasing numbers of foreign corporations register their shares pursuant to the U.S. securities laws, attention needs to be focused on the manner in which the operations of those foreign corporations are conducted.

As foreign companies are brought to the U.S. markets, their investment bankers and advisors need to pay special attention from a due diligence standpoint to not only the corrupt payments issues, but also the controls issues, both with respect to corrupt payments and general accounting controls.

Note that it is theoretically possible that the SEC could have sued Montedison for violations of the anti-bribery provisions, although it is a question as to whether the registration of securities in the U.S. suffices as a “use of the mails or any means or instrumentality of interstate commerce” to support prosecution of a foreign company for payments to a foreign official. Furthermore, the SEC could theoretically have sued the directors and officers of Montedison under either or both the anti-bribery or books and records provisions.

The SEC has demonstrated its commitment to enforcing both the accounting and the controls provisions against companies, be they foreign or domestic. Indeed, the Montedison case perhaps represents only the first volley in what may be an increasing assertion of jurisdiction by the SEC against foreign corporations. With regard to the Triton case, the lapse of time between the alleged payoffs and the SEC’s prosecution of this action suggests a new willingness to prosecute the illegal payments offense.

Management should be especially vigilant of sweetheart deals. (What sorts of substantive services are “consultants” or brokers retained in foreign countries providing?) At bottom, however, the Triton and BellSouth cases underscore the importance of adequate internal controls since the company’s U.S.-based senior management would never have been in a position to detect or prevent the offenses occurring in the distant Indonesian subsidiary in the former case, or in Nicaragua with regard to the latter.
American employees working abroad need to be aware that whatever the environment of the country in which they are operating, they are still subject to standards applicable in the U.S. Conversely, foreign nationals working in foreign subsidiaries must be trained in and conditioned to abide by American standards for the conduct of business.

[1] Investigation of Offenses Under the FCPA by the SEC

On a worldwide basis, securities regulators have developed a successful multi-faceted approach to the enforcement and regulatory challenges posed by the internationalization of the markets. While these understandings do not specifically include corrupt practices, they clearly include accounting and disclosure violations and thus it should be expected that the SEC will have the ability to obtain and provide assistance with respect to matters arising under the FCPA.


Recently, the SEC has successfully advocated a broad-based approach to fighting bribery in other international fora. In addition to efforts undertaken at the organization for Economic Cooperation and Development to criminalize illicit payments, and at the Inter-American Convention Against Corruption, the SEC has been working with its regulatory counterparts to broaden cooperative efforts. At the encouragement of the SEC, the Council of Securities Regulators of the Americas ("COSRA")\(^{19}\)

\(^{19}\) COSRA was formed in 1992 to strengthen cooperation among securities regulators within this hemisphere. Since its inception, COSRA has worked to develop principles for market development and oversight and conducted a work plan to address ways that securities regulators can fight foreign bribery. This work plan resulted in a Declaration on Combating Bribery in the Americas, which COSRA members signed in June, 1996.

In connection with COSRA's implementation of the Summit of the America's Plan of Action for combating corruption, the organization initiated a work program addressing the issue of illicit payments. Under this work program, COSRA members evaluated the approach to foreign bribery in place within their respective countries and the role securities regulators could play to further this approach. The work plan resulted in the signing on June 20, 1996, of a Declaration on Combating Bribery in the Americas. By signing this Declaration, COSRA members state their intention to: (1) develop and promote the effective enforcement of laws that address illicit payments by public companies; (2) seek to ensure that independent auditors of public companies design appropriate audit procedures for the detection of illegal acts such as bribery; and (3) provide mutual assistance in enforcing securities laws that relate to illicit payments, seeking to permit greater access to information for use by securities authorities during investigations, and foster better communication among authorities investigating illicit payments.


The Montedison case demonstrates that the SEC will be looking to new types of fact patterns in its assertion of jurisdiction. No longer will its enforcement be focused solely on U.S. companies conducting bribes from abroad.

to foster securities enforcement and regulatory cooperation within the region. Membership in COSRA is open to all securities regulatory authorities in the hemisphere.
Indeed, it is advisable for companies which are conducting their international business from many locations to reevaluate whether the controls they have in place are appropriate both for detecting and addressing foreign corrupt payment activity that could be subject to U.S. jurisdiction. This is the lesson both Triton and BellSouth.

It is a truism that as companies become increasingly international, their personnel and affiliates are constantly shifting from jurisdiction to jurisdiction. What may be legal in one jurisdiction may not be legal in another. Moreover, the expectations with respect to commissions or other payments may be very different from jurisdiction to jurisdiction. In the past, this has been an issue which was raised with respect to the legality of the actual payment. However, in today's era of internationalization of markets and shifting of personnel between jurisdictions, the issue may actually be whether the conduct was legal in the country from which the activity emanated. Two examples of these issues follow below.

In many emerging markets, privatization is just beginning to occur. Indeed some of the largest players in the market may not be private companies but rather might be public entities trading on behalf of the central bank or the government itself. People controlling that portfolio of most companies are government officials within the meaning of the Foreign Corrupt Practices Act. As do their private counterparts, these officials often receive soft dollars - be they monetary rebates or services - related to the amount of activity they generate for broker-dealers. Query: Are these soft dollar arrangements subject to the Foreign Corrupt Practices Act and therefore the scrutiny of the SEC and the Department of Justice?

A second illustration of this problem would occur where a trader of a large multinational bank, who had operated in a jurisdiction such as Germany where Foreign Corrupt Practices are not yet outlawed, is transferred to a trading room in the United States. The employee may be fully aware of all of the operations and requirements of the multinational bank for whom he or she works, however, he or she continues the activity, which was legal when it emanated from Germany, while in the United States. Thus, what may have been a legal payment of fees or sharing of a commission may be converted into a corrupt act using the means and instrumentalities of interstate commerce. Query: What level of knowledge should be required for this conduct on the part of the bank's management?

Given the aggressiveness of the SEC's enforcement, companies should proactively evaluate their internal controls in order to assure their adequacy for this purpose.

X. Conclusion

The dynamic nature of the global securities markets has required regulators and courts to assess the effectiveness of existing regulatory schemes, and to develop new and creative measures to enhance market integrity and protect investors. Securities regulators will undoubtedly continue to explore their authority to investigate violations of the federal securities laws both by agreement and in foreign courts as the global markets expand and develop. Unquestionably, as world markets have evolved, the success of United States regulators in achieving effective cooperation with foreign counterparts is chiefly related to the evolution of laws similar to our own countries in around the world. In fact, assistance now is sought from the SEC as often as the SEC seeks it. The greatest challenge for regulators will be to keep pace with rapidly evolving markets and dramatic advances in technology.
Ironically, the expansion of regulation of markets worldwide and better cooperation is resulting in a limitation of the power of United States regulators to act as parens patriae for the global marketplace. For the first time, the United States courts have begun to reevaluate the expansive interpretation of United States jurisdiction. This limitation on the assertion of authority by the United States reflects the understanding that in some circumstances, regulators in another jurisdiction may have a greater interest in enforcement against securities law violators and, more importantly, that sufficient regulatory protection exists in those jurisdictions to justify the reluctance of the SEC and the United States courts to become involved. The recent enactment of the Sarbanes-Oxley Act constitutes an attempt to return to the parens patriae role, but its reception by the international community may cause United States regulators to reevaluate its practical implementation.
SURVEY OF SECURITIES REGULATION
PROFESSOR CARLSON
FALL 2004

FOLLOW-UP QUESTIONS
CLASSES 1 - 14

1. A frustrated farmer in Nebraska decides that there must be an easier way to make a living than growing corn. He decides to organize a limited liability company, and offer membership interests therein to every farmer in Nebraska, and a few farmers in neighboring South Dakota. Each farmer is told to transfer all of the corn grown on his farm to the limited liability company, which will then pool every participant’s corn, and then offer the pooled bulk of corn to competing large corporate corn buyers with the objective of creating a bidding frenzy among potential corporate buyers to get the top price for the participating farmers’ corn.

In materials describing the opportunity, farmers are given some financial projections prepared by a financial consultant, but who is never available during the period of the offering to answer questions. That financial consultant is paid a flat fee by the company at the outset of the offering, although the consultant is told, by the founding farmer, that if the company is successful, there may be future advisory opportunities available to him.

Sale proceeds from the corn of the participating farmers would be split among the farmer participants based upon the amount of corn they transferred to the limited liability company and upon their willingness to place several small-time (and generally ineffective) testimonials about their corn’s quality in the regional newspapers. In the limited liability company agreement relating to the company, the membership interests are expressly stripped of any management or control authority, since the founding farmer retains all marketing and selling authority, except that the final price at which the corn is to be sold on behalf of all farmers must be approved by two-thirds of the membership investors. About 18 months after the time that the farmers invest in the company, it begins to lose serious money, defaults on its obligations and goes bankrupt.

Questions:

1.A. Are the membership interests securities?

1.B. If the membership interests might otherwise be considered to be securities, and the farmer wishes to avoid the membership interests from being legally viewed as securities, how might the farmer restructure his approach, limited liability company and the membership interests to avoid the membership interests from being viewed as securities?

1.C. While the participating farmers grudgingly acknowledge that they were fully informed at the time regarding their investment, they now want to sue the financial consultant under Section 12(a)(1) of the Securities Act, alleging that he was a substantial participant in an improper in-state offering under Section 3(a)(11) of the Securities Act. Should the consultant be worried about this claim?
2. A company located in an unregulated Caribbean island creates a new financial product called "stock investment notes" (or "SINs"). Why travel to the casino, the company asks potential participants, when they can have just as much speculative fun putting their money in SINs?

The SINs promise a high fixed rate return from the company's activities, instead of any dividends, and do not provide any consent, veto or voting rights as to the company. The SINs cannot be sold or traded by a participant, but the SINs have no final maturity date, but can be exchanged at any time, by either the participant or the company, for gambling discounts at any internet casino.

The SINs are exclusively offered through the company's website, to anyone who accesses the company's website. Participants who access the company's website are given an amount of SINs free of charge, so long as they fill out a questionnaire confirming that they are wealthy, experienced gamblers and indicating their gambling preferences, and agree that the personal information reflected in the questionnaire can be given to internet casinos that offer various internet gambling opportunities.

**Questions:**

2.A. **Are the SINs securities?**

2.B. **Assuming a security is involved,**

2.B.1. **Is this an "offer" of a security for purposes of the Securities Act?**

2.B.2. **Assuming a security and an offer of a security, is the offer part of a valid private placement under the Section 4(2) of the Securities Act?**

3. Hurricanes devastated the coastal regions of North Carolina and caused huge losses for North Carolina home insurers. There is broad disagreement if such hurricanes will continue. In this confusion, a Wall Street financial institution senses an opportunity for a new financial product, to be called "North Carolina Uninsured Notes", or so-called "NUN" financial products. (NUN products are created and marketed by the financial institution, but technically represent an obligation of a subsidiary of the financial institution which isn't an insurance company or a bank). NUN products are marketed to all home owners in the North Carolina coastal areas. In determining whether to buy NUN products, these home owners are told they must make at least a $5,000 payment, and in exchange, the purchaser will receive a NUN product paying them a 4% annual interest rate (which is similar to bank deposit rates, they are told), but that this interest rate will increase to a much higher 15% annual interest rate if a hurricane sweeps North Carolina that causes $5 billion or more of property damage in North Carolina. The idea is to provide some payments in the event of a devastating hurricane. Wherever a hurricane occurs, the financial institution will simply check on insurance reports in order to determine the damage caused by the hurricane and whether an increase in interest rates are required under the term of the NUN product. In five years, the NUN product terminates, and the purchaser's initial payment is returned to him. Each Spring, when the hurricane season is over, purchasers of NUN products are told that they can sell all of their NUN product back to the Wall Street financial institution at a discounted price.
Question:

3.A.  Are the NUN Products securities?

4. An accounting firm is currently organized as a general partnership, but to avoid unlimited personal liability for its partners, decides to reorganize as a limited liability company (an "LLC"). This accounting firm has 100 partners who become members, each contributing $100,000 of capital to the LLC, and then holding membership interests in the LLC. New members are admitted only upon the private approval of a majority of existing members. Each membership interest is non-transferable, except with the permission of the LLC. Each membership interest has a variable amount of votes, depending on the compensation paid on that membership interest. All LLC decisions are made by the elected managing member of the LLC. Compensation, in turn, is allocated to each member and their membership interests by a formula, one-third of which is based on the LLC's overall profits, and two-thirds of which is based upon the particular members' business and revenues that he attracted.

Questions:

4.A.  Are the membership interests securities?

4.B.  What securities are being offered?

4.C.  Who are the issuers of the securities being offered?

5. Big Bank arranges a $100 million loan to a company, Bold Buyer, which intends to use the borrowed money to launch a hostile takeover of another company. Bold Buyer's obligation to repay the loan is evidenced by notes, which bear a high fixed 15% rate of interest (reflecting the riskiness of the financing), and are not secured by any collateral or other assets. The notes are marketed by Big Bank using a confidential memorandum containing many projections about Bold Buyer to several hundred financial institutions and investment funds that are attracted to the relatively high level of interest income and the apparent ease that the notes can be privately traded among the financial institutions.

Question:

5.A.  If you were a plaintiff's lawyer, how would you argue that the loan involved a security?

6. Along with nine other sophisticated investors, Mr. Trout, a highly sophisticated investor, is approached by a broker-dealer, Montgomery, Inc., who solicits them to provide to bridge loan in the amount of $100,000 each (or $1 million in the aggregate) to Technifuture Inc., a start-up company which expects to conduct an initial public offering in approximately 12 to 18 months, once it has brought its new digital e-mail phone into production. The loans would bear interest at 12 ½% and each would be independently secured by real estate owned by Technifuture or its controlling shareholders. Trout hopes to supply Technifuture with computer software through a firm he controls. When Technifuture goes into bankruptcy, Montgomery believes that they can avoid any securities law liabilities because the bridge loans are not securities.
Question:

6.A. **Are the loans securities?**

7. Morgan Bank wishes to transfer some risky loans (at a discount) to a sophisticated purchaser. That purchaser – Hedged Risk Associates ("HRA") – is only willing to purchase these risky assets if Morgan will manage them. They strike a deal under which the loans will be transferred to a limited partnership, LHIW Partners, in which Morgan will be the General partner (and will receive 10% of the profits and losses) and HRA will be the sole limited Partner (with 90% of the profits and losses). Morgan will service the loans and sue defaulting borrowers in the event of defaults. On this basis, HRA will contribute 90% of the previously agreed purchase price for the loans (which price was 65% of the loans' face value). Under the LHIW limited partnership, Morgan must agree to liquidate the partnership, sell the assets, foreclose on the assets, or take any other financial measure with respect to these assets as 51% in interest of the limited partners instruct it (and HRA is the only limited partner). Six months later, HRA comes to the conclusion that Morgan defrauded it by failing to disclose how closer to default (or in default) most of the loans were. It brings suit under Rule 10b-5 claiming securities were involved.

Question:

7.A. **What result on Morgan's motion to dismiss as to the issue of securities?**

8. A broker-dealer solicits investors to invest their funds in bank certificates of deposit, which it will select and monitor. The broker-dealer will select the banks paying the most competitive rates and will evaluate each bank's risk level. Investors' funds will not be pooled in any way, and the broker will be compensated by retaining 1/2 of 1% annually from the interest, if any, paid by each bank to each account. The broker will also make a limited secondary market in the bank certificates of deposit, giving investors some liquidity.

Question:

8.A. **Does this amount to an investment contract?**

9. A U.S. bank holding company, with a national bank subsidiary, has a class of common stock traded on the New York Stock Exchange. The bank holding company is considering a public offering of a package of securities, consisting of a note issued by the bank subsidiary and a separate warrant issued by the bank holding company which is exercisable within 30 days for its common stock. No related registration statement has yet been filed under the Securities Act. At this time, the president of the bank holding company, at an investor conference held in London with lots of eager investors and a number of carefully selected, favorably disposed financial reporters, tells the rapt audience about this potential public offering, the prospective underwriters and the expected pricing range of the package of securities.

Questions:

9.A. **What securities are being offered?**

9.B. **Are any of such securities exempt securities under Section 3 of the Securities Act?**
9.C. Would any of the president’s statements be viewed as impermissible offers that cannot be fit into any potential safe harbors?

9.D. Would the president’s statements trigger Regulation FD disclosure requirements?

10. A publicly traded holding company believes that its inherent values would be better appreciated by the markets if it arranged for a partial spin-off of shares of its important Internet subsidiary, which as a stand-alone company could obtain better financing and offer employee stock options. It decided to structure a spin-off in three steps: (a) one subsidiary common share was distributed as a dividend on each outstanding company share, (b) each company stockholder was offered the opportunity through a broadly distributed proxy by a proxy and solicitation firm to exchange an additional company share for 1/2 of a subsidiary common share, and (c) the subsidiary would privately place shares of convertible preferred stock (convertible into subsidiary common shares) with a major Internet portal company.

Question:

10.A. Can each of the three steps be exempt from registration under the Securities Act?

11. New Chip Company (“NCC”), a Delaware corporation, believes that it has developed a highly sophisticated, proprietary silicon chip manufacturing technology that will enable it to leapfrog all other computer chip companies. Keeping this technology secret from competitors and any followers of the computer industry is critical. NCC was founded by two women who recently graduated from MIT and live in Massachusetts and who each serve as director of New Chip Company. To initially finance itself, on January 1, 2002, NCC sold $750,000 of common stock to one of the founder’s father, a very wealthy investor living in New York City in a Section 4(2) private placement. He also became a director, even though unproven allegations of industrial espionage against him bring controversy to any company with which he associates.

By August, 2002, the two founders determined that NCC must raise another $4,500,000 of additional common stock financing by the end of 2002, or else it will go bankrupt. The two founders, together with the father, are interested in investing. They also locate, through private contacts, three large institutional investors in Boston, Massachusetts, as well as ten recent MIT graduate students that are all living in Boston, Massachusetts, all of whom are making their first investment, and will be joining the Company as engineers, but have been strictly informed by the founders not to consult any financial types, for fear of word leaking out regarding their new technology.

The two founders also want to be careful about keeping the alternative alive of shifting, immediately after closing the $4,500,000 common stock financing, to an immediate filing of a registration statement registering an initial public offering of NCC common stock.

Questions:

11.A. It’s now December 1, 2002. The two founders approach you, and ask you to briefly tell them what aspects of their situation, if any, will raise problems for the $4,500,000 common stock financing under Section 3(a)(11), Section 4(2), Regulation D and Regulation A.
(i) 3(a)(11)
(ii) Section 4(2)
(iii) Rule 504
(iv) Rule 505
(v) Rule 506
(vi) Regulation A

11.B. If the $4,500,000 common stock exempt financing is closed using either 4(2) or Rule 505, what would you tell NCC to do to avoid any "integration" problems involving the exempt financing and the initial public offering?

12. An investment banker is trying to structure a new note financing so that the offer of those Notes will not require registration under Section 5 of the Securities Act. After talking with many financial institutions, the banker determines to arrange either for a bank holding company of a national bank or an insurance company to guaranty payment in full of the notes.

Question:

12.A. Will the notes be securities exempt from registration under Section 5 of the Securities Act?

13. Hot Internet Company ("HIC") failed in its attempted initial public offering of common stock, because of poor market conditions. But HIC never withdrew the registration statement, hoping that market conditions would change. Two months later, it desperately needs to raise money to fund its business, and tells you that they have identified a large institutional investor that they had never contacted before, and which is prepared to step in and immediately privately buy a substantial common stock interest in HIC.

Questions:

13.A. Do you see any "integration" or similar problems with the proposed private placement?

13.B. If there were "integration" problems, what might HIC consider to minimize this risk?

14. Do "restricted securities" under the Securities Act arise when purchased pursuant to the following transactions:

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<thead>
<tr>
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<th>Yes</th>
<th>No</th>
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<tr>
<td>14.A. Rule 504?</td>
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<td>14.B.</td>
<td>Rule 505?</td>
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<td>14.C.</td>
<td>Rule 506?</td>
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<td>14.D.</td>
<td>Rule 701?</td>
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<td>14.E.</td>
<td>3(a)(9)?</td>
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<td>14.F.</td>
<td>3(a)(10)?</td>
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<td>14.G.</td>
<td>Purchase of securities from an affiliate of the issuer (which affiliate, in turn, had acquired the same securities in the public trading markets)?</td>
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<tr>
<td>14.H.</td>
<td>3(a)(2) issued securities?</td>
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<tr>
<td>14.I.</td>
<td>Purchase by you of publicly offered securities from a securities broker/dealer?</td>
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<td>14.J.</td>
<td>Purchase by a bank of commercial bank loans?</td>
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<tr>
<td>14.K.</td>
<td>Purchase by you of real estate?</td>
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15. A company has outstanding $100 million of publicly traded notes, which can be amended by their terms, with a vote of 80% of the noteholders. The company wants to amend the terms of the notes to eliminate its covenants that restrict future company debt, and to change the interest payment periods from semi-annual to annual payments.

**Question:**

15.A. **Do the amendments involve the creation of a new security?**

16. A company has outstanding $100 million of publicly traded notes, which are in default. The company’s financial advisor tells the company that they can successfully complete an exchange offer with the noteholders, as part of a broader workout and reorganization of the Company’s financial arrangements, which involves (a) the company’s noteholders exchanging their old notes for the company’s common stock and new company notes guaranteed by the company’s major subsidiary, (b) the company’s payment in cash of accrued interest on the old notes as part of the exchange, (c) waiver by the old noteholders of securities law claims against the company’s and its directors, and (d) payment by the company of a fixed financial advisory fee to the financial advisor, subject to completion of the exchange offer.

**Question:**

16.A. **Does each component of the proposed exchange offer work for purposes of a Section 3(a)(9) exemption?**
17. BioTech, Inc., a young start-up company that is not yet a reporting company, needs to raise $10,000,000 to complete the testing of a potential drug, which, if successful, promises to have broad applications and be a major innovation in cancer treatment. But there is no realistic way to estimate whether it will prove successful. The most that can be said is that the drug looked promising in trials on mice, and it has at least a 10% chance of providing significant benefits for humans. If successful, the drug could make BioTech worth $1 billion or more to the other pharmaceutical companies.

At present, BioTech has very limited funds and could not afford the cost, time, or delay incident to a public offering. Nor do underwriters want to touch it, given the high risk it faces. BioTech is however, a potentially interesting investment for some institutional investors and some high-wealth “angel” investors who like to invest in high-risk start-ups.

BioTech’s CEO, Dickie Nerd, knows that he needs a capital infusion within weeks to stay in business. Without the assistance of counsel or an investment banker, he approaches over 100 institutions and high-wealth investors, making no attempt to comply with any exemptive rule (because he is simply unaware of their existence).

Assume that Mr. Nerd finds some 20 persons or entities that may be willing to provide the financing. He may also have solicited some person who would not qualify as accredited investors and none of those that he has found (all of whom would qualify as accredited investors) have any prior relationship with BioTech. Mr. Nerd does not believe that there is time (or money) available to prepare a disclosure document equivalent to a registration statement. But he is quite willing to answer questions, take the investors on a tour of the company, and give them free rein to inspect whatever they like and talk to whomever they please inside the company.

Question:

17.A. You are brought in at the last minute as counsel to company. Can you structure this offering (without significantly changing the foregoing facts) to be an exempt private placement?

18. BioTech, Inc., the same non-reporting start-up company as in Problem 17, supra, faces the same capital raising crisis: it must raise $10 million quickly or it will not be able to continue, even though its potential “miracle drug” may be just that. Again Dickie Nerd approaches and actually makes offers to over one hundred potential investors. Eventually, he finds twenty “accredited investors” who will provide the capital. Again, as BioTech’s attorney, you face the same issue: Can this offering be considered exempt from registration under Section 4(2) (now pursuant to Rule 506 of Regulation D)?

Question:

18.A. What information or access must BioTech provide?

19. Same problem and same facts as in Problems 17 and 18 above, except that now Nerd has found 30 accredited investors and also three sophisticated persons who do not qualify as accredited investors. Again, there is the same need to act quickly, expeditiously and at low cost.
Question:

19.A. **What advice do you give as BioTech's securities counsel?**

20. Same problem and same facts as in Problems 17, 18 and 19 above, and suppose, despite the use of at least some reasonable efforts to comply with Rule 506, BioTech does sell to one individual who lacks the requisite sophistication to be "capable of evaluating the merits and risks of the prospective investment."

Question:

20.A. **Can the other investors rescind if the BioTech's stock price later declines and they wish to escape the transaction?**

21. Buzz's Steakhouse, Inc. ("Buzz") is a local chain of "steak and ale" restaurants doing business in New York, New Jersey, and Pennsylvania. It has a loyal clientele, some of whom are eager to invest in this basically family owned business. Between January 1 and February 28, 2003, Buzz sells 1,000,000 shares of its common stock at $5 per share to some thirty investors, most of whom were loyal customers, not sophisticated investors. In September, it contacts some institutional investors and sells another 2,000,000 shares, this time at $8 per share to ten of them. Assume that there were no offers made between March 1, 2003 and September 10, 2003.

Question:

21.A. **Has Buzz complied adequately with Regulation D?**

22. Same facts as in Problem 21, except that now the January to February 28, 2003 offering was to the ten institutional investors who buy $16,000,000 Buzz's convertible debentures, which are convertible at an $8 per share conversion price into its common stock. Beginning in June, 2003, Buzz retains a broker-dealer to find additional investors. The broker-dealer, Hot Shot Securities, advertises to its clients that it has attractive private placements available on its web site for persons who can qualify as accredited investors. The web site is password protected, so that inventors can obtain access to Buzz's file and the private placement memorandum that Hot Shot and Buzz have jointly prepared on Buzz only if (i) the investor answers questions about the investor's personal financial status and experience and (ii) Hot Shot, after reviewing the investor's responses, deems the investor to be either an accredited investor or otherwise sophisticated. In this way, Hot Shot identifies twenty investors between July and September 15th, 2003, who buy in the aggregate 500,000 additional shares of Buzz's common stock at $8 per share at a joint closing on October 1, 2003. Assume that three investors in this October 1 transaction misrepresented facts about their financial status and experience and are in reality very far from qualifying as accredited investors.

Question:

22.A. **Any problems now under Regulation D?**

23. Same problem and same facts as in Problems 21 and 22, and assume now, in the alternative, that Buzz wishes to offer only 120,000 of its shares at $8 per share to some fifteen or twenty loyal customers. But it does not want to prepare any formal prospectus or similar offering document, and it realizes that its prospective investors are ordinary people who do not
have any special investment experience. Its friendly broker, Hot Shot Securities, believes it can find such investors for Buzz by inviting them to seminars that it sponsors by advertising "investment seminars" in North Jersey and Westchester newspapers.

Question:

23.A. As securities counsel, what is your advice?

24. Five months ago, New Company was started by two engineers, who just graduated from college saddled with student loans and no real financial resources. Each of these founders invested $10,000 from 10 shares of stock of New Company (for a total of 20 shares for $20,000), and the founders appointed themselves co-presidents and directors of New Company.

Recently, New Company's products were recognized by a widely published technology magazine as a very promising new technology, although the critical engineering details weren't cited. To capitalize on this product opportunity, the two founders decided that they had to obtain $5 million of financing immediately, and decided to structure a convertible preferred stock offering (which was convertible into underlying stock at any time). They identify, as investors, three groups. First, the rich uncle of one of the founders, who is worth millions, and will become a director, even though unproven allegations of industrial espionage against him bring controversy to any company with which he associates. Second, they identify 40 very large, very wealthy institutional investors. Third, they identify 10 other engineering students, who will invest their own funds into New Company, as well as separately receive for no additional consideration stock options pursuant to New Company's stock option plan for employees. These engineering students are also poor, debt-burdened students, all of whom are making their first investment, and will be joining the Company as engineers, but have been strictly informed by the founders not to consult any financial types, for fear of word leaking out regarding their new technology.

24.A. In the 20 share offering five months ago by the founders, would the two founders be viewed as "accredited investors" for purposes of a Rule 506 offering?

24.B. Would the $5m convertible preferred stock financing confront the following issues:

(a) Aggregation issues (if a Section 3(b)-based offering)?

(b) Integration issues?

24.C. Could the $5m convertible preferred stock financing be structured so as to utilize the issuer exemptions found in:

(a) Section 4(2)

(b) Rule 506

(c) Rule 505
Hot Company closed its initial public offering of its stock 6 months ago, and has listed its stock on the New York Stock Exchange, registered that stock under the Exchange Act and timely filed all reports required under the Exchange Act since going public. Hot Company has 100,000 shares of outstanding stock, and the weekly average trading volume of that stock over the past 4 weeks has been 20,000 shares per week. Hot Company needs to determine when and how many of its securities issued in various exempt transactions prior to the closing of the initial public offering could be resold now (i.e., 6 months after the initial public offering). Specifically, Hot Company is considering these questions as to the following investors:

25.A. One non-officer employee, who was issued by Hot Company 10 shares in a Rule 701 offering 7 months ago (i.e., 1 month before the initial public offering).

(a) Can the employee resell his/her shares now into the U.S. public markets?

25.B. A venture capital investor, who was issued by Hot Company 200,000 shares in a 4(2) private placement 9 months ago (i.e., months before the initial public offering), and whose principals comprise 2 of 7 of Hot Company’s directors.

(a) Is the venture capital investor an affiliate of Hot Company?

Yes __________ No __________

(b) When can the venture capital investor first sell shares of the Hot Company:

(i) into the U.S. public markets?

(ii) in the U.S. to a private institutional investor pursuant to a “4(1/2)” sale?

(iii) off-shore to a foreign investor pursuant to a Rule 904 sale?

(c) Assuming that the amount of outstanding shares and level of weekly trading volume continue, when the venture capital investor is able to first sell shares of the Hot Company into the U.S. public markets, how many shares will they be able to publicly resell?

____________ shares

(d) In determining how many shares can be resold into the U.S. public markets, must the venture capital investor aggregate with their resales:

(i) private institutional resales of Hot Company stock by that same venture capital investor in the U.S. pursuant to a “4(1/2)” resale?
(ii) public market resales of Hot Company stock by another company that is 9% owned by the venture capital investor, although such sales are not coordinated with the venture capital investor?

Yes ____________ No ____________

(e) The venture capital investor, in order to borrow some money, now pledges 50,000 of their 200,000 shares to a bank.

(i) Can the bank now publicly resell any of the pledged shares into the U.S. public markets after foreclosing on the pledged shares?

Yes ____________ No ____________

(ii) Assuming that the amount of outstanding shares and level of weekly trading volume continue, and 13 months after the pledge the bank proposes to publicly resell 10,000 of the pledged shares after foreclosing on the pledged shares, how many additional shares (if any) could the venture capital investor resell into the U.S. public markets at the same time?

___________ shares

25.C. A private investor, who was issued by Hot Company a warrant exercisable for 3,000 shares at an exercise price of $1 per share and a note convertible into 3,000 shares in a Rule 506 private placement 3 years ago.

(a) If the private investor exercises the warrant now, when can the private investor first publicly resell these underlying shares issued upon exercise?

(b) If the private investor converts the convertible note now, when can the private investor first publicly resell his/her underlying shares issued upon conversion?

(c) If the private investor now acquires 13,000 shares from the venture capital investor pursuant to a “4(1/2)” private resale, when could the private investor first publicly resell these acquired shares into the U.S. public markets?

26. Frances Founder started an internet company, and privately acquired its stock in January 2001. In January 2002, the company closed an initial public offering, after which Founder held about 21% of the company’s stock and continued as the chairman and a director of the company. In June 2002, Founder privately sold some of her stock to her husband, privately pledged some of her stock to her bank in order to obtain a loan, and privately donated some of her stock to a charity.
Questions:

26.A. Can Founder now begin publicly reselling her stock without volume limitation pursuant to Rule 144(k)?

26.B. When can Founder’s husband begin to publicly resell his stock under Rule 144?

26.C. When can the charity begin to publicly resell its stock under Rule 144?

26.D. Can the bank foreclose on the stock pledged to it and resell without volume limitation under Rule 144?

26.E. What “transaction exemption” from Section 5 registration must Founder have relied upon when she sold stock to her husband?

26.F. If Founder decided to resell her shares in July 2002 in reliance on Rule 144, would she have to consider whether concurrent resales by the following persons would be aggregated or counted together with her resales for purposes of the volume limitations under Rule 144:

<table>
<thead>
<tr>
<th>(i) Founder’s husband?</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>(ii) Bank?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(iii) Charity?</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

27. On Day 1, a company sells its common stock in a 4(2) private placement for $2 million. On Day 30, the company issues stock to its employees pursuant to a 701 offering for $1 million. On Day 60, the company sells preferred stock convertible into its common stock in a 506 offering for $4 million. At Day 90, the company proposes to raise $5 million of additional capital, in a private, non-registered offering, and is considering either Regulation A, Rule 505 or Rule 506 offerings.

Question:

27.A. See any limitations at Day 90 on these alternatives?

28. A company has a web site on the Internet, and is engaged in a 506 private offering. On a web site, the company states that it is engaged in this capital raising, and interested persons should contact the company’s placement agent or can download the confidential offering memorandum from the placement agent’s web site.

Question:

28.A. See any problems?

29. An individual owns 17% of the stock of a publicly traded company, and is 1 of 3 directors of that company, and proposes to publicly resell stock of that company.
Question:

29.A.  Is the individual an affiliate, or a statutory underwriter, as to the company?

30. The owner of a website on the internet proposes to the chairman and majority stockholder of a publicly traded company that the stockholder post a notice on the website that anyone can buy the shares owned by the chairman. The website owner promises to advertise the availability of the shares on several affiliated websites, commits to purchase on a standby basis any unpurchased shares and expects to receive a fee based upon the number of shares sold through the website.

Question:

30.A.  Is the website owner a statutory underwriter or a statutory broker?

31. Can properly limited “directed selling efforts” in the U.S. for purposes of a Regulation S off-shore offering involve impermissible “general solicitation” for purposes of a concurrent Rule 506 private placement in the U.S. under Regulation D?

32. Three years ago, Hot Company privately sold 220,000 shares (representing 22% of the 1 million outstanding shares) of its common stock to Mr. Big, its Chairman and Chief Executive Officer. Hot Company is now a publicly traded company listed on the New York Stock Exchange. In the face of financial pressures, Mr. Big, six months ago, sold in a private transaction 25,000 shares to Joe Smith, a regional sales manager for Hot Company. Joe now wants to resell those 25,000 shares. Hot Company won’t be troubled with a registration statement to cover his resale shares. In evaluating alternatives, Joe tells you that his sole concerns are the speed with which he can sell all 25,000 shares, and the price he can get from his buyer (which is a function, he believes, of the U.S. public market resale opportunities for his buyer).

Question:

32.A.  For Joe Smith, and solely from the perspective of his concerns with speed and U.S. public market resale liquidity for his buyer, rank his alternatives for (a) U.S. public market resale, (b) U.S. private resale, and (c) foreign resale.

33. A company does an offering of notes concurrently using Rule 506 for the U.S. offering and Rule 903 for the off-shore offering. While the company’s common stock is publicly traded on the New York Stock Exchange, the newly-minted notes are not publicly traded.

Questions:

33.A.  For an off-shore buyer of the notes, how long until that buyer can resell their notes to U.S. institutional investors on a private basis and to U.S. general public investors?

33.B.  For an off-shore buyer of the notes, how long until that buyer can resell their notes to a U.S. institutional investor on a private basis or to an affiliate of the company?
33.C. If on-shore buyers exchange their original notes for new notes of the company issued pursuant to an exchange offer under a registration statement (a so-called "A/B Exchange"), how long until the buyers can resell the new notes received in the exchange offer to U.S. general public investors?

34. One perceived impact of the internet and web sites which use internet communication is that the availability of information to everyone becomes difficult to restrict.

Question:

34.A. Provide several examples of this information explosion in challenging some of the assumptions and practices of the exemptions from Section 5 registration under the Securities Act.

35. Medium Tech, Inc. is a Nasdaq listed "reporting" company that designs software and web sites for large corporate clients. Becky Gill was hired by Medium Tech two years ago, at which point she purchased 10,000 shares from Medium Tech in a private sale (the purchase price was $120,000 and she paid $20,000 in cash and gave a full recourse promissory note for $100,000, which was secured by a pledge of securities having a market value of $80,000). Becky paid off this note in full three months ago. Becky's title is Director of Web Design for Medium Tech, which is an important creative position, but does not make her an executive officer. Becky now owns 25,000 shares in Medium Tech, having purchased 5,000 shares in the open market on Nasdaq last week and 10,000 shares on the exercise of a stock option six months ago. Becky was awarded the stock option under the company's employee stock option plan, which is a "qualified" plan. She is not quite clear on whether the stock option plan is registered. You are counsel to Merrill, Shearon, the brokerage firm, which she has asked to help her sell all of the stock she can without registration (she wants to buy a ski chalet in Colorado). Medium Tech has 1,400,000 shares outstanding and its trading volume over the last four weeks has been 10,000, 13,000, 16,000, and 14,000 shares, respectively.

35.A. Advise her as to what she can and cannot now sell.

36. Same facts as in Problem 35, except that now (1) Becky Gill has been promoted to Executive Vice President and made a director of Medium Tech, (ii) Beck financed her purchase two years ago of 10,000 Medium Tech shares with a full-recourse bank loan (not a loan from Medium Tech), and the bank received no collateral other than a pledge of the Medium Tech shares, and (iii) Becky gave 2,000 of the 5,000 shares that she recently purchased in the market to her 19 year old son, Ronald, as a birthday present. Ronald sold those shares last week to buy a car.

36.A. Now, how many shares can Becky sell immediately.

37. Donald Duck is the Vice Chairman of Disney Enterprises, Inc. the movie studio. On January 10, 2003, he makes a gift of 1 million shares each to his three nephews, Huey, Dewey, and Louie (none of whom live with Donald). The 3 million shares have been held by Donald Duck for over ten years. Disney has 100 million shares of its Common Stock outstanding and its average weekly trading volume is 600,000 shares. On June 30, 2003, both Huey, Dewey, and Louie decide to sell 500,000 shares each.
37. A. **Any problem?**

Same facts in Problem 37, but Huey, Dewey and Louie agree that sales of 500,000 by each of them would depress the market. Thus, they agree that Huey will sell in Week One, Dewey in Week Two, and Louie in Week Three.

37. B. **Any problem now?**

38. United States. Industries, a reporting company whose common stock is listed on the New York Stock Exchange, makes a private placement of $100 million in face amount of 10% Convertible Debentures through Goldman Brothers, its placing agent. The bonds were purchased at their face value without any discount. The purchasers are twenty or so large institutional investors, most of whom would satisfy the definition of “qualified institutional buyer” in Rule 144A(a)(i). Both these institutions and United States Industries would like to list these debentures on the Portal system administered by the NASD. Each $1,000 bond is convertible into 20 shares of United States Industries, which on the date that the offering closed was trading at $40 per share.

38. A. **Do these securities qualify for Rule 144A?**

39. Belgian Industries is a Belgian incorporated company, listed on the Brussels stock exchange, with over 70% of its shareholders being Europeans. It is not a U.S. “reporting” company, but it does occasionally trade on the Nasdaq Bulletin Board, with such trading never accounting for more than 10% of the overall trading in its stock. On December 20, 2003, it makes an offering of 10,000,000 shares of its common stock in Europe pursuant to Rule 903. You may further assume that (i) offering restrictions were implemented, (ii) no “directed selling efforts were made by anyone in the United States, (iii) all offers and sales were made in “offshore transactions,” and (iv) that the securities carry a legend to the effect that transfers are prohibited except in accordance with the provisions of Regulation S or pursuant to an exemption from registration under the Securities Act of 1933. After the offering, 20,000,000 shares of Belgian Industries’ common stock are outstanding (and the average weekly trading volume is roughly 50,000 shares a week). Jacques Café, a wealthy Belgian investor, bought 800,000 shares of XYZ’s stock in the December offering. He thereafter sells 400,000 shares on January 15, 2004 to a U.S. broker dealer, XYZ Securities, Inc. in a transaction negotiated in Europe. Between January 20th and January 23, 2004, XYZ Securities sells 250,000 Belgian Industries shares over the Nasdaq Bulletin Board to ten different buyers.

39. A. **Are these sales in compliance with the requirements of the Securities Act of 1933? Explain specifically why or why not, discussing the relevant rules and exemptions.**

40. Small Co., a Delaware corporation that is not a reporting company, makes an offering of common stock in Europe on January 15, 2004, selling some 5,000,000 shares through a combination of U.S. and European distributors. Offering restrictions are implemented; no directed selling efforts are made in the U.S.; the legend and stop transfer order mandated by Rule 903(b)(3)(iii) are properly complied with; and all offers and sales by the distributors are made in offshore transactions. The Gallic Fund, a French mutual fund, buys 250,000 shares on January
15th, and on February 1, it sells its shares to CalPERS, the California pension fund pursuant to Rule 144A.

40.A. Is this permissible? Can CalPERS resell and when?

41. Hot Internet Company ("HIC") is about to embark upon an initial public offering. The filing of their registration statement with the SEC is imminent. The Company's chairman is very frustrated with the legalisms of the securities laws, and feels that several articles in Fast Times magazine are much clearer in explaining the Company's technology and future prospects than any stuffy, lawyer-written prospectus.

Questions:

The Chairman demands to know the following answers:

41.A. Why can't he simply hand these articles out to potential investors at the present time?

41.B. Why can't he simply distribute these articles to potential investors during the road show for the initial public offering?

41.C. Why can't the prospectus provide internet hyperlinks where these articles are available?

41.D. Why can't the company's own website, during the initial public offering, be expanded to include prominent internet hyperlinks to these articles?

41.E. What are the limitations on HIC in mailing these articles out to investors once the initial public offering is closed?

41.F. Assuming the initial public offering is closed, when can HIC mail out these articles to stockholders?

41.G. Assuming the initial public offering is closed, when can HIC's underwriters mail out these articles to stockholders?

42. Net Security Company ("NSC") was founded by two recent MIT graduate students, and believes that it has developed the security systems necessary to protect consumer payments over the Internet. Seeing the recent success of Internet stocks, NSC's founders decide to examine an initial public offering of Net Security's common stock. But they don't want to go through the substantial expense of preparing and filing a registration statement and an initial public offering without believing they have a high degree of success. So they discuss NSC's potential valuation and pricing at length with several potential underwriters, as well as several of their leading brokers and the leading mutual fund buyers of high-tech stock offerings. They also decide to discuss their Internet security systems at several well-attended computer conferences. Excitement generated at these conferences leads NSC to establish their own home page on the Internet, where the technical and consumer aspects of its new computer system are extolled. To attract the best software engineers, whose reputation may be essential to NSC's upcoming initial
public offering, NSC places hiring advertisements in several computer industry magazines, in which they note the possibility of their initial public offering, and the attractiveness of Net Security stock options for engineers, given their excitement about the particular leading underwriters that NSC has retained, as well as the expected pricing for the initial public offering and implicit valuation of NSC.

Question:

42.A. If you are counsel to the underwriters, do you see any problems at this point?

About 6 months later, NSC starts the efforts for an initial public offering. Everyone is very busy, and underwriter questions for the company are few, especially with regard to Microsoft, the most fearsome competitor in the software business. Soon, the initial public offering successfully closes, and the NSC common stock is listed and traded on the New York Stock Exchange. Two weeks after closing, however, Microsoft announces that its operating systems, which dominate personal computers that access the Internet, will only work with a Microsoft security system, and not the NSC system. Everyone is shocked at this wholly unexpected development. NSC’s management thinks this may be the death of their company. They want to immediately post a notice and rebuttal on NSC’s website on the Internet, which states NSC’s belief that its revenues will triple in the coming year, without condition or qualification.

Questions:

42.A.1. How should this unforeseen development be disclosed to investors receiving the NSC Prospectus?

42.A.2. Are there any problems under Section 5 of the Securities Act with the Company promptly posting notice of these developments and their response on the Company’s website on the internet?

42.A.3. Would the posted rebuttal on NSC’s website constitute sufficient public market dissemination of information for purposes of Regulation FD?

42.A.4. When can the underwriters’ analysts advise all of their customers, regarding this Microsoft development and its impact on all Internet stocks, through delivery of analysts reports discussing the 25 Internet stocks of 25 different Internet companies generally, including NSC as one of these 15 Internet stocks?

42.A.5. When can the underwriters stop delivering final prospectuses with their trades in NSC common stock?

43. Hot Company just closed its initial public offering, although it has agreed to a standard 30-day “green shoe” option to issue additional shares to its underwriters pursuant to the underwriting agreement relating to the public offering. On the 20th day following the initial closing, the underwriters exercise the green shoe option and buy the additional shares on the 25th
day following the initial closing. The underwriters in connection with the initial public offering ask you a series of questions:

43.A. When can Hot Company’s president be interviewed on the TV networks about the great prospects for Hot Company?

43.B. Prior to the “green shoe” closing, should Hot Company refrain from adding to its corporate Web site the annual updates to its business product offerings?

43.C. When delivering final prospectuses in connection with confirmations and sales, can Hot Company mail a physical confirmation to all investors which includes on its back side the e-mail address through which the final prospectus can be downloaded by purchasing shareholders?

43.D. When can underwriters’ security analyst publish an analyst report about Hot Company and 3 other companies in their industry which features on the cover Hot Company and their increased earnings prospects since the closing of the initial public offering?

44. A company does an initial public offering pursuant to a registration statement under the Securities Act in December 2001, and afterwards, has $100m of assets and 525 stockholders, but the company at the time of the initial public offering decides not to list its stock on any securities exchange or NASDAQ.

Questions:

44.A. Must the company now file reports under the Exchange Act?

44.B. Must the company register its stock under the Exchange Act?

44.C. Could the company terminate its registration under the Exchange Act?

44.D. Is the company subject to Regulation FD?

44.E. Is the company subject to Sarbanes-Oxley Act?

45. A company files a registration statement with the SEC under the Securities Act, including a prospectus therein, exhibits thereto, and in response to SEC inquiry, also delivers to the SEC pursuant to a supplementary request some market share information about the company. Later, in distributing the prospectus, the company “stickers” a supplement on the prospectus prior to its delivery to investors.

Question:

45.A. What is part of the registration statement, among the prospectus, the exhibits, the supplemental market share information and the supplement?

46. Can a registration statement be filed “silently” with the SEC, with sensitive disclosures in certain documents filed as exhibits thereto made not available to investors?
47. During the "road show" for a public offering, several institutional investors hear some confusing statements, and want to verify some factual assertions by the company prior to purchasing the securities offered. Accordingly, they e-mail some questions to the company, through an investor "chat room" on the company's website, and the company replies via e-mail and posts the exchange in the chat room, since they want to be careful and avoid selective disclosure to certain investors. This occurred both before and after effectiveness of the registration statement relating to the offering.

Question:

47.A. See any problems?

48. Two months ago, a company circulated a Rule 430 preliminary prospectus for its initial public offering included in its registration statement at that time. Since then, most recent quarterly financials have been published showing a 25% drop in profits, and a large acquisition have been announced, all of which were not disclosed in the preliminary prospectus, but are now reflected in the registration statement, as amended, whose disclosures have all been cleared by the SEC.

Question:

48.A. Will the SEC declare the registration statement effective?

49. Once a registration statement is effective, can an underwriter's salesperson call up their customer and say, "Okay, the registration statement is effective. I am legally confirming and binding your purchase order."

50. After completion of an initial public offering and listing on the New York Stock Exchange, when can a company begin sending copies of its press releases to investors and when can the underwriter for that offering begin sending analyst recommendations to investors?

51. Prior to effectiveness, must an underwriter make sure that an investor has reviewed and read the Rule 430 preliminary prospectus?

52. After an IPO, an investor reads carefully the final prospectus delivered to him in connection with the confirmation of sale, and notices some concerns that he had not previously taken the time to understand.

Question:

52.A. Can the investor back out, saying that there is a Securities Act violation?

53. In connection with the initial public offering of common stock, an analyst at the lead underwriter is pressured by major investors to provide them with his views and answer questions about the offering; otherwise the major investors say that they may not invest in the offering. He asks a series of questions:

53.A. During the roadshow in the waiting period, can I orally discuss this company's prospectus and my views on the company?
53.B. During the road show, can I arrange for my friend at another broker/dealer that isn’t participating in the selling group for this offering to publish his views about the company?

53.C. During the several weeks following closing of the offering, can I publish reports about 10 other firms in the company’s industry, including the offered company, or can I publish reports about the company’s debt securities?

54. A company engages in an initial public offering, and at the time of effectiveness, the registration statement (and related prospectus) comply with Rule 430A, and thus omit pricing and selling group information. Twelve days after effectiveness, the offering is priced at a disappointing level 15% below expectations, thus reducing the funds available for the company’s expansion opportunities portrayed in the preliminary prospectus, and the offering is scheduled to close 5 days later. Twenty days after closing, the company determines that a significant amount of the planned expansion will not be able to go forward due to the disappointing pricing levels and new increases in construction costs.

Question:

54.A. Can the company use Rule 430A?

54.B. Should the company amend, supplement or do nothing as to the prospectus used in the post-effective period?

55. Does the Sarbanes-Oxley Act apply to:

55.A. Non-U.S. company whose stock is traded on the New York Stock Exchange?

55.B. U.S. company with one private stockholder and 100 bondholders pursuant to bonds that were privately placed, followed by an A/B exchange offer?

55.C. U.S. company that privately placed common stock to 900 U.S. persons?

56. Does the Sarbanes-Oxley Act prohibit issuer loans and advances to lower level employees of the issuer?

57. Describe some changes in the authority and role of audit committees of the boards of publicly reporting companies after the Sarbanes-Oxley Act and the corporate governance proposals of the New York Stock Exchange.

58. Must a U.S. publicly reporting company, whenever it becomes aware of material, non-public information about the company, issue a press release or make a public filing in order to promptly inform their investors?

59. Is a Regulation FD disclosure requirement triggered by:

59.A. Company disclosure to securities analysts, who informally agree to embargo that information until the company publicly discloses it?
59.B. Company statements on a roadshow in connection with a public offering or Rule 144A private placement?

59.C. Company engineer disclosures to outside engineering consultants?
Exam Number: __________

NEW YORK UNIVERSITY
SCHOOL OF LAW

Survey of Securities Regulation
Fall 2004
Professor Carlson

Instructions

1. YOU MAY TAKE UP TO TWO HOURS (2:00) FOR THIS EXAM.

2. There are 11 questions, most with subparts, totaling 116 points.

3. No ambiguity is intended in any question. If you believe any question to be ambiguous, make any assumption of fact, consistent with the facts given, which you believe necessary to resolve the ambiguity. Please state any assumption so made at the beginning of your answer to the question.

4. You may assume that the Securities Act and the Exchange Act and the Rules and Regulations of the SEC thereunder in the form in which they appear in the Selected Statutes, together with the case law presented in the assigned materials and discussed during our Classes and reflected in our materials, have been in effect at all relevant times.

5. There are no restrictions on materials, including your casebook, notes, outlines, other publications, secondary materials and other documents, which you may use in taking this examination.

6. **PLEASE WRITE THE EXAM IDENTIFICATION NUMBER IN THE BLANK PROVIDED AT THE TOP OF THIS PAGE.**

7. Don't worry; you will do fine. Happy Holidays.
5 Total Points

1.

Big Bank arranges a $100 million loan to a company, Bold Buyer, which intends to use the borrowed money to launch a hostile takeover of another company. Bold Buyer’s obligation to repay the loan is evidenced by notes, which bear a high fixed 15% rate of interest (reflecting the riskiness of the financing), and are not secured by any collateral or other assets. The notes are marketed by Big Bank using a confidential memorandum containing many projections about Bold Buyer to several hundred financial institutions and investment funds that are attracted to the relatively high level of interest income and the apparent ease that the notes can be privately traded among the financial institutions.

1.A. If you were a plaintiff’s lawyer, how would you argue that the loan involved a security? (5 Points)

11 Total Points

2.

A U.S. bank holding company, with a national bank subsidiary, has a class of common stock traded on the New York Stock Exchange. The bank holding company is considering a public offering of a package of securities, consisting of a note issued by the bank subsidiary and a separate warrant issued by the bank holding company which is immediately exercisable for its stock. No related registration statement has yet been filed under the Securities Act. At this time, the president of the bank holding company, at an investor conference held in London with lots of eager investors and a number of carefully selected, favorably disposed financial reporters, tells the rapt audience about this potential public offering, the prospective underwriters and the expected pricing range of the package of securities. In response to investor inquiries moreover, the bank holding company determines to issue a press release which notes the upcoming public offering and describes the estimated proceeds and valuation expected in the offering and the expected underwriters that will lead the public offering.

2.A. What securities are being offered? (3 Points.)

2.B. Are any of such securities exempt securities under Section 3 of the Securities Act? (2 Points.)

2.C. Would any of the president’s statements be viewed as impermissible gun-jumping in the pre-filing period that cannot be fit into any potential safe harbors? (3 Points)

2.D. Would the press release be viewed as impermissible gun-jumping? (3 Points)
3. Which types of securities financings that are not subject to registration under the Securities Act could be made through a website posting generally available on the Internet? (4 Points)

4. BioTech is a new start-up company that is organized in a Delaware corporation, with all of its assets, employees, customers and sales in New York. BioTech is not yet a reporting company under the Exchange Act.

About one year ago, BioTech needed to raise some start-up capital. After making presentations of several venture capital symposiums held in New York City, where BioTech sought to interest a number of previously unknown individuals and institutions to invest in BioTech. BioTech didn't have the time or money to prepare any disclosure document, although BioTech and its investors are freely available to answer questions. Nine months ago, these efforts were successful, and BioTech sold $500,000 of its common stock to its president and two of its directors, all of whom lived in New York, and then $2,500,000 of its common stock to Vulture Ventures, a very large institutional investor in New York City.

4.A. Could BioTech utilize a 3(a)(11) exemption to offer and sell its common stock? (3 Points)

4.B. Could BioTech utilize a 4(2) exemption to offer and sell its common stock? (3 Points)

About seven months ago (i.e., five months after the foregoing sales) BioTech began to face a financial crises, which could only be solved by quickly raising another $3,500,000 million. To reach potential investors, BioTech quickly contracts about 100 potential investors who had met BioTech at the previously mentioned venture capital symposium and corresponded with BioTech ever since. Due to these efforts, BioTech identified 35 investors, who purchased $3.5 million of BioTech's convertible preferred stock, which was convertible into its common stock. As before, no disclosure document was prepared, but questions were answered. All 35 of these investors certified to BioTech that they were accredited investors and provided summary financial statements to confirm their status, although BioTech later discovered that 5 of them had lied and were not accredited investors.

4.C. Assuming that the $3,000,000 common stock financing of one year ago was made on the basis of Rule 506, could this convertible preferred stock financing be made on the basis of:

(i) Rule 505 (3 Points)

(ii) Rule 506? (3 Points)
4.D. Assuming that the $3,500,000 convertible preferred stock financing was made under Rule 506, could the 30 accredited investors later rescind their investment because 5 of the others later turned out to be non-accredited investors? (3 Points)

4.E. Again assuming that the $3,000,000 common stock financing was made under Rule 505, and the $3,500,000 convertible preferred stock financing was made under Rule 506, could BioTech now consider a Rule 903 off-shore offering of common stock to 50 individual, non-accredited investors in London without giving rise to:

(i) Aggregation issues with regard to the Rule 505 common stock financing? (3 Points)

(ii) Integration issues with regard to the Rule 506 convertible preferred stock financing? (3 Points)

22 Total Points

5. One year ago, Tech Company privately placed 100,000 shares of its stock pursuant to Section 4(2) to Vulture Investor, 50,000 shares of its stock pursuant to Section 4(2) to its president and 50,000 shares of its stock to 5 of its new engineers pursuant to Rule 701, for a total of 200,000 shares. Six months ago, Tech Company closed its initial public offering of (i) 600,000 shares of its stock pursuant to a registration statement, (ii) privately placed its convertible notes to Vulture Ventures (a big institutional investor) pursuant to Section 4(2) which convertible notes were immediately convertible into 150 shares of its stock at a conversion price that equaled the initial public offering price, and (iii) privately place its options to junior employees pursuant to Rule 506 which were immediately exercisable for 50,000 shares of its stock. Consequently, Tech Company had outstanding 800,000 shares of its stock, and 150,000 shares of stock reserved for future issuance under the convertible notes and 50,000 shares of stock reserved for future issuance under the options. At this time, the average weekly public trading volume of the stock has been 10,000 shares per week.

5.A. When is the earliest time that the 5 new engineers can sell all of their 50,000 shares of stock into the U.S. public markets and on the basis of what exemption? (2 Points)

5.B. Is Vulture Ventures an affiliate of Tech Company? In any event, what additional facts would strengthen a conclusion that Vulture Ventures was an affiliate? (2 Points)

5.C. When is the earliest time that the president can sell any of his 50,000 shares of stock:

(i) Into the U.S. public market and on the basis of which exemption? (2 Points)

(ii) To widows and orphans in London and on the basis of which exemption? (2 Points)

(iii) In the U.S. to Vulture Ventures and on the basis of which exemption? (2 Points)

5.D. Can the convertible notes be resold by Vulture Ventures to a “qualified institutional buyer” under Rule 144A? (2 Points)
5.E. If the 5 engineering students privately resell 25,000 of their shares to the president for cash and 25,000 of their shares to an institutional investor in London for cash:

(i) When is the earliest time that the president can resell these 25,000 shares into the U.S. public markets? (2 Points)

(ii) When is the earliest time that the London Institutional investor can resell these 25,000 shares into the U.S. public markets? (2 Points)

5.F. If the junior employees who received the options exercise those options by exchanging and surrendering a portion of these options in order to acquire the underlying stock, when is the earliest time that these junior employees can resell such stock into the U.S. public markets? (2 Points)

Today, the president privately transfers 10,000 of his shares to his brother who lives for away, 10,000 shares of his shares to a trust of which he is a 50% beneficial owner (but doesn’t control) and 10,000 of his shares to a partnership of which he is a 5% beneficial owner (but directs and controls all stock transactions), leaving him with 20,000 shares.

5.G. (i) Today, which of the president, his brother, the trust and the partnership, if any, can now sell shares into the U.S. public markets pursuant to Rule 144? (2 Points)

(ii) Slightly less than one year from today, if the president was considering selling shares into the U.S. public markets pursuant to Rule 144, which, if any, of his brother, the partnership or the trust could make sales into the U.S. public markets pursuant to rule 144 that would be aggregated with the president’s sales for purposes of Rule 144? (2 Points)

6. Hot Company just closed its initial public offering, although it has agreed to a standard 30-day “green shoe” option to issue additional shares to its underwriters pursuant to the underwriting agreement relating to the public offering. On the 20th day following the initial closing, the underwriters exercise the green shoe option and buy the additional shares on the 25th day following the initial closing. The underwriters in connection with the initial public offering ask you a series of questions:

6.A. When can Hot Company’s president be interviewed on the TV networks about the great prospects for Hot Company? (2 Points)

6.B. Prior to the “green shoe” closing, should Hot Company refrain from adding to its corporate Web site the annual updates to its business product offerings? (3 Points)
6.C. When delivering final prospectuses in connection with confirmations and sales, can Hot Company mail a physical confirmation to all investors which includes on its back side the e-mail address through which the final prospectus can be downloaded by purchasing shareholders? (3 Points)

6.D. When can underwriters' security analyst publish an analyst report about Hot Company and 3 other companies in their industry which features on the cover Hot Company and their increased earnings prospects since the closing of the initial public offering? (3 Points)

13 Total Points

7. Hot Company ("Hot") has stock registered under Section 12(a) of the Exchange Act and has recently filed a registration statement under the Securities Act to publicly offer additional shares of its stock, although that registration statement has not yet been declared effective. In connection with that public offering, Hot is now participating in a road show presentation for institutional investors who are interested in buying shares in the public offering. At the beginning of the presentation, those invited institutional investors are orally instructed to keep confidential all information provided to them at the presentation, since Hot's new secret technology will be explained in important non-public scientific detail by scientist/analysts who are employed by the Technical Brokerage Firm that is not acting as an underwriter in the public offering but is paid a retainer fee by the Company's managing underwriter to make road show presentations like this one. At the end of the presentation, at the request of Hot, the scientist/analysts hand out to the institutional investors their scientific analyst report published by the Technical Brokerage Firm that extols Hot's new technology.

7.A. Must Hot publicly disclose the non-public scientific information presented at the roadshow in order to avoid selective disclosure under Regulation FD? (3 Points)

7.B. Is it appropriate under the Securities Act for the Technical Brokerage Firm to distribute their scientific/analyst reports at the roadshow meeting? (3 Points)

7.C. To reach institutional investors who couldn't attend the roadshow, could the sales persons of Hot's managing underwriters e-mail the scientific/analyst report of Technical Brokerage Firm to:

(i) those non-attending investors along with the preliminary prospectus? (2 Points)

(ii) the editors of a global scientific magazine publisher headquartered in London who are about to sponsor an internet symposium on profitable new technologies of the new decade? (2 Points)

7.D. Could Hot's managing underwriters tell the institutional investors that they will only be permitted to buy Hot's shares in the public offering if they commit to buying a specified number of shares in an upcoming, struggling public offering of another company being underwritten by the same managing underwriter and being presented at an upcoming road show? (3 Points)
8.

A frustrated farmer in Nebraska decides that there must be an easier way to make a living than growing corn. He decides to organize a limited liability company, and offer membership interests therein to every farmer in Nebraska. Each farmer is told to contribute all of the corn grown on his farm to the limited liability company, which will then pool every participant’s corn, and then offer the pooled bulk of corn to competing large corporate corn buyers with the objective of creating a bidding frenzy among potential corporate buyers to get the top price for the corn.

In materials describing the opportunity, farmers are given some financial projections prepared by a financial consultant, but who is never available during the period of the offering to answer the farmer’s questions. That financial consultant is paid a flat fee by the company at the outset of the offering (irrespective of the success of the offering). The financial consultant is told, by the founding farmer, that if the company is successful, there may be future advisory opportunities available to him.

Sale proceeds from the corn of the participating farmers would be split among the farmer participants based upon the amount of corn they transferred to the limited liability company and based upon their willingness to place several small-time (and generally ineffective) testimonials about their corn’s quality in the regional newspapers. In the limited liability company agreement relating to the limited liability company, the membership interests are expressly stripped of any management or control authority. The founding farmer retains all marketing and selling authority, except that the final amount and price at which the corn is to be sold on behalf of all farmers must be approved by two-thirds of the membership investors. About 18 months after the time that the farmers invest in the company, it begins to lose serious money, defaults on its obligations and goes bankrupt.

8.A. Are the membership interests securities? (6 Points)

8.B. If the membership interests might otherwise be considered to be securities, and the farmer wishes to avoid the membership interests from being legally viewed as securities, how might the farmer restructure his approach, limited liability company and the membership interests to avoid the membership interests from being viewed as securities? (5 Points)

4 Total Points

9.

In discussing the Securities Act, we noted several examples in the Securities Act and the rules and case law that reflected a differentiation of commercial and consumer financing from investment banking and securities market financings.

9.A. Cite some examples in the federal securities law of this differentiation. (4 Points)
10.

The cash, stock option and company loan compensation package of chief executive officer of a U.S. company publicly traded and listed on the New York Stock Exchange was in the past a matter often proposed by the chief executive officer and then negotiated with and finally approved by the company’s board acting with the discretion provided by the “business judgment rule” developed by Delaware state corporate law.

10.A. With the Sarbanes Oxley Act, the corporate governance requirements of the New York Stock Exchange and other corporate governance developments under the Federal securities laws in the past few years, discuss some of the changes that now confront this compensation decision. (5 Points)

9 Total Points

11.

Would U.S. companies that have the following characteristics be required to file Current Reports on Form 8K and to comply with Regulation FD, and if so, pursuant to which of Sections 12(a) of the Exchange Act, 15(d) of the Securities Act or 12(g) of the Exchange Act.

Questions:

<table>
<thead>
<tr>
<th>FILE FORM 8K?</th>
<th>COMPLY WITH FD?</th>
<th>UNDER 12(a) OF EXCHANGE ACT?</th>
<th>UNDER 15(d) OF SECURITIES ACT?</th>
<th>UNDER 12(g) OF EXCHANGE ACT?</th>
</tr>
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<tbody>
<tr>
<td>YES</td>
<td>NO</td>
<td>YES</td>
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- Company with $100 million of assets whose notes are held by 400 holders and are listed and publicly traded on the New York Stock Exchange. (3 Points)

- Company with $100 million of assets which recently privately placed notes to 250 holders and then completed an “A/B” exchange offer pursuant to a registration statement filed and declared
<table>
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<tr>
<th>FILE FORM 8K?</th>
<th>COMPLY WITH FD?</th>
<th>UNDER 12 (a) OF EXCHANGE ACT?</th>
<th>UNDER 15(d) OF SECURITIES ACT?</th>
<th>UNDER 12(g) OF EXCHANGE ACT?</th>
</tr>
</thead>
<tbody>
<tr>
<td>YES</td>
<td>NO</td>
<td>YES</td>
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**effective under the Securities Act. (3 Points)**

- Company with $100 million of assets which privately placed its stock to 900 accredited investors pursuant to Rule 506 under the Securities Act. (3 Points)
Exam Number: ________________

NEW YORK UNIVERSITY
SCHOOL OF LAW

Survey of Securities Regulation
Fall 2005
Professor Carlson

Instructions

1. YOU MAY TAKE UP TO TWO HOURS (2:00) FOR THIS EXAM.

2. There are 10 questions, most with subparts, totaling 122 points.

3. No ambiguity is intended in any question. If you believe any question to be ambiguous, make any assumption of fact, consistent with the facts given, which you believe necessary to resolve the ambiguity. Please state any assumption so made at the beginning of your answer to the question.

4. You may assume that the Securities Act and the Exchange Act and the Rules and Regulations of the SEC thereunder in the form in which they appear in the Selected Statutes, together with the case law presented in the assigned materials and discussed during our Classes, along with the Securities Act Offering Reforms included in your assigned materials and effective as of December 1, 2005, have been in effect at all relevant times.

5. There are no restrictions on materials, including your casebook, notes, outlines, other publications, secondary materials and other documents, which you may use in taking this examination.

6. PLEASE WRITE THE EXAM IDENTIFICATION NUMBER IN THE BLANK PROVIDED AT THE TOP OF THIS PAGE.

7. Don’t worry; you will do fine. Happy Holidays.
1.

Hot Company ("Hot") has stock registered under Section 12(a) of the Exchange Act and is a very large company that has been subject to the Exchange Act for years. Hot has recently filed a registration statement under the Securities Act to publicly offer additional shares of its stock, although that registration statement has not yet been declared effective. In connection with that public offering, Hot is now participating in a road show presentation for institutional investors who are interested in buying shares in the public offering. At the beginning of the presentation, those invited institutional investors are orally instructed to keep confidential all information provided to them at the presentation, since Hot’s new secret technology will be explained in important non-public scientific detail by scientist/analysts who are employed by the Technical Brokerage Firm that is not acting as an underwriter in the public offering but is paid a retainer fee by the Company’s managing underwriter to make road show presentations like this one. At the end of the presentation, at the request of Hot, the scientist/analysts hand out to the institutional investors their scientific analyst report published by the Technical Brokerage Firm that extols Hot’s new technology.

1.A. When confirming the sale, must Hot’s managing underwriters make sure that a physical, hard-copy of the final prospectus is actually delivered to purchasers prior to their sale? (3 Points)

1.B. Could Hot’s managing underwriters tell the institutional investors that they will only be permitted to buy Hot’s shares in the public offering if they commit to buying a specified number of shares in an upcoming, struggling public offering of another company being underwritten by the same managing underwriter and being presented at an upcoming road show? (3 Points)

1.C. After selling the shares, when can the managing underwriters send to investors new and updated scientific/analyst reports without having them be viewed as illegal prospectus? (3 Points)

1.D. To reach institutional investors who couldn’t attend the roadshow, could the sales persons of Hot’s managing underwriters e-mail the scientific/analyst report of Technical Brokerage Firm to:

(i) Those non-attending investors along with the preliminary prospectus? (2 Points)
(ii) Would that emailed document be a permitted “free writing prospectus under the Securities Act Offering Reforms”? (2 Points)

1.E. Is it appropriate under the Securities Act for the Technical Brokerage Firm to distribute their scientific/analyst reports at the roadshow meeting? (3 Points)

1.F. Must Hot publicly disclose the non-public scientific information presented at the roadshow in order to avoid selective disclosure under Regulation FD? (3 Points)
2.

A frustrated farmer in Nebraska decides that there must be an easier way to make a living than growing corn. He starts and manages the business out of his barn in Nebraska, and decides to organize a Delaware limited liability company, and offer membership interests therein to every farmer in Nebraska. Each farmer is told to contribute all of the corn grown on his farm to the limited liability company, which will then pool every participant’s corn, and then offer the pooled bulk of corn to competing large corporate corn buyers with the objective of creating a bidding frenzy among potential corporate buyers to get the top price for the corn.

Sale proceeds from the corn of the participating farmers would be split among the farmer participants based upon the amount of corn they transferred to the limited liability company and based upon their willingness to place several small-time (and generally ineffective) testimonials about their corn’s quality in the regional newspapers. In the limited liability company agreement relating to the limited liability company, the membership interests are expressly stripped of any management or control authority. The founding farmer retains all marketing and selling authority, except that the final amount and price at which the corn is to be sold on behalf of all farmers must be approved by two-thirds of the membership investors. About 18 months after the time that the farmers invest in the company, it begins to lose serious money, defaults on its obligations and goes bankrupt.

2.A. Are the membership interests securities? (6 Points)

2.B. If the membership interests might otherwise be considered to be securities, and the farmer wishes to avoid the membership interests from being legally viewed as securities, how might the farmer restructure his approach, limited liability company and the membership interests to avoid the membership interests from being viewed as securities? (4 Points)

2.C. Could the membership interests be offered and sold under the “in-state” exemption under the Securities Act? (2 Points)

5 Total Points

3.

3.A. Why does Regulation FD and shelf registrations under the Securities Act render less important the type of investment banking and Wall Street business that depends on personal relationships between individual bankers representing those banks and senior executives at corporate issuer customers of the banks? (5 Points)
10 Total Points

4.

New Company wants to sell stock to fund its exciting new technology, which is so ground-breaking that its only understood by government scientists working at research laboratories.

4.A. If New York Company wants to solicit investors on the internet for its stock through an offering exempt from registration under the Securities Act, what alternatives does it have? (3 Points)

4.B. If New Company retains a broker to solicit investors on the internet for its stock through an exempt offering, how can that broker make offers to its customers on the internet and avoid general solicitation issues? (3 Points)

4.C. If New Company decides to pursue a private placement utilizing Section 4(2), can New Company target its offering at the government scientists at the research laboratories and not provide to them disclosures and the details of the new technology since the government scientists already know and understand it? (4 Points)

15 Total Points

5.

Five months ago, New Company was started by two engineers, who just graduated from college saddled with student loans and no real financial resources. Each of these founders invested $10,000 from 10 shares of stock of New Company (for a total of 20 shares for $20,000), and the founders appointed themselves co-presidents and directors of New Company.

Recently, New Company’s products were recognized by a widely published technology magazine as a very promising new technology, although the critical engineering details weren’t cited. To capitalize on this product opportunity, the two founders decided that they had to obtain $5 million of financing immediately, and decided to structure a convertible preferred stock private placement (which was convertible into underlying stock at any time). They identify, as investors, three groups. First, the rich uncle of one of the founders, who is worth millions, and will become a director, even though unproven allegations of industrial espionage against him bring controversy to any company with which he associates. Second, they identify 40 very large, very wealthy institutional investors. Third, they identify 10 other engineering students, who will invest their own funds into New Company, as well as separately receive for no additional consideration stock options pursuant to New Company’s stock option plan for employees. These engineering students are also poor, debt-burdened students, all of whom are making their first investment, and will be joining the Company as engineers, but have been strictly informed by the
founders not to consult any financial types, for fear of word leaking out regarding their new technology.

5.A. In the 20 share offering five months ago by the founders, would the two founders be viewed as “accredited investors” for purposes of a Rule 506 offering? (2 Points)

5.B. Would the $5m convertible preferred stock financing confront the following issues:

(i) Aggregation issues (if a Section 3(b)-based offering)? (2 Points)
(ii) Integration issues? (2 Points)

5.C. Could the $5million convertible preferred stock financing be structured so as to utilize the issuer exemptions found in:

(i) Section 4(2)? (2 Points)
(ii) Rule 506? (2 Points)
(iii) Rule 505? (2 Points)

5.D. If the $5 million convertible preferred financing is closed using a Rule 506 offering exemption, could New Company immediately file a registration statement under the Securities Act or register a public offering of its stock, yet avoid integration issues with that exempt financing? (3 Points)

6 Total Points

6.

On Day 1, a company sells its common stock in a 4(2) private placement for $2 million. On Day 30, the company issues stock to its employees pursuant to a Rule 701 offering for $1 million. On Day 60, the company sells preferred stock convertible into its common stock in a Rule 506 offering for $4 million. At day 90, the company proposes to raise $5 million of additional capital, in a non-registered exempt offering, and is considering either Regulation A, Rule 505 or Rule 506 offerings.

6.A. See any limitations at Day 90 on these alternatives?

(i) Regulation A? (2 Points)
(ii) Rule 505? (2 Points)
(iii) Rule 506? (2 Points)
7.

A company located in an unregulated Caribbean island creates a new financial product called "sin investment notes" (or "SINs"). Why travel to the casino, the company asks potential participants, when they can have just as much speculative fun putting their money in SINs?

The SINs promise a high fixed rate return from the company’s activities, instead of any dividends, and do not provide any consent, veto or voting rights as to the company. The SINs cannot be sold or traded by a participant, but the SINs have no final maturity date, but can be exchanged at any time, by either the participant or the company, for gambling discounts at any internet casino.

The SINs are exclusively offered through the company’s website, to anyone who accesses the company’s website. Participants who access the company’s website are given an amount of SINs free of charge, so long as they fill out a questionnaire confirming that they are wealthy, experienced gamblers and indicating their gambling preferences, and agree that the personal information reflected in the questionnaire can be given to internet casinos that offer various internet gambling opportunities.

7.A. Are the SINs securities? (3 Points)

7.B. Assuming a security is involved, is there an “offer” of a security involved for purposes of the Securities Act? (3 Points)
A U.S. bank holding company, with a national bank subsidiary, has a class of common stock traded on the New York Stock Exchange. The bank holding company is considering a private placement of a package of securities in the U.S., consisting of a note issued by the bank subsidiary and a separate warrant issued by the bank holding company which is immediately exercisable for the stock of the bank holding company. At this time, the president of the bank holding company, at an investor conference held in London with lots of eager investors and a number of carefully selected, favorably disposed financial reporters, tells the rapt audience about this potential private placement, the prospective placement agents, the Company’s financial forecasts for next year for the first time, and the expected pricing range of the package of securities. This press conference is simultaneously webcast into the U.S. through the company’s website. In response to investor inquiries moreover, the bank holding company determines to issue a press release which notes the upcoming private placement and describes the estimated proceeds and valuation expected in the offering and the expected placement agent that will lead the private placement.

8.A. Would any of the president’s statements trigger a Regulation FD disclosure obligation? (3 Points)

8.B. Would the press release or the web-casting be viewed as impermissible offers or solicitation? (3 Points)

8.C. Would any of the president’s statements be viewed as impermissible offers or solicitation that cannot be fit into any potential safe harbors? (3 Points)

8.D. Are any of such securities exempt securities under Section 3 of the Securities Act? (2 Points)

8.E. What securities are being offered? (3 Points.)
9.

A Company just closed an initial public offering of its stock under the Securities Act, and afterwards, has $90 million of assets and 525 stockholders, although the Company decides not to list its stock on a national securities exchange or NASDAQ.

9.A. **Must the Company file reports under the Exchange Act?** (2 Points)

9.B. **Must the Company register its stock under the Exchange Act?** (2 Points)

9.C. **If registered under the Exchange Act, could the Company de-register under the Exchange Act in 6 months?** (2 Points)

9.D. **Is the Company subject to Regulation FD?** (2 Points)

9.E. **If registered under the Exchange Act, and if the Company possessed material non-public information, would the Company be required to disclose that information by virtue of being registered under the Exchange Act?** (2 Points)

25 Total Points

10.

Six months ago, Tech Company privately placed 50,000 shares of its stock pursuant to Section 4(2) to Vulture Investor, 50,000 shares of its stock pursuant to Section 4(2) to its president and 50,000 shares of its stock to 5 of its new engineers pursuant to Rule 701, for a total of 150,000 shares outstanding. Six months ago, Tech Company closed its initial public offering of (i) 650,000 shares of its stock pursuant to a registration statement, (ii) privately placed its convertible notes to Vulture Ventures (a big institutional investor) pursuant to Section 4(2) which convertible notes were immediately convertible into 150,000 shares of its stock at a conversion price that equaled the initial public offering price, and (iii) privately place its options to junior employees pursuant to Rule 506 which were immediately exercisable for 50,000 shares of its stock. Consequently, Tech Company had outstanding 800,000 shares of its stock, and 150,000 shares of stock reserved for future issuance under the convertible notes and 50,000 shares of stock reserved for future issuance under the options. At this time, the average weekly public trading volume of the stock has been 20,000 shares per week, and Tech Company has listed its stock for trading on the NYSE and is current in all reporting obligations under the Exchange Act.

10.A. **If Vulture Investors determines to sell one-half of the convertible notes to a U.S. institution in a private 4(1-1/2) resale and the other half of the convertible notes to a**
London institution in a Rule 904 resale, how much will each of these resales reduce the amount of shares of stock that Vulture Investors can concurrently sell in the U.S. public markets under Rule 144? (3 Points)

10.B. If the junior employees who received the options exercise those options by exchanging and surrendering a portion of these options in order to acquire the underlying stock, when is the earliest time that these junior employees can resell such stock into the U.S. public markets and on the basis of what exemptions or Rule? (2 Points)

10.C. If the 5 engineering students privately resell 25,000 of their shares to the president for cash and 25,000 of their shares to an institutional investor in London for cash:

(i) When is the earliest time that the president can resell these 25,000 shares into the U.S. public markets and on the basis of what exemption or Rule? (2 Points)

(ii) When is the earliest time that the London Institutional investor can resell these 25,000 shares into the U.S. public markets and on the basis of what exemption or Rule? (2 Points)

10.D. Is Vulture Ventures an affiliate of Tech Company? In any event, what additional facts would strengthen a conclusion that Vulture Ventures was an affiliate? (2 Points)

10.E. When is the earliest time that the president can sell any of his 50,000 shares of stock:

(i) Into the U.S. public market and on the basis of which exemption? (2 Points)

(ii) To widows and orphans in London and on the basis of which exemption? (2 Points)

(iii) In the U.S. privately to Vulture Ventures and on the basis of which exemption? (2 Points)

10.F. When is the earliest time that the 5 new engineers can sell all of their 50,000 shares of stock into the U.S. public markets and on the basis of what exemption? (2 Points)

Today, the president privately transfers 10,000 of his shares to his brother who lives far away, 10,000 shares of his shares to a charity pursuant to a charitable donation and 10,000 of his shares to a partnership of which he is a 5% beneficial owner (but which he directs and controls all stock transactions), leaving him with 20,000 shares.

10.G. For purposes of Rule 144, would public market resales by the brother, the charity or the partnership be deemed to be sales by the president as a single person?

(i) brother? (1 Point)

(ii) charity? (1 Point)

(iii) trust? (1 Point)
10.H. For purposes of the required holding periods for restricted securities under Rule 144, could the brother, charity or the trust “tack” their holding periods or to the holding period of the president?

(i) brother?  (1 Point)
(ii) charity?  (1 Point)
(iii) trust?  (1 Point)