

K&L ALERT

Securities Law Commentary

April 2002

New SEC Rules—The Deluge Begins

As expected, the SEC proposed formally the first two of its promised revisions of the periodic reporting rules. To some involved in the reporting process, the first¹ is terrifying and the second² confusing.

Under the first proposal, starting next year most companies will have to file their Form 10-Qs within 30 days after the end of each quarter (instead of 45 days) and to file their Form 10-Ks within 60 days after the end of the fiscal year (instead of 90 days). Consistent with this “accelerated filing,” the Commission set an “accelerated comment period” for the proposal, allowing the public only 30 days to weigh in on the practicalities of the new reporting regime. Comments are due on May 23rd, and it is fair to assume that the Commission will soon thereafter consider (and adopt) a new Rule.

The confusion arises from the Commission’s second proposal. It requires companies to report promptly on Form 8-K transactions in the company’s securities by its officers and directors. This is in addition to the individual’s responsibility to file a Form 4 (or Form 5) for many of the same transactions. The confusion, or better “consternation,” arises because companies have little ability to police officers’ and directors’ securities transactions and inadequate means to assure compliance with corporate policies requiring them to tell the company about what they often regard as personal business.

ACCELERATED REPORTING

Although the Commission concedes that reporting has become more complex over the years, it asserts that technology improvements and better planning will allow companies, and particularly larger companies, to meet the accelerated filing deadlines. Accordingly, the Commission distinguishes between companies that will be subject to the new 30/60-day regime and others that remain on the 45/90-day schedule. “Accelerated filers,” however, cuts a wide swath through corporate America: all companies with market capitalization in excess of \$75 million (excluding shares held by affiliates) will be subject to the new 30/60-day schedule if they have been in the reporting system for a year and have already filed their first Form 10-K. If adopted, and there is plenty of momentum in that direction, the new schedule will become effective for fiscal years ending after October 31, 2002, meaning that for calendar-year companies, their next Form 10-K will be due on March 1, 2003, rather than March 31, 2003, and their 2003 Form 10-Qs will be due on April 30, July 30, and October 30, 2003.

Those who wish to comment on the feasibility of this accelerated reporting schedule can e-mail the SEC at rule-comments@sec.gov and refer to File No. S7-08-02 in the subject line.

¹ Proposed Rule: Acceleration of Periodic Reporting Filing Dates and Disclosure Concerning Website Access to Reports, Release No. 33-8089; 34-741; File No. S7-08-02 (April 12, 2002).

² Proposed Rule: Form 8-K Disclosure of Certain Management Transactions, Release No. 33-8090; 34-45742; File No. S7-09-02 (April 12, 2002).

WEBSITE DISCLOSURE

Because it already reflects widely accepted practice, it seems unlikely that many will disagree with the Commission's effort to encourage website publication of periodic Form 8-K, 10-Q and 10-K reports. The Commission proposes to accomplish this by requiring Form 10-K disclosure about whether and where investors can obtain immediate internet access to the company's periodic reports, and if website disclosure is not available then an explanation of why not. The Commission is not mandating website disclosure of periodic reports, merely "encouraging" it. Website publication will not, however, substitute for SEC filing. If adopted, the new rule will become effective three months after the final rule is adopted.

OFFICER AND DIRECTOR TRADING

Highly publicized events clearly show that a whole range of transactions by corporate insiders in their company's securities remain unreported for extended periods of time, and under certain circumstances never have to be reported. The second of the Commission's new reporting releases seeks to close these loopholes. In a significant departure from the past, it would make it the company's responsibility to provide prompt reporting of an insider's transactions.

Under the proposal, there will be a new Form 8-K reporting requirement, Item 10, that, subject to a modest *de minimis* exception, will require all domestic companies with registered equity securities to report within two days transactions by officers and directors in the company's equity securities (including derivatives) of \$100,000 or more, whether with the company or with third parties. The scope of transactions covered by new Item 10 is substantially greater than what's now required to be reported on Forms 3, 4 and 5. For transactions under \$100,000, reporting would be required on the second business day of the week following the transaction. The *de minimis* exception is for transactions of less than \$10,000, and allows the required Form 8-K report to be deferred until the cumulative value of unreported events reaches \$10,000.

The reach of proposed new Item 10 goes substantially beyond typical Form 3, 4, and 5 reporting requirements. For instance, it would include gifts, pledges, employee benefit plans

transactions and option repricings, among other things. And, more specifically, the new Item 10 would be triggered by planned purchase or sale transactions under Rule 10b5-1(c) (which provides an affirmative defense for preplanned transactions in the company's securities) and loans to directors or executive officers that are made or guaranteed by the company and any action by the company to forgive, release, pay under a guaranty, or foreclose any such loan.

Many, and especially those who have been charged in the past with (and often frustrated by) administering Form 4 reporting programs, will ask "How in the world will we ever get the information, let alone meet a two day (or next week) Form 8-K filing deadline?" It is a frightening prospect if the past is any indication. "What are we supposed to do if the directors and officers don't tell us (the company) of their transactions promptly or ever, either deliberately or through inadvertence?" In anticipation of this concern, the Commission included in the proposal a limited "safe harbor" if the company has procedures in place and a system designed to meet the Item 10 prompt disclosure requirement. The Commission cautions, however, that repeated failure to meet the new regulatory requirement will indicate a failure of the company's procedures and that the safe harbor will be lost. (The design of such programs is likely to begin a new cottage industry for corporate counsel and administrators). There is some further comfort because the Commission rejected a private right of action from the remedies for violation of the Item 10 filing requirement.

It is important to repeat that the new proposed Item 10 to Form 8-K does not change individual officers', directors', and 10% shareholders' Form 4 (and Form 5) filing requirements. Some have already suggested that dual reporting of the same insider transaction may confuse the marketplace.

The comment period for this new trading reporting requirement is the more typical 60 days and it expires on June 24th. Those who wish to comment on the accelerated and expanded trade reporting requirement can e-mail the SEC at rule-comments@sec.gov and refer to File No. S7-09-02 in the subject line.

WHAT'S NEXT?

In a number of recent presentations, Alan Beller (Director of SEC's Division of Corporation Finance) described generally the next round of reporting releases. First up is likely to be a rule further clarifying the Commission's repeated-but-informal entreaties that companies disclose critical accounting policies. Because of confusion in defining the term, notwithstanding SEC Chief Accountant Bob Herdman's clarification efforts³, the SEC staff is likely to use the term "critical accounting judgments and estimates," capturing the notion that only the most complex and the most significant judgments, and particularly those where accounting entries are based on estimates or estimating techniques, need be discussed.

Next on the plate is an MD&A release that we can expect to drive home, once again, that MD&A is to provide a narrative explanation of the company's business and an explanation of its finances and financial statements "through the eyes of management." The Commission will likely emphasize in its MD&A proposal trend disclosure and evaluative discussions of the quality of earnings and the risks to the continuation of those earnings. "Is past performance a meaningful indicator of the future performance?" In this regard, the SEC has sometimes suggested that an MD&A should identify

key drivers of the business in a manner that allows comparative analysis with other companies, rather than simply providing raw information.

Finally, we can expect an SEC proposal vastly expanding the list of events that will trigger a Form 8-K filing. These new Items will surely include a number of additional financial and financing events and matters involving officers, directors and key employees.⁴

Although the first two proposals are out and have some momentum, they are not yet adopted. The comment periods are open and the SEC and its staff have asked many questions in the Releases and solicited input. Input and comment from the issuer community is always particularly welcomed. We encourage companies who have strong views on any of these proposals, or others as they are formally announced, to join the comment process either directly or through us.

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³ Speech by SEC Staff: Critical Accounting and Critical Disclosures (Jan. 24, 2002) <http://www.sec.gov/news/speech/spch537.htm>.

⁴ See K&L Alert – Securities Law Commentary, "Carpe Diem—'Enron' Facilitates Major Changes—SEC Corporate Procedure Rules," February 2002.



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