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### Recent SEC Rule Proposals to Enhance Corporate Disclosure

In its continued effort to improve corporate reporting and ensure accurate and timely disclosure in the wake of the Enron collapse, the Securities and Exchange Commission has proposed rules that would require corporations to provide additional information more quickly to shareholders and require a company's top executives to personally certify corporate results. These rule changes will affect every public company. According to SEC Chairman Harvey Pitt, these changes, if adopted, should give investors "a greater sense of comfort" about investing in public companies. These proposed rules follow the SEC's proposals in April and May that would accelerate the due dates for quarterly and annual reports, impose new obligations to report insider transactions and require companies to provide extensive additional disclosures in the management's discussion and analysis ("MD&A") section of annual reports regarding "critical accounting policies" used in the preparation of their financial statements. Each of the following proposals is still pending and no final action has been taken. The SEC anticipates that some or all of these proposals will be adopted in the fall of 2002.

The SEC has proposed the following specific rules:

#### **Acceleration of Periodic Report Filing Dates and Disclosure Concerning Website Access to Reports**

The acceleration of periodic report filing dates was the first proposal in a series of steps designed to improve the financial reporting disclosure system. The SEC has proposed accelerating the filing of quarterly and annual reports for domestic companies that have a public float of at least \$75 million, that have been subject to the Securities Exchange Act reporting requirements for at least 12 calendar months, and that have previously filed at least one annual report. These companies are deemed "accelerated filers." The rule would require these companies to file their quarterly reports 30 calendar days after quarter end (rather than the current 45 day requirement) and 60 calendar days (rather than the current 90 days) after fiscal year end. According to the SEC, the significantly reduced time periods for the capture and analysis of information and significant technological advances since these time

periods were last revised necessitate a new consideration of the timing of mandated disclosure to the markets.

The SEC also believes that mandated public company disclosure should be more readily available to investors in a variety of locations. To further this goal, the SEC's proposed rule would require these companies to disclose in their annual reports whether their public filings are available on their websites the same day the reports are filed with the SEC. A company that does not make their filings available on their websites must disclose the reasons why it does not do so, one or more locations where the public can access these filings electronically immediately upon filing, if any, and whether there is a fee for such access, and whether the company will voluntarily provide electronic or paper copies of its filings free of charge upon request.

If these rules are adopted as proposed, the SEC expects to make them effective as of the end of a company's first fiscal year ending after October 31, 2002. The comment period on the proposed rule ended May 23, 2002.

### **Form 8-K Disclosure of Certain Management Transactions**

Given the obvious importance to the marketplace of transactions by corporate executives and directors, the SEC has proposed a rule that would require companies with a class of securities registered under Exchange Act Section 12 to disclose on a current basis significant transactions in the company's stock by its executive officers and directors. The proposed amendment to Form 8-K would require companies to report the following information:

- Directors' and executive officers' transactions in company equity securities (including derivative securities transactions and transactions with the company);
- Directors' and executive officers' adoption, modification or termination of a contract, instruction or written plan for the purchase or sale of company equity securities intended to satisfy the affirmative defense conditions of Exchange Act Rule 10b5-1(c) (i.e. showing a plan or obligation to effect transactions in company stock in the future); and
- Loans of money to directors and executive officers made or guaranteed by the company or an affiliate of the company.

The proposal also dramatically shortens the reporting deadlines by requiring companies to report no later than two business days following any insider transaction or loan with an aggregate value of \$100,000 or

more, other than a grant or award pursuant to an employee benefit plan. Reports of transactions and loans with a smaller aggregate value, grants and awards pursuant to employee benefit plans, and Rule 10b5-1 arrangements generally would be due by the close of business on the second business day of the following week. However, reports of transactions and loans with an aggregate value less than \$10,000 would be deferrable until the aggregate cumulative value of those unreported events for the same director or executive officer exceeds \$10,000. The SEC will expect companies to institute procedures and systems to insure timely compliance with these disclosure requirements and may sanction a company and its directors and executive officers for repeated violations.

The proposed rule would not relieve officers and directors from their obligation to file Section 16 reports (i.e. Forms 4 and 5) with respect to the transactions reported on Form 8-K.

The SEC stressed that requiring companies to file current reports disclosing information about directors' and executive officers' transactions, Rule 10b5-1 arrangements, and loans (or loan guarantees) by the company or its affiliates should enable investors to make investment and voting decisions on a more timely and better-informed basis, protect investors, and promote fair dealing in company equity securities. Current information regarding changes in directors' and executive officers' holdings of company equity securities would reveal shifts in the alignment between management's and shareholders' economic interests. Such current information, particularly with respect to derivative securities used for hedging purposes, would disclose transactions by directors and executive officers that in effect sever the link between executive compensation and company equity securities performance.

Making available current information regarding directors' and executive officers' transactions in company equity securities also would provide public investors timely disclosure of potentially useful information as to management's views of the performance and prospects of the company.

Similarly, timely disclosure that a director or executive officer has entered into, modified or terminated a Rule 10b5-1 contract, instruction or written plan for the purchase or sale of company equity securities would provide public investors with more complete disclosure of useful information as to the performance and prospects of the company. Finally, current disclosure of loans (and loan guarantees) by the company or its affiliates to directors and executive officers would

inform investors of financial arrangements not generally available to shareholders that may result in the receipt of *de facto* additional compensation by the director or executive officer.

The comment period on the proposed rule ended June 24, 2002.

### **The Critical Accounting Estimates and Policies**

The proposed amendments to the SEC rules for Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) would require disclosure about critical accounting policies and will significantly change how reporting companies portray their earnings to the investing public. As described in a Cautionary Advice Release issued by the SEC on December 12, 2001, critical accounting policies are those that are both most important to the portrayal of a company's financial condition and results, and require management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain.

The proposed rules would require public companies to include in their MD&A full explanations, in clear and understandable format and language, of their critical accounting policies, the judgments and uncertainties affecting the application of those policies, and the likelihood that materially different amounts would be reported under different conditions or using different assumptions. Companies must also include disclosure concerning the initial adoption by the company of an accounting policy that has a material impact on its financial presentation.

The objective of this disclosure would be consistent with the objective of MD&A to provide information on events or uncertainties known to management that would have a material impact on reported financial information. Such disclosure would assist investors in understanding a company's financial condition, changes in financial condition, and results of operations. These rules would require companies to provide extensive additional disclosure in the MD&A regarding critical accounting estimates used in the preparation of their financial statements and the adoption of new accounting principles. The new disclosures would be included in the MD&A under a separate caption and would be required for both U.S. and non-U.S. companies. Small business issuers that have not had revenues from operations during the last two fiscal years will not be required to comply with the rules.

Under the proposed rule, an accounting estimate is a “critical accounting estimate” if:

- the accounting estimate requires the company to make assumptions about matters that are highly uncertain at the time the accounting estimate is made; and
- different estimates that the company reasonably could have used in the current period, or changes in the accounting estimate that are reasonably likely to occur from period to period, would have a material impact on the presentation of the company's financial condition, changes in financial condition or results of operations.

To inform investors of each critical accounting estimate, and to place it in the context of the company's financial condition, changes in financial condition and results of operations, the proposals would require the following information in the MD&A section:

- A discussion that identifies and describes the estimate, the methodology used, certain assumptions and reasonably likely changes;
- An explanation of the significance of the accounting estimate to the company's financial condition, changes in financial condition and results of operations and, where material, an identification of the line items in the company's financial statements affected by the accounting estimate;
- A quantitative discussion of changes in line items in the financial statements and overall financial performance if the company were to assume that the accounting estimate were changed, either by using reasonably possible near-term changes in certain assumption(s) underlying the accounting estimate or by using the reasonably possible range of the accounting estimate;
- A quantitative and qualitative discussion of any material changes made to the accounting estimate in the past three years, the reasons for the changes, and the effect on line items in the financial statements and overall financial performance;
- A statement of whether or not the company's senior management has discussed the development and selection of the accounting estimate, and the MD&A disclosure regarding it, with the audit committee of the company's board of directors;
- If the company operates in more than one segment, an identification of the segments of the company's business the accounting estimate affects; and

- A discussion of the estimate on a segment basis, mirroring the one required on a company-wide basis, to the extent that a failure to present that information would result in an omission that renders the disclosure materially misleading.

Companies would be required to update material changes to this information in quarterly reports.

The proposed rule also calls for disclosure regarding a company's initial adoption of an accounting policy if the accounting policy was adopted in the past year and had a material impact on the company's financial condition, changes in financial condition or results of operations. In their annual reports, registration statements, and proxy and information statements, companies would be required to disclose:

- The events or transactions that gave rise to the initial adoption;
- The accounting principle that has been adopted and the method of applying that principle;
- The impact on the company's financial condition, changes in financial condition and results of operations (discussed on a qualitative basis);
- If the company is permitted a choice between acceptable principles, an explanation that it had made such a choice, what the alternatives were, and why it made the choice it did (including, where material, qualitative disclosure of the impact on the company's financial presentation that the alternatives would have had); and
- If no accounting literature exists that governs the accounting for the events or transactions giving rise to the initial adoption, an explanation of its decision regarding which accounting principle to use and which method of applying that principle to use.

The comment period on the proposed rule ended July 19, 2002.

### **Certification of Quarterly and Annual Reports**

Following the Enron collapse, President Bush called for CEO certification of corporate results as part of his "10-Point Plan to Improve Corporate Responsibility and Protect America's Shareholders." As proposed, the SEC rule is consistent with the President's plan. New Exchange Act Rule 13a-14 would require the principal executive officer and principal financial officer of a company each to certify, with respect to the company's quarterly and annual reports that:

- he or she has read the report;
- to his or her knowledge, the information in the report is true in all important respects as of the last day of the period covered by the report; and
- the report contains all information about the company of which he or she is aware that he or she believes is important to a reasonable investor as of the last day of the period covered by the report.

For purposes of the proposed certification, information is considered "important to a reasonable investor" if:

- there is a substantial likelihood that a reasonable investor would view the information as significantly altering the total mix of information in the report; and
- the report would be misleading to a reasonable investor if the information was omitted from the report.

In addition, proposed new Exchange Act Rule 13a-15 would require a company to maintain procedures to provide reasonable assurance that the company is able to collect, process and disclose the information required in the company's periodic and current reports pursuant to the Exchange Act, and also require a periodic review and evaluation of these procedures. This annual evaluation would need to be presented to the company's principal executive officer and principal financial officer, and these individuals would be required to certify in the company's annual report that they have reviewed the results of the evaluation.

Currently, CEOs sign annual reports, while the chief financial officer or controller typically signs quarterly reports. Mr. Pitt said that the proposed rule will "make individual senior managers personally liable" if they certify quarterly or annual reports that are untrue or would mislead investors.

The comment period on the proposed rule ends August 19, 2002.

## **SEC Administrative Order**

Although the above proposal has yet to go into effect, on June 27, 2002, in response to continuing disclosures regarding accounting issues at large public companies, the SEC issued an administrative order requiring both the principal executive officer and the principal financial officer of 945 public companies with revenues of at least

\$1.2 billion in their last fiscal year to file a one-time written statement under oath personally certifying that their most recent reports filed with SEC are both complete and accurate. Officers who make false certifications will face personal liability as the order could lead to civil penalties or criminal charges of perjury or lying to the government if an officer is later found to have lied under oath.

The SEC has stated that this order is intended to assure the investing public and the SEC that the corporate disclosure in reports already filed this year is in compliance with federal securities laws, or, provide information quickly about those companies where that is not the case.

The order requires the principal executive and financial officers of SEC-registered companies to each file with the Commission a sworn written statement in which the officer must personally attest that the company's most recent periodic reports are materially truthful and complete or explain why such a statement would be incorrect.

The officers are required to file their written statements with the Commission no later than the close of business on the first date that their company is required to file a Form 10-K or Form 10-Q with the Commission on or after August 14, 2002. The SEC intends to make the certifications available to the public on the SEC Web site. The certifications will apply to:

- the company's most recent Annual Report on Form 10-K filed with the Commission;
- all of the company's reports on Form 10-Q, all reports on Form 8-K and all definitive proxy materials filed with the Commission subsequent to the filing of the most recent Form 10-K; and
- any amendments to any of the above.

With the deadline for these certifications fast approaching, several inquiries have been made to the SEC asking whether CEOs and chief financial officers can modify their sworn statements by adding words, footnotes or explanations, but still be considered by the SEC to be attesting to the accuracy of their results. The SEC has responded that this is not going to be allowed. All companies must file the exactly prescribed sworn statement or else they will be deemed unable to certify to the accuracy of their reports.

## **New Form 8-K**

In light of the SEC's view that markets and investors need more

## **Disclosure Requirements and Deadlines**

timely access to a greater range of important information concerning public companies, the SEC has proposed a rule that would require companies to report a wider group of changes and events on a Form 8-K and report them more quickly. The proposed rules would require current reports on Form 8-K of the following 11 new items or events:

- Entry into a material agreement not made in the ordinary course of business;
- Termination of a material agreement not made in the ordinary course of business;
- Termination or reduction of a business relationship with a customer that constitutes a specified amount of the company's revenues;
- Creation of a direct or contingent financial obligation that is material to the company;
- Events triggering a direct or contingent financial obligation that is material to the company, including any default or acceleration of an obligation;
- Exit activities including any material write-off or restructuring;
- Any material impairment;
- A change in a rating agency decision, issuance of a credit watch or change in a company outlook;
- Movement of the company's securities from one national securities exchange or inter-dealer quotation system of a registered national securities association 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;
- Notice to the company from its currently or previously engaged independent accountant that the independent accountant is withdrawing a previously issued audit report or that the company may not rely on a previously issued audit report; and
- Any material limitation, restriction or prohibition, including the beginning and end of lock-out periods, regarding the company's employee benefit, retirement and stock ownership plans.

The proposed rules would move two disclosure items that currently are required in a corporation's annual and quarterly reports to Form 8-K:

- Unregistered sales of equity securities by the company; and
- Material modifications to rights of holders of the company's securities.

The proposed rules would also amend several existing Form 8-K disclosure items to include:

- disclosure regarding the departure of a director for reasons other than a disagreement or removal for cause;
- the appointment or departure of a principal officer, and the election of new directors; and
- disclosure regarding any material amendment to a company's certificate of incorporation or bylaws.

Currently, a company has a five business day deadline for disclosure about changes in a company's independent accountant and resignations of directors and a 15 calendar day deadline for other required disclosures. The proposed rules would accelerate these deadlines to two business days so that there would be a uniform period for all of the mandated Form 8-K disclosure items.

The comment period on the proposed rule ends August 26, 2002.

The full text of the rule proposals is available on the SEC's web site at <http://www.sec.gov/rules/proposed.shtml>.

This document is intended as an informational reminder and does not constitute legal advice. If you have any questions or would like to discuss a particular situation, you should contact your usual W&D attorney or **David B. Fein** (203-363-7603/[dfein@wiggin.com](mailto:dfein@wiggin.com)), **Michael Grundei** (203-363-7630/[mgrundei@wiggin.com](mailto:mgrundei@wiggin.com)), or **Patricia Roer** (203-363-7623/[proer@wiggin.com](mailto:proer@wiggin.com))

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