

ADVISORY

SULLIVAN & WORCESTER CORPORATE ADVISORY

What Public Companies Need to Know About This Year's Annual Reports and Proxy Statements – *2005-06 Edition!*

Each year, we provide a summary regarding the latest SEC and stock exchange rule changes for public companies.¹ While there have been fewer rule revisions of late than in the last couple of years, a few notable new rules have taken effect since last year and several proposals are on the horizon that will impact the upcoming annual reports on Forms 10-K and 20-F or annual proxy statements. This advisory presents some of the key issues² that clients should consider while preparing annual disclosure documents for fiscal years ending on or after December 31, 2005.

NEW RULES AND CHANGES

Accelerated Deadlines. Last year, the filing deadlines for accelerated filers³ for annual and quarterly reports were reduced to 75 days and 40 days, respectively, after the end of the relevant period. This year, accelerated filers' 10-K and 10-Q deadlines were scheduled to be further reduced to 60 days and 35 days, respectively. The SEC, however, received many complaints about this further acceleration. In response, it created a new category of "large accelerated filer" which requires a \$700 million public float, rather than the \$75 million public float for accelerated filers. For 10-Ks covering 2005, accelerated filers and large accelerated filers will continue to have 75 day and 40 day deadlines. For 10-Ks covering 2006, however, large accelerated filers will be subject to a 60 day deadline (though the 10-Q deadline will remain at 40 days). Companies that are not accelerated filers can continue to comply with the currently existing, longer deadlines – 10-Ks within 90 days after the fiscal year end and 10-Qs within 45 days after the quarter end.

Risk Factors in 10-Ks. As part of a larger proposal of securities offering reforms,⁴ the SEC now requires companies to include plain English risk factors in 10-Ks like to those already required in most registration statements. Forms 10-Q will be used for material updates.

Unresolved SEC Staff Comments. Also as part of the offering reforms, 10-Ks of accelerated filers will need to disclose the substance of any material unresolved SEC staff comments on their periodic reports, which comments date back more than 180 days prior to the end of the year covered by the 10-K.

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Disclosure of Penalties for Using Tax Avoidance Transactions. Under Internal Revenue Service guidance relating to the requirements of the American Jobs Creation Act of 2004, public companies must now make appropriate disclosure in the legal proceedings sections of their 10-Ks when they are subject to penalties for using certain tax avoidance transactions referred to as “reportable transactions” and “listed transactions.” The penalties triggering disclosure generally relate to gross valuation misstatements, accuracy-related understatements for certain tax avoidance transactions and failure to include information on tax returns relating to these transactions. The disclosure must, in each 10-K covering the year in which the company is required to pay the penalty until the penalty has been paid, include the amount of the penalty, whether or not it has been paid, the Internal Revenue Code section under which the penalty was imposed and a description of the penalty. Failure to make the required disclosure will result in additional monetary penalties.

Technical Changes for 10-Ks. Several new technical rules impact the cover page of 10-Ks. First, a company must now check a box on 10-Ks and 10-Qs indicating whether or not it is a “shell company” - a public company with no or nominal operations and assets other than cash and cash equivalents. Second, a company must check a box in 10-Ks indicating whether or not it is a “voluntary filer” - a company that files periodic reports even though its obligation to do so has been suspended or it is not otherwise required to do so under SEC rules. Affirmatively checking this box alerts investors that the filer may stop making filings at any point in time, for any reason and without further notice. Third, a company must check a box on 10-Ks and 10-Qs indicating whether it is an accelerated filer, large accelerated filer or non-accelerated filer. Finally, a company must check a box in 10-Ks indicating whether or not it is a “well-known seasoned issuer,” or WKSI. The WKSI designation was created by the SEC as part of its offering reforms.⁵ Companies that meet the thresholds for WSIs are the most active issuers in the U.S. public capital markets and this designation notifies investors of these companies’ size and increased regulatory flexibility under the offering reform rules.

In addition, the 10-K and proxy rule requiring disclosure of late reports of insider transactions was changed to no longer allow a report received by the issuer within three days after its required date to be presumed timely. In light of electronic filing, website posting and shorter deadlines, the SEC no longer deems such a grace period to be warranted.

UPCOMING RULES, CHANGES AND TRENDS

New York Stock Exchange Corporate Governance Requirement Changes. At the end of November, the New York Stock Exchange proposed amendments to its corporate governance listing standards. While these remain subject to SEC publication and approval (and, therefore, their status for the upcoming proxy season is uncertain), the NYSE’s interpretations are instructive for their views on their existing proxy disclosure rules and listed company governance practices.

In order to improve what the NYSE believed were insufficient proxy disclosures about director independence, the proposals would more clearly require that companies disclose which directors are independent based on one of two alternatives. First, a company could determine that certain types of relationships with the company are categorically immaterial, describe those categories and not have to make any more detailed disclosure about director relationships that fall within those categories. Relationships that meet the SEC’s thresholds for related party disclosure could not be considered immaterial. Alternatively, a company that did not have categorical standards would need to include specific descriptions of every relationship with the company for each director and disclose the basis for the board’s determination that such relationships are immaterial and do not preclude the director’s independence. The NYSE views these changes as clarifications rather than changes. Therefore, boards of NYSE listed companies should consider these proposals in their annual determinations of independence and their related proxy disclosures.

Other NYSE rule proposals that would impact corporate governance include:

- clarifying that audit committees must meet (in person or telephonically) to review and discuss Management’s Discussion and Analysis of

Financial Condition and Results of Operations, or MD&A, in quarterly and annual reports, rather than just conducting an individual "polling" of audit committee members in lieu of a meeting;

- clarifying that meetings of independent directors (as opposed to the potentially broader group of non-management directors) can satisfy the requirement to hold executive sessions and related director communications rules;
- clarifying that prompt disclosure of director and executive officer code of conduct waivers requires disclosure within 4 business days on an 8-K, press releases or website;
- requiring maintenance of a website, but no longer requiring proxy statement disclosure regarding the availability of board committee charters, codes of conduct and corporate governance guidelines;
- eliminating the requirement to disclose in annual reports to shareholders that a company has filed the NYSE-required CEO certification and the SEC's CEO and CFO certifications; and
- requiring listed company CEOs to promptly make disclosure to NYSE in writing after becoming aware of *any* non-compliance with corporate governance listing standards, not just material non-compliance.

Limitations on Tax Services to Be Provided by

Auditors. The Public Company Accounting Oversight Board has proposed rules that, if adopted, would treat registered public accounting firms as not being independent of their audit clients if (1) they enter into contingent fee arrangements with those clients; (2) the firm provides services related to planning or opining on the tax consequences of a transaction that is a listed or confidential transaction under Treasury regulations or the firm provides services related to planning or opining on a transaction that is based on an aggressive interpretation of applicable tax laws and regulations; or (3) the firm provides tax services to officers in a financial reporting oversight role of an audit client. The proposed rules would also increase the firm's responsibilities in connection with seeking audit committee pre-approval of tax services. Companies should consider the potential impact of these proposals as

their audit committees engage auditors for new services. In addition, companies should consider adding items to their director and officer questionnaires to cover any tax (or other) services received by individuals from the companies' outside auditors.

Internal Control Over Financial Reporting. For the first time last year, under Section 404 of the Sarbanes-Oxley Act of 2002, accelerated filers had to provide new management reports, audit reports and CEO and CFO certifications relating to the effectiveness of their internal control over financial reporting.

For non-accelerated filers, the deadline for compliance with these requirements was recently extended such that non-accelerated filers need not comply with these rules until their first fiscal year ending after July 15, 2007. The auditing standards and frameworks may be better tailored for smaller companies during this delay, but, at a minimum, non-accelerated filers should be taking advantage of this extra time to work on formalizing and improving their internal control structure.⁶

Option Expensing. Under Financial Accounting Standards Board standards, calendar year end companies will start including expensing of options on their income statements in their first 10-Q in 2006. Although the FASB did not specify a particular method of valuing options or the formulas companies should use to assign costs to the options, the SEC has issued interpretive guidance regarding the transition rules applicable to this new standard. In addition, the SEC has emphasized the need for clear disclosure in MD&A sections about the impact on companies' operating results, accounting policies and equity compensation practices from option expensing and known trends and uncertainties arising out of the transition to option expensing.⁷ Because the option expensing rules are effective beginning in 2006, the SEC expects companies in their 10-K financial statement footnotes and MD&A sections to provide greater detail than in past quarters about the expected impact. Many companies have simply been stating that they expect the new standard to have a material impact without describing any quantitative or qualitative known changes or trends. Such changes or trends are likely now more easily determinable since the effective date is imminent.

Other SEC "Hot" Issues and Disclosure

Trends. Although no new rules or interpretations have recently been issued by the SEC in the following areas, they continue to be the focus of increased SEC scrutiny, comments and enforcement actions.

- *Executive compensation disclosure.* In recent speeches, SEC staff members have emphasized the need for full disclosure of all compensation and perquisites received or to be received by company management. In addition, the SEC has initiated an increased number of enforcement actions and investigations which relate to the adequacy of disclosures about executive compensation.

The SEC is expected to propose new rules in the near future to attempt to clarify executive compensation disclosure in proxy statements (and also to clarify when executive compensation changes must be reported on 8-Ks). According to the SEC, the proposed rules will unambiguously confirm that "all means all" when describing compensation. The proposals will likely change the required executive compensation tables and require more user-friendly descriptions of every element of compensation and related party transactions. Totals will need to include all deferred and retirement compensation and change of control payouts. While such proposals are pending, companies should consider complying with these themes in spirit and attempt to fully report all compensation arrangements and totals in a clear manner.

While the SEC has been contemplating rule-making, the "Protection Against Executive Compensation Abuse Act" has been introduced in Congress. This Act would require increased proxy disclosures about executive officers' total compensation and company policies for executives paying back compensation that is paid out despite a company's not having achieved short- or long-term performance targets upon which the compensation was to be based. The bill would also require clear disclosure on company websites regarding compensation and shareholder approval of certain executive compensation plans and severance arrangements.

Further, corporate governance ratings organizations are carefully evaluating executive compensation disclosure and often

recommending withhold votes against compensation committee members if a company's compensation policies and/or disclosure do not rise to the preferred standards of the governance organization. For example, Institutional Shareholder Services generally requires companies to give "tally sheet" disclosure, meaning full-blown descriptions of all monetary, equity and perquisite components of executive compensation for the past year.

- *MD&A generally.* In a December 2003 release that it continues to reference, the SEC provided public companies with interpretive guidance on ways to improve MD&A sections in filings. Among other suggestions, the release recommended more analysis of trends and uncertainties, the use of executive overviews, more captions and tables, increased focus on liquidity, cash flow and capital resources and related risks and the use of sensitivity analyses for critical accounting policies.⁸
- *Accounting issues.* The SEC accounting staff continues to closely examine practices relating to the timing of option pricing, revenue recognition, restructuring charges, pension plans and impairment charges.

Other Proxy Issues and Trends.

- *Majority voting for directors.* Many companies are receiving shareholder proposals to mandate majority voting for directors instead of plurality voting, which is the most widespread system for elections. Companies often fight such proposals, as they can be unworkable when a company does not have a contested election and a nominee does not receive a majority of the votes cast. Some companies are voluntarily adopting (and disclosing) alternative systems or policies even in the absence of shareholder proposals. These alternatives are designed to address the process a company using plurality voting will follow, and the possible remedies the company will pursue, if a nominee receives a majority of "withhold" votes.
- *Other shareholder proposals.* The number of shareholder proposals submitted each year continues to increase and the SEC continues to allow more and more proposals to be included in proxy statements over company objections. Since last proxy season, the SEC has issued further interpretive guidance on issues such as director independence and public health issue shareholder proposals, clarifying how proponents can successfully avoid exclusion from proxy statements. If companies become aware of

shareholder concerns prior to actual submission of a formal proposal, they should consider whether engaging in a dialogue with the shareholders would help lead to a compromise that would avoid inclusion of a proxy item.

- *Disclosure of caps on liability of accountants.* Accounting firms are increasingly demanding in their engagement letters with their clients that clients agree to resolve disputes outside of the court system, such as in arbitration or mediation, and agree to caps on the potential liability of the accountants in the event of a claim by the client. While not clearly mandated by the proxy rules, companies are increasingly disclosing such arrangements to their investors to promote transparency, particularly where shareholders are voting on auditor ratification.
- *Tax rules impacting compensation.* As part of the American Jobs Creation Act of 2004, new Internal Revenue Code Section 409A is impacting the structure of many compensation arrangements, including deferred compensation, employment agreements, severance agreements and equity compensation. Because many of these arrangements are the subject of proxy disclosure, 10-K exhibit filings or shareholder votes, companies should be reviewing their compensation arrangements prior to the preparation of their 10-Ks and proxy statements to ensure compliance with Section 409A and related IRS regulations and guidance.
- *Electronic delivery.* In November, the SEC proposed a system of electronic delivery of proxy statements and annual reports. This system would allow companies to post these documents on their websites and simply notify shareholders of their location and availability, along with whatever state law notice is required. While this system will not be in place for this year's annual meetings, it will likely be adopted in time for next year, affording companies the opportunity to greatly reduce their printing and mailing costs.

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The SEC's rules, stock exchange listing standards and the Sarbanes-Oxley Act continue to emphasize a trend of increased and more transparent disclosure. The SEC has stated that it is not sufficient to merely adhere to technical rules. Disclosure must be complete, understandable and not misleading.

The summary above is meant to describe the major changes affecting upcoming 10-Ks and

proxy statements. To discuss these topics in more detail or other matters relating to annual reporting, please contact your lawyer at Sullivan & Worcester LLP or the lawyer above.

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¹ For last year's summary, see our December 2004 client advisory: "What Public Companies Need to Know About This Year's Annual Reports and Proxy Statements – 2004-05 Edition!," available at www.sandw.com.

² This advisory is not intended to cover all changes that might affect the preparation of financial statements or other financial information.

³ An "accelerated filer" is a public company that at the end of its fiscal year: (1) has a public float (i.e., voting and non-voting common equity not held by affiliates of the company) of \$75 million as of the last day of its most recently completed second fiscal quarter; (2) has been filing periodic reports (e.g., 10-Ks and 10-Qs) under the Securities Exchange Act of 1934 for at least 12 months; (3) has filed at least one annual report; and (4) is not eligible to file 10-K and 10-Q forms applicable to small business issuers.

⁴ See our November 2005 client advisory: "SEC Modernizes Public Offering, Communication and Liability Rules," available at www.sandw.com, for a summary of the SEC's recent reforms to the communications rules and registration and offering processes.

⁵ A company is a WKSI if it is required to file reports under the Securities Exchange Act of 1934 and satisfies the following requirements as of the date on which its status as a WKSI is determined:

- it is eligible to use Form S-3 or Form F-3 (including a condition that the issuer is current and timely in its Exchange Act filings);
- within 60 days of such determination date, the issuer must have either:
 - a worldwide public equity float of at least \$700 million; or
 - issued in the last three years, at least \$1 billion in aggregate principal amount of non-convertible securities, other than common equity, in primary offerings for cash (not exchanges) registered under the Securities Act of 1933; and
- it is not an ineligible issuer, a concept that includes companies that are not current in their Exchange Act filings and companies that are, or during the past three years were, a blank check company, shell company or an issuer of penny stock.

⁶ Foreign private issuers that meet the definition of accelerated filer have to comply with the internal control rules for fiscal years ending after July 15, 2006.

⁷ See our April 2005 client advisory: "New Disclosures About Option Expensing," available at www.sandw.com, for a summary of the SEC's guidance on this topic and the related issue of presenting results that exclude the impact of the option expensing standard.

⁸ See our January 2004 advisory, "SEC Issues Interpretive Guidance on MD&A," available at www.sandw.com.