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Recent Developments In

Federal Securities Regulation

of Corporate Finance

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Recent Developments in Federal Securities Regulation of Corporate Finance

I. Introduction

This outline reviews recent cases, no-action letters, releases and other information promulgated by the Securities and Exchange Commission (the "SEC" or "Commission"), along with actions taken by the major securities exchanges that address many recent and proposed changes to the federal securities laws, the related rules and regulations and the Commission's practices. Among the recent developments covered in this outline are (i) the developing law relating to, and the SEC's treatment of, electronic communications and Internet offerings, (ii) proposed, but now abandoned, fundamental changes to the registration process, (iii) the recent adoption of Regulation M-A and new rules regarding audit committees and auditor independence, (iv) proposed rules clarifying insider trading prohibitions and proposed regulations regarding selective disclosure, (v) revisions to various rules and regulations, including Regulation S and Rule 701, and (vi) other matters, including summaries of the SEC staff's recent Staff Legal Bulletins and Staff Accounting Bulletins.

II. Electronic Communications and Internet Offerings

A. Introduction

Much has been written about the experiences of development stage companies and their efforts (not always successful) to raise capital via the Internet. Start-up companies have been the pioneers in the use of electronic media for capital raising. With novel approaches to the public offering process, a few adventuresome companies have helped focus the attention of the Securities and Exchange Commission ("SEC") and the Wall Street community on the possibilities that electronic media may hold for the capital raising process. Until relatively recently, however, the on-line phenomenon has not had a major impact on the way traditional Wall Street players do business.

Due to a number of factors, most public companies have been slow to change their ways of raising capital in response to the recent and rapid developments in electronic media and communications technology. Practical considerations, including corporate issuers' reliance upon the financial support and advice of established investment banks and their established methods of raising capital, have created natural impediments to the development of a purely electronic offering process devoid of investment banks, traditional road shows and paper-based disclosure. Regulatory constraints, including SEC rules that continue to require the preparation of paper based offering materials and notices under certain circumstances, have also slowed the evolution of an electronic offering marketplace. Nonetheless, the proliferation of Internet brokers and on-line transactions and the gradual reduction of regulatory barriers is beginning to generate significant changes in the way capital is raised in the United States.

B. Direct Public Offerings over the Internet

The information age is not simply changing the way prospectuses are produced and disseminated. The instantaneous worldwide reach of the Internet has caused some issuers to rethink entirely the process of raising capital and to question the need for traditional investment banking services. The Internet's reach allows an issuer to contact and screen potential investors directly and, in the view of some, may eliminate the need for an underwriter or broker dealers. Interestingly, it has been mostly start-up companies, not established public companies, that have tested the waters by offering securities over the Internet directly to investors. In an attempt to gain access to public capital more cheaply and at an earlier stage in the development process, development stage companies have been the most eager to change the paradigm for raising public capital, while established public companies have done little to experiment with electronic media in the capital raising process. In some respects, however, public companies may be better suited to direct, non-underwritten electronic offerings than the small, start-up companies that have brought such attention to electronic offerings -- primarily due to issues regarding market valuation, management credibility and investor liquidity.

The most common criticism leveled at companies that choose to raise capital over the Internet without the assistance of an underwriter is that, in so doing, they are arbitrarily setting the price for their securities without receiving independent, arms length valuation advice from a securities professional. Although some emerging company issuers may engage advisors to assist in the valuation process, for a company in the early stages of development, the valuation may be highly speculative, particularly where no banker has committed its own capital to the offering on a firm commitment basis. Management credibility is also a question for issuers who attempt to raise capital directly from investors. Private start-up companies and their management teams are, more often than not, unknown to the investment community. Without the benefit of due diligence

performed by an independent banker and its counsel, potential investors are often forced to take a leap of faith that the issuer, on its own, has uncovered and addressed all material disclosure issues. Finally, start-up ventures that have raised capital through direct public offerings have been subject to criticism that, following the offering, there is often no market for the stock, leaving the stock price to drift (oftentimes downward) with an insufficient public float and virtually no institutional following to generate sufficient trading activity or investor interest.

A seasoned public company with an established record of earnings and an established market for its stock would appear to be a far better candidate for a direct public offering over the Internet because market valuation, management credibility and investor liquidity are typically less of an issue for investors. Although there is no question that investment banks provide valuable services to their clients in most contexts, one could ask why a seasoned public company with a large public equity float would need the advice and assistance of an investment bank in connection with an equity offering of modest size.

In the real world, however, the benefits and drawbacks of direct electronic offerings are not always so clear cut. Public companies are not necessarily devoid of management credibility issues and do not always enjoy an established trading history, a large public float or a strong earnings history. Early stage companies, though often lacking a financial track record, may enjoy substantial public awareness and management credibility. Given the ease of access to investors and the reduced cost of direct electronic offerings, emerging companies may in many cases be ideal candidates for direct offerings over the Internet. For the reasons discussed above, however, as electronic media evolves and becomes a more accepted form of capital raising, established public companies are likely to represent a growing percentage of the companies accessing capital by direct offerings over the Internet.

1. Public Company Electronic Offering Efforts

Although established public companies have been reluctant to adopt the use of new media, that reluctance is waning as companies are finding more practical uses for electronic media in the offering process. Four primary areas in which electronic media have made inroads are (i) mutual fund on-line offerings, (ii) public company dividend reinvestment and stock purchase plans, (iii) the use of "electronic roadshows" and (iv) the expanding role of the electronic subsyndicate in traditional offerings.

(a) Mutual Fund Offerings

With their historical experience selling directly to investors, mutual funds, not surprisingly, have been the first public entities to make substantial use of electronic media. Not generally dependent on investment bankers or underwriters in connection with the sale of their shares, mutual funds have begun to embrace the Internet as a more efficient and cost-effective means of disseminating offering materials and receiving subscriptions. Many mutual fund groups have established a major presence on the Internet, offering potential investors the opportunity to learn more about fund offerings, firm philosophies and historical performance, to download prospectuses and to place investment orders. According to one source, as of July 1998, 312 funds ran web sites, up from 181 in 1997, and there are expected to be over 600 mutual fund web sites by 2000. Many of the major mutual fund companies' Web sites are linked to Web sites maintained by mutual fund clearing houses that provide information and historical performance data for large groups of mutual funds.

(b) Dividend Reinvestment and Stock Purchase Plans

Based upon one source, as of September 1998, roughly 80% of all U.S. public companies sponsored Web pages, and, in the last couple of years, an increasing number of companies have used their web sites to offer dividend reinvestment and stock purchase plans ("DRSPP"). A DRSPP program allows investors to buy shares of a company directly from the company without a broker, thus avoiding brokerage commissions. Only 86 U.S. companies offered such programs in 1996, compared to 400 companies in 1998, and, as of July 2000, Net Stock Direct provided information with respect to over 1,500 programs. Companies offerings such programs include many of the best known names in corporate America, such as Disney, McDonald's, American Express and Eastman Kodak. Companies such as Net Stock Direct have created web sites which offer an index of companies with either direct stock purchase plans or dividend reinvestment plans, the participating companies' plan summaries, plan materials and enrollment forms. The development of such service providers will certainly increase in light of recent SEC no action letters, as discussed below, which have confirmed that a service provider may operate an Internet bulletin board offering information about DRSPP's without violating Section 5 of the Securities Act of 1933, as amended (the "Securities Act"). Nonetheless, many of the efficiencies offered by the Internet appear to remain largely untapped, as evidenced by the fact that of the 400 plus public companies selling stock directly, as of February 1999, only 40 of the companies provide copies of their prospectuses in electronic format.

(c) Electronic Roadshows

The phenomenon of "electronic roadshows" represents another area of increased use of the Internet by public companies. As discussed in more detail below, various companies such as Bloomberg, Net Roadshow, Inc., Thomson Financial Services, Inc. and Charles Schwab & Co., Inc. have received favorable SEC no action advice allowing the transmission of electronic roadshows for public offerings over the Internet to qualified investors and, in limited circumstances, to retail investors as well, so long as certain specified safeguards are implemented. These services typically involve the posting of actual live or recorded roadshow presentations on a password protected Web site available to pre-screened potential investors. The practice has become an accepted part of the traditional offering process, and, to date, Bloomberg estimates that it has arranged over 400 electronic roadshows. The advent of electronic roadshows and the recent SEC no action advice given to Charles Schwab & Co., Inc. allowing transmission of electronic roadshows to retail investors under certain circumstances represents a significant step toward the democratization of the traditional roadshow process and, more importantly, the liberalization of traditional securities practices to accommodate the efficiencies made available by technology.

(d) The Electronic Subsyndicate

The traditional investment banks, while they have not dramatically changed the way they do business in response to the Internet, have begun to realize the increasing importance and power of on-line investors. The dramatic increase in on-line brokerage business and interest in Internet stocks

The traditional investment banks, while they have not dramatically changed the way they do business in response to the Internet, have begun to realize the increasing importance and power of on-line investors. The dramatic increase in on-line brokerage business and interest in Internet stocks have convinced many Wall Street firms that on-line brokerage houses are an important distribution outlet to the retail market in a public offering. Increasingly, traditional firms are including on-line brokerages such as Wit Capital, e*Trade and DLJdirect as a part of the underwriting group -- a sort of electronic "subsyndicate." More dramatic changes are occurring. As an example, technology banker Bill Hambrecht, the co-founder of Hambrecht & Quist, has formed a start-up investment bank, W.R. Hambrecht & Co., that has underwritten initial public offerings through the Internet, distributed offering documents on-line and incorporated a computer driven auction to sell the underwritten shares. In this cyber-auction, investors bid for shares and a computer sets the price and allocates the shares, with investors who submitted bids above the offering price receiving the full quantity of shares they requested and buyers who bid at the offer price or lower receiving scaled-back allotments. Sources suggest that other firms are pursuing similar strategies, and clearly these developments will have a dramatic impact on how traditional investment banks engage in business.

(e) Slow acceptance of New Media by Public Companies

There are many reasons why electronic offerings have not been more popular with public company issuers:

First, and most importantly, established businesses, unlike start-up ventures, are typically more conservative in their approach to new and emerging concepts that challenge accepted ways of engaging in business. The tendency to wait and observe developments before joining the Internet bandwagon, at least with respect to matters as critical as capital raising, will act as a natural governor on the pace of change.

Second, the pre-eminent investment banks, although they have shown an interest in electronic subsyndicates and have implemented technological advances that allow electronic dissemination of prospectuses, have not dramatically changed the way they do business, in part, no doubt, out of a fear of the impact on their traditional full commission underwriting business and in part because they may perceive the electronic phenomenon merely as a change in the mechanics of prospectus distribution and not as a fundamental change in the way the securities business will be conducted.

Third, SEC rules and guidance in the electronic realm, although intended to encourage the expanded use of new media in the offering process, have not yet completely rationalized existing securities law principles to the Internet and emerging information technologies, with the result that uncertainties and disincentives to change remain.

Finally, public issuers, whether or not they adopt newer technologies for the dissemination of disclosure, are not likely to dispense entirely with the traditional underwriting process because of the important role that the traditional investment banks play in the process. While a small equity offering by a seasoned New York Stock Exchange company could be structured and sold as a direct offering over the Internet without the financial support and advice of an investment bank, more complex transactions involving preferred stock, debentures, secured instruments, convertible securities and other hybrids or derivatives will always require careful analysis and input from professional financial advisors, both with respect to structuring and valuation, and often require direct financial backing from, and intensive and active marketing efforts by, investment bankers.

Without a doubt, the use of electronic media in the offering process by public companies will continue to increase dramatically. As more companies create their own Web sites, it will become increasingly common for issuers to post their prospectuses on the Internet. Over time, as personal computers become even more pervasive and SEC rules evolve, paperless prospectus disclosure may eventually become the accepted norm rather than the exception. As SEC rules governing marketing and "free writing" during the waiting period are liberalized or if more dramatic changes to the federal securities regulatory scheme are adopted that eliminate entirely the regulation of offers and/or prospectus delivery requirements, the securities marketing process may become more streamlined and more accessible by institutional and individual investors alike. If so, issuers and investors may ultimately be allowed to rely entirely on the Internet or other electronic media for the delivery of prospectuses and sales literature. Public issuers may also someday attempt to reduce their costs of raising capital by reducing the role of the investment banker, much like the offering model used by mutual funds. Only as changes in the regulatory framework and the consumer and business acceptance of electronic media evolve, however, will public issuers begin to take full advantage of the substantial cost savings and efficiencies made available by today's emerging technologies.

(f) Internet Securities Fraud

On October 28, 1998, the SEC announced the completion of its first nationwide fraud sweep resulting in 23 enforcement actions against 44 individuals and companies from 10 different cities based on acts of fraud over the Internet and deceiving investors around the world. The acts ranged from fraudulent spams (Internet junk mail) to online newsletters to message board postings and websites. The investigation, uncovering violations of the anti-fraud and anti-touting provisions of the federal securities laws, revealed that more than 235 microcap companies were touted by such means as misrepresentations about the financial condition and business of the companies, misrepresentations or omissions relating to the Internet promoters' lack of disclosure about their own "independence" from the companies and failing to disclose the sources and amount of their compensation paid to the promoters by the companies. According to the SEC, in total, there was more than $6.3 million and nearly two million shares of discounted insider stock and options paid to Internet promoters in exchange for touting services.

On May 14, 1999, the SEC announced another nationwide sweep that resulted in 14 enforcement actions against 26 companies and individuals using the Internet to defraud investors. This sweep targeted the sale of bogus securities. Each enforcement action involved the sale or marketing of securities on the Internet containing outrageous or baseless promises to investors, such as annual returns of up to 100 to 2000 percent.

On November 2, 1999, the SEC announced that it was investigating websites that recommended stock picks without adequately disclosing their trading in the touted stocks. The SEC expressed concern that the sites were being used for "pump and dump" schemes and "scalping."

2. Basic Rules Applicable to Electronic Offerings

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The SEC has issued a number of formal interpretive releases and no-action letters in which it has made clear its desire to encourage the use of electronic media in the capital raising process. In its October 5, 1995 release (the "October Interpretive Release"), the SEC set forth a series of guidelines for issuers desiring to use electronic media for disclosure presentation and dissemination. In two companion releases issued on May 9, 1996, the SEC confirmed the applicability of the guidelines set forth in the October Interpretive Release to broker-dealers, transfer agents and investment advisors and adopted a series of technical amendments to its rules designed to allow electronic issuers flexibility in satisfying certain prospectus formatting requirements (type size, font size and color print requirements, etc.). The SEC's releases in this area are intended to apply to all categories of electronic media that may be used in the offering process, including such media as audio tapes, video tapes, facsimiles, CD-ROM, e-mail, electronic bulletin boards, Internet Web sites and computer networks (including local area networks and on-line services). In the Internet Release, the SEC reiterated its prior policies regarding electronic offerings.

(a) The October 1995 Release; Analogy to Paper-Based Offerings

In the October Interpretive Release, the SEC stated as the premise for its regulatory approach that its rules should be interpreted to permit the use of any and all types of electronic media for dissemination of disclosure so long as investors receive substantially the same disclosure with the electronic media as they would receive with a paper-based disclosure document. In effect, the SEC's position is that the principles of the Securities Act, though adopted long before the electronic age, apply equally well to paper-based disclosure and electronic disclosure, and substantially all guidelines relating to the use of electronic media can be derived by analogy to principles governing paper-based disclosure. In the SEC's words, an electronic prospectus must be "prepared, updated and delivered" in a manner consistent with the Securities Act in the same manner as paper documents. Whether in the form of CD-ROM, video tape, audio tape or a Web posting, all of the disclosure forms mandated by the Securities Act rules, and the specific disclosure requirements of Regulation S-K, must be satisfied in an electronic document, and information should be presented in an electronic prospectus in substantially the same order as required in a paper-based prospectus. As expected, the October Interpretive Release also confirmed that the liability provisions of the federal securities laws -- specifically, Section 10(b) of the Securities Exchange Act of 1934, as amended (the "Exchange Act") and Rule 10b-5 -- apply equally to electronic and paper-based disclosure.

(b) Basic Requirements for Electronic Delivery

Beyond stating the SEC's general analogy to paper-based disclosure, the guidelines in the October Interpretive Release reveal the SEC's overriding concern that, in an electronic offering, the investing public may not receive the same notice of availability of, access to, and actual delivery of, prospectus disclosure as would be expected in an offering in which paper-based disclosure is mailed to investors. In the SEC's view, when an issuer uses an emerging technology such as a CD-ROM or the Internet, intended recipients of the disclosure may not always have the capability to access and use the disclosure, and, therefore, until such media become more universally accepted, a presumption may exist that the use of these technologies by issuers does not result in actual delivery of disclosure. The SEC has, in effect, promulgated a set of guidelines, summarized below, that will allow an electronic issuer to overcome this presumption.

(i) Notice

Any electronic information disseminated to investors must provide timely and adequate notice that information is available. Posting disclosure on a Web site alone will not suffice, absent some independent confirmation that the investor has actually accessed the document. If necessary, an issuer sending a prospectus electronically to a prospective investor may need to consider supplementing the electronic message with a second communication designed to provide notice similar to that provided with a paper notice. The actual delivery of a computer disc, CD-ROM, audio tape, video tape or e-mail message containing disclosure would normally be adequate notice in and of itself, provided that the investor has the requisite hardware to allow access to the disclosure and the issuer has received some form of consent from the investor that delivery of disclosure in such electronic form is acceptable.

(ii) Access

Recipients of disclosure through electronic delivery should have access to disclosure similar to the access one would have to disclosure delivered by mail. In other words, the process of accessing the disclosure through a particular medium (for example, over the Internet) "should not be so burdensome that intended recipients cannot effectively access the information." Any method of electronic delivery must provide the recipient with the opportunity to retain the information or have ongoing access equivalent to personal retention of a paper document -- for example, by allowing the recipient to download and/or print the information.

(iii) Evidence of Delivery

Issuers providing disclosure electronically must have a reason to believe that their means of dissemination will result in actual delivery of disclosure in compliance with the prospectus delivery requirements of the Securities Act. The SEC stated explicitly that this is not an exhaustive list of the methods by which the delivery requirements of the Securities Act can be satisfied. Any method of electronic delivery will suffice that provides "assurance comparable to paper delivery that the required information will be delivered."

If an issuer relies on the consent of recipients to the delivery of disclosure by electronic media, the consent must be an informed consent and the consent must specify the medium or source through which disclosure will be disseminated. If an investor consents to the delivery of disclosure in the form of a CD-ROM, an issuer cannot rely upon that consent for the delivery of disclosure by e-mail, for example. Likewise, if an investor revokes consent to a particular means of electronic delivery, the continued use of that means of delivery by the issuer would not be deemed to provide access to the disclosure, and the delivery requirement would not be satisfied. The SEC has recently confirmed that telephonic consent is permitted within certain parameters.

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(c) Purely Electronic (i.e., Totally Paperless) Capital-Raising Offerings

While endorsing in concept the possibility of a purely electronic public offering, the SEC's interpretations of the Securities Act as applied to electronic media indicate that, for the time being at least, certain paper-based notification, delivery and confirmation of sale requirements will remain, except for with respect certain types of non capital-raising offerings. In the Internet Release, the SEC requested comments on whether paper copies should be required in what would otherwise be electronic-only offerings.

Paper-Based Prospectuses Must Still be Made Available. While the SEC has indicated that an offering may properly be limited entirely to persons who consent to receive a prospectus electronically, if an offering is not so limited, a participating broker-dealer would be required to deliver paper copies of the preliminary prospectus to prospective investors that do not have the requisite hardware to access disclosure. Even if an offering is made only to persons who have consented to the receipt of on-line disclosure, the secondary market prospectus delivery requirements of the Securities Act would mandate that an issuer in an initial public offering make paper copies of its prospectus available for a period of time after the offering to after-market purchasers who may not have on-line access. Likewise, the exchange upon which the issuer's securities are listed will be entitled to request paper copies of the final prospectus.

Written Consent to Electronic Delivery. As noted above, if an investor does not have access to the Internet or, for any reason, withdraws its consent to receive disclosure electronically, an electronic issuer will simply be foreclosed from offering or selling securities to the investor or will be required to deliver a paper copy of the prospectus to that investor.

Paper Notice of Prospectus Delivery may be Required. Because the posting of a final prospectus on the Web would not, in itself, provide notice of the availability of the final prospectus, an issuer undertaking an on-line offering, even if it has received investor consents to the Internet dissemination of the prospectus, must seek to provide investors with actual notice of the availability of the final prospectus. If an investor has not provided an e-mail address to confirm delivery of the notice, the issuer would likely be required to deliver a paper notice by mail or other means.

3. Electronic Prospectuses and Sales Literature

Section 5 of the Securities Act divides the registration process into three time periods: (i) the "pre-filing" period, (ii) the "waiting period" (the period after filing of the registration statement and prior to effectiveness), and (iii) the "post-effective" period. During the pre-filing period, an issuer is prohibited from making any offers of its securities, whether orally, in writing or through any other media. If a statement by an issuer during the pre-filing period has the effect of pre-conditioning the market for the issuer's securities (commonly referred to as "gun jumping"), the SEC may delay the issuer's registration by imposing a cooling off period designed to allow the market to recover from the impact of the premature disclosure. During the waiting period, an issuer may make oral offers, but is prohibited from making any offers in writing except pursuant to the preliminary ("red herring") prospectus filed with the SEC as a part of the registration statement. Accordingly, during the waiting period, no written sales literature or any other written materials may be used to solicit potential investors. During the post effective period, an issuer may make oral and written offers, including the dissemination of written sales literature, so long as any written sales material is accompanied by or preceded by a final prospectus meeting the requirements of Section 10(a) of the Securities Act.

Although these basic securities law principles are relatively clear-cut and have remained unchanged since the adoption of the Securities Act, the advent of new media, including the pervasive use of websites for company advertising, hyperlinks between websites and the growing use of electronic marketing materials, raises a host of new issues, many of which have yet to be fully addressed by the courts or the SEC.

(a) What Constitutes the Prospectus -- Web Sites Generally.

During each stage of the public offering process, there is a risk that information made publicly available about the issuer, including marketing information posted on the issuer's website or links to the issuer's website, may be deemed to constitute offering materials (*i.e.*, a prospectus) disseminated in violation of the provisions of Section 5 of the Securities Act. Regardless of the stage of the offering, if a website maintained by the issuer includes sales and marketing information that has the effect of conditioning the market for the issuer's securities, the website itself may be deemed to be a prospectus. On the other hand, a website that contains only ordinary and customary information about the issuer of the type used in marketing the issuer's products or services to customers or in providing support or feedback to customers (like customary paper-based product or service marketing materials), the issuer should be safe from Section 5 scrutiny. Unfortunately, the line of distinction may not always be clear and there have been no cases to provide guidance. In the Internet Release, the SEC provided further guidance regarding web site content prior to and during a registered offering.

In practice, issuers in registration or anticipating registration should take special care to avoid including marketing related information on their websites that goes beyond customary product or service marketing. An issuer should scrutinize its website postings with the same care that it scrutinizes press releases or other announcements; counsel or other designated disclosure experts should review for accuracy any statements regarding sales, earnings, growth expectations or prospects generally and new information as to such matters should not be added to the website during the pre-filing or waiting periods, or until the offering is complete, without legal review and consideration of potential issues. Ordinary business postings, including marketing materials and customer support information, should be segregated from investor relations disclosure in order to provide a stronger defense in a lawsuit to any argument that marketing materials on the website were directed toward investors or were designed to condition the market for an offering. As discussed below, issuers should take care to avoid links to websites containing investor-sensitive material (such as analysts' reports) that might be deemed endorsed or "adopted" by the issuer.

(b) Web Site Links -- Analysts Reports: The *Presstek* Case

(b) Web Site Links -- Analysts Reports; The *Presstek* Case

Ordinarily, an issuer cannot be held responsible for material misstatements or omissions contained in information disseminated by third parties. With the growing use of the Internet and the ability to link websites, however, it has become more difficult to determine the actual source of disclosure. With today's technology, a company can include on its website (or even within its electronic prospectus) direct links allowing a reader to jump instantaneously to third party websites, and the links could be viewed as an endorsement of, or, at least, a restatement by the company of, the information accessed through the link.

The SEC, in the October Interpretive Release, appears to have endorsed this view at least in theory. The October Interpretive Release states that a Web link providing "direct access" from one website to another "associates" the two Web pages as one electronic document. In one hypothetical included in the October Interpretive Release, the SEC staff suggested, for example, that electronic sales literature posted on a website would be deemed delivered concurrently with a prospectus in compliance with SEC rules if directly hyperlinked to a website containing the prospectus.

The concern regarding responsibility for third party statements is most apparent in the context of securities industry analyst reports. Typically, it is the analysts who provide the only publicly available forward looking information regarding an issuer's earnings expectations, and, in a litigation context, plaintiffs in search of legal recourse have argued that the statements made by analysts can, in certain circumstances, be attributed to the issuer. This is the so-called "entanglement" theory, whereby it may be asserted that the issuer has either selectively disclosed material information to an analyst, which the analyst used in preparing its earnings estimates, or that the issuer somehow endorsed the analyst's earnings estimate by disclosing the estimate to investors or making the estimate available.

The Presstek Case. In 1997, the SEC indicated in an enforcement action against Presstek, Inc. ("Presstek") and certain of its officers that an issuer that disseminates false third party reports may be deemed to have adopted the contents of those reports even if it had no role in the preparation of the report. Presstek's officers disclosed misleading information to financial analysts and disseminated third party analyst reports which they allegedly knew to be false. The SEC noted in its order and findings that an issuer who knows, or is reckless in not knowing, that information it distributes is false or misleading, cannot be insulated from liability even if management was not actively involved in the preparation of that information. In the Presstek enforcement proceeding, the SEC also reiterated the entanglement theory in a case where the issuer reviewed and partially edited an analyst's report.

In the Internet context, particularly in light of the SEC's interpretations expressed in the October Interpretive Release and in the absence of any case law authority, an issuer that includes on its website a direct link to an analyst report faces a significant risk of being found to have endorsed the analyst report. At the opposite extreme, an issuer that avoids any mention of, or endorsement of, analysts' estimates, or simply provides a list of analysts providing coverage, would seem to face less risk on the entanglement issue. In the Internet Release, the SEC set forth a non-exclusive list of factors it would consider relevant with respect to the adoption of information through hyperlinks.

Practical Suggestions. The *Presstek* case is a timely reminder that certain dealings with analysts can lead to liability. It also gives the SEC's endorsement to a new and potentially wide-ranging basis of liability. The case should encourage every public company to reexamine its policies for dealing with analysts. In doing so, a company should consider the following:

- Companies should have an express policy of not commenting on analysts' forecasts. The policy should be affirmatively stated whenever management is engaged in discussions with analysts and should be confirmed in writing to the analyst.
- If a company decides to review analyst draft reports for historical accuracy, in order to prevent the company from adopting the analyst's forecasts, it is important that the company have a corporate policy of not commenting on projections and that it communicate that policy in writing to the analyst, so that the analyst does not assume that the company is also passing on the analyst's projections, and the company has a clear record that it has not done so.
- Companies that distribute analysts' reports, post them on their website or maintain hyperlink connections to them from their own websites should consider suspending that practice. An alternative is to distribute the name and firm affiliation of each analyst known to follow the company, and a telephone number where the analysts' offices can be reached for copies of the research reports.
- Companies that do distribute analysts' reports should label each report with a disclaimer that affirmatively states that the Company does not endorse any analyst's views and that the company's distribution of a report should not be viewed as indicating that the company agreed with the report either as of the date it was first prepared or as of the date it is being distributed. These companies should not limit their distribution to only the most favorable report.
- Companies that distribute reports should periodically have a senior officer review the reports to ensure that they are reasonable. When a report contains information that the company believes is unreasonable, the company must evaluate the pros and cons of ceasing to distribute a single report vs. the extent to which it believes the report is unreasonable.

(c) Underwriter Use of Websites to Confirm IPO Offers

Websites may be used by underwriters to electronically confirm conditional offers in an initial public offering. *See* Wit Capital Corporation, SEC No-Action Letter, 1999 WL 498545 (July 14, 1999). In Wit Capital, the Commission staff concurred in Wit Capital's proposal to seek electronic affirmative re-confirmations over the Internet of investors conditional offers to purchase IPO securities up to 48 hours in advance of a registration statement's effective time.

C. Blue Sky Preemption and Internet Exemption for Non-Covered Securities

The very nature of the Internet is its global reach, and the posting on the Internet of a prospectus or ancillary sales literature therefore raises important questions regarding compliance with state and foreign securities laws. Every state imposes a "Blue Sky" securities regulatory scheme that

requires some form of registration or qualification as a condition to the offer or sale of securities. Although the question of a state's jurisdiction over out-of-state persons who post securities offerings on-line is not yet entirely settled, state securities regulators have taken the position that an offer made over the Internet is subject to state regulation if it is accessible in-state -- a prospect that could require an issuer posting a prospectus on the Internet to register, or obtain an exemption, in all 50 states. As described below, however, certain states have adopted exemptions.

1. Blue Sky Preemption

While the prospect of registering or qualifying an offering in all states may be a significant issue for a development stage issuer, under the National Securities Markets Improvement Act of 1996 (the "NSMIA"), public companies whose securities are listed or approved for listing on the New York Stock Exchange, the American Stock Exchange or admitted or approved for admission and trading on the NASDAQ National Market are exempt from state securities regulation with respect to the issuance of listed securities or any securities that rank equal to or senior to listed securities (as defined in the NSMIA, "covered securities"). Under the NSMIA, no state law, rule or order "requiring, or with respect to, registration or qualification of securities, or registration or qualification of securities transactions, shall directly or indirectly apply" to any "covered security" or to a security that would become a covered security upon completion of the transaction. In short, the NSMIA eliminates entirely the threat of Blue Sky securities regulation for most public companies, and even for initial public offerings of securities that will be traded in the major markets. As a consequence, seasoned public companies and new issuers who qualify for the major markets face no Blue Sky regulatory hurdles or burdens in connection with public offerings of covered securities over the Internet. To the contrary, once federal registration is obtained, an issuer of covered securities may post a prospectus on its website and allow access to potential investors in any state without regard to state securities qualification or regulation.

2. Internet Exemption for Non-Covered Securities

Private companies, as well as public companies whose securities do not qualify for exemption from Blue Sky regulation under the NSMIA, remain subject to regulation in the states. To address concerns expressed by securities industry members that state regulation could discourage Internet use for securities offerings, the Pennsylvania Securities Commission issued an order on August 31, 1995 exempting from state registration requirements securities offerings made on the Internet where: (i) the offer indicates directly or indirectly that the securities are not being offered to persons in Pennsylvania; (ii) an offer is not being made to any person in Pennsylvania by other means; and (iii) no sales of the issuer's securities are made in Pennsylvania as a result of the Internet offer. As a result of the efforts of its Offers and Sales on the Internet Committee, the North American Securities Administrators Association (NASAA) followed Pennsylvania's lead and adopted a resolution in January 1996 which encouraged all states to adopt an Internet exemption similar to Pennsylvania's (the "NASAA Guidelines"). To date, at least thirty-five states have adopted exemptions for Internet offerings similar to the Pennsylvania exemption and the NASAA Guidelines.

D. International Regulation

1. Certain Internet Offerings Not Subject to U.S. Securities Law

On March 23, 1998, the SEC issued an interpretive release, analogous to the NASAA Guidelines, to provide guidance to offshore issuers on how to offer securities over the Internet without requiring registration under United States securities laws. The SEC's release indicates that a website posting that is not directed at United States citizens or residents will not be considered an offer subject to the United States securities laws, and, therefore, will not require registration in the United States, provided that the issuer takes adequate measures to prevent U.S. persons from participating in the offering. An informal safe harbor has been set up for non-U.S. offerors that requires: (1) the display of a prominent disclaimer on the website that states that the offering is not made to U.S. persons and (2) the implementation of procedures that are reasonably designed to prevent sales to U.S. person. United States issuers are required to take more stringent precautions, such as password-type procedures, and all issuers must demonstrate good faith efforts to avoid inadvertent offers and sales to U.S. persons. The SEC release indicates that issuers are not generally responsible if U.S. persons attempt to evade their procedures without the advance knowledge or collusion of the issuer; however, if an issuer discovers that it has sold to U.S. persons, despite its precautions, its procedures may need to be improved.

2. Foreign Regulation of Internet Offerings

Just as the reach of the Internet may give rise to United States securities laws and to United States Blue Sky issues, the posting of a prospectus on the Internet will generate compliance issues under the securities laws of foreign jurisdictions. By way of example, in the United Kingdom, the Public Offers of Securities Regulations 1995 provide that, unless the offer falls within an applicable exemption, any offer of securities must be accompanied by a complying prospectus and must be registered with the appropriate regulatory authorities. Under the Financial Services Act of 1986, any advertisement inviting persons to enter into, or to offer to enter into, an investment agreement (including, presumably, any solicitation of investor interest) must, unless it falls within an applicable exemption, be issued by or approved by a person authorized to engage in the investment business in the United Kingdom. U.K. authorities, like U.S. Blue Sky securities regulators, deem an offer or advertisement to be issued where it is received, and the U.K. regulations would therefore presumably apply to the posting of a prospectus or securities advertisement on the Internet if it is accessible in the United Kingdom. Although the terminology and specific rules vary by jurisdiction, the same basic principles apply in most other foreign jurisdictions that regulate securities offerings.

Securities regulators in foreign jurisdictions are only now beginning to address the novel issues posed by the Internet, and, for now, they have not issued much interpretive guidance, nor have they taken much regulatory action to prosecute persons making offers over the Internet. Although it is too early to tell, it is possible that foreign jurisdictions may adopt the approach proposed by Pennsylvania and NASAA -- offering an exemption for offers over the Internet that, by their terms, are not directed to those jurisdictions, provided that sales in those jurisdictions that are not otherwise exempt do not occur. For example, on February 10, 1999, the Australian Securities and Investment Commission (the "ASIC") released its final policy outlining when it will regulate fund raising activities on the Internet under the Australian Corporations Law. The ASIC Policy Statement 141, "Offers of Securities on the Internet," provides that the ASIC will not seek to regulate Internet offers of securities which can be accessed in Australia if there

is no misconduct, the offer is not targeted at people in Australia, the offer clearly indicates by use of a disclaimer the jurisdictions in which the offer is available and the offer does not have a significant effect on Australian markets or consumers. The ASIC noted that its approach is consistent with that taken by regulators in the United States and the United Kingdom. For the time being, however, securities practitioners should caution clients that the international regulatory treatment of Internet offerings in many jurisdictions remains unclear. In light of the growing acceptance in the United States of the NASAA Guidelines, a pragmatic approach to preserve some basis for exemption from foreign regulatory oversight would be to counsel clients to include in any on-line prospectus, in addition to any legend specifically required, a general legend stating that no offers or sales will be made in any jurisdiction in which the offer and sale of securities is not qualified or is otherwise exempt from regulation.

E. Electronic Roadshow Presentations

During the waiting period, it has become commonplace for issuers and underwriters to engage in a series of "roadshow" presentations to potential investors -- showcasing management and providing video and/or slide presentations regarding the issuer and its business. Because a roadshow presentation is oral and visual and not in writing, it is not deemed to constitute a prospectus under the Securities Act, and, accordingly, a roadshow as traditionally conceived is not deemed to constitute an unlawful waiting period communication. Television and radio broadcasts (which are deemed to be "prospectuses" under Section 2(10)) have been distinguished on the basis that they are broadcast to a mass audience, whereas roadshow presentations are typically targeted at a select group of investors.

With the emergence of the Internet, there has been increasing pressure to allow for the electronic dissemination of road show content, as well as calls to democratize the roadshow process by making management roadshow presentations and slide shows available to more or to all potential investors. From a policy standpoint, it has been argued that it is inherently unfair to the ordinary retail investor to allow sophisticated institutional investors to ask questions and obtain information directly from management while limiting individual investors to the disclosure contained in the prospectus. Indeed, the SEC's Task Force on Disclosure Simplification (the "Disclosure Task Force") suggested in its March 1996 report that the SEC study means of eliminating this "dual track" of unequal disclosure, and the SEC's recent "Aircraft Carrier Proposal" suggests that the SEC proposed to eliminate all prohibitions on offers during the waiting period, which would allow electronic roadshow presentations to be disseminated to all investors. In its most recent no-action letter, Charles Schwab & Co., Inc., the SEC took a considerable step toward eliminating the "dual track" disclosure scheme in the roadshow context by allowing retail investors in certain circumstances to participate in electronic roadshow presentations. The SEC had previously indicated in seven recent no-action letters that electronic roadshows transmitted over the Internet to a limited audience (and with other specific safeguards) would not be deemed to constitute a prospectus and thus would be permitted during the waiting period -- however, the SEC before the Schwab no-action letter had continued to perpetuate a dual track disclosure scheme by limiting access to electronic roadshows to sophisticated institutional investors. The following is a brief summary of the no-action letters laying out the SEC's evolving position with respect to electronic roadshows.

1. Private Financial Network No-Action Letter

In a no action letter issued in March 1997, the SEC addressed directly the question of whether roadshow presentations may be disseminated electronically to persons not actually attending a presentation in person. The advice was requested on behalf of Private Financial Network, a subsidiary of MSNBC (the on-line venture of Microsoft and NBC), which proposed to disseminate video transmissions of roadshow presentations to paying subscribers. As described to the SEC, Private Financial Network would transmit road show presentations only on the following conditions: (1) video transmissions would be available only to Private Financial Network subscribers, who would agree not to videotape, copy or distribute the transmissions; (2) before each transmission, each subscriber would receive a copy of the issuer's filed prospectus; (3) issuers and underwriters would be required to take reasonable steps to ensure that information disclosed in the roadshow is not inconsistent with the filed prospectus; and (4) each roadshow transmission would include reminders of the importance of the filed prospectus and the prohibition against videotaping, copying or further distribution.

In support of its conclusion that its electronic dissemination of roadshow presentations did not constitute a violation of Section 5 of the Securities Act, Private Financial Network argued that the definition of "prospectus" within the Securities Act excludes video communications directed toward a specific and limited audience and, therefore, the electronic dissemination of road show materials as contemplated by Private Financial Network should not be subject to the registration requirements of the Securities Act. The SEC staff concurred with Private Financial Network's position and granted no-action advice on the facts presented.

2. Bloomberg L.P. No-Action Letter.

In a subsequent no-action letter dated October 22, 1997, the SEC granted no-action advice supporting the notion that multimedia presentations broadcast over Bloomberg's subscriber-based service would not constitute a prospectus under Section 2(10) of the Securities Act. Bloomberg indicated that it intended to transmit audio-visual recordings of live road shows over its multimedia system, and it listed several safeguards in its letter to the SEC: (1) the audience would be limited to qualified subscribers of the Bloomberg service that were specifically screened by underwriters to receive transmission of the road show; (2) viewers would be able to interrupt their viewing and view less than the entire road show, if they wish; (3) viewers would also be able to ask questions via Bloomberg e-mail to the Bloomberg representative at the live site; (4) the sponsoring underwriters would determine the entire content of the road show, and recorded roadshows would remain unedited; (5) viewers would have the option of accessing the prospectus via the Bloomberg service and in any event would receive delivery of a paper prospectus unless advance written consent was obtained; and (6) each show would be preceded and concluded with a cautionary statement.

3. Net Roadshow Inc. No-Action Letter; Public Offering Roadshow.

Similarly, in a no-action letter available September 8, 1997, the SEC indicated in no-action advice that an electronic roadshow transmitted over the Internet (rather than over a subscriber based system as described in the Bloomberg letter) to qualified investors would not constitute a "prospectus"

for purposes of Section 2(10) of the Securities Act. As described to the SEC: (1) Net Roadshow would set up a Web site containing the roadshow material; (2) qualified investors who would normally attend a "live" roadshow presentation such as broker-dealers and investment advisors would obtain a special access code from one of the underwriters and access the Internet Web site; (3) Net Roadshow would maintain a log of each person who received the access code; and (4) the code would be changed such that each qualified investor would be allowed to view the road show for a certain issuer for one day only.

Net Roadshow's letter to the SEC indicated that its roadshows presented via the Internet would be the equivalent of a videotape of a live roadshow meeting, including questions and answers. Like the Bloomberg road shows, charts and spoken words would be presented at a similar speed as the live roadshow presentation (similar to a slide show), and an on-screen "button" would be available that would take Internet viewers to the full text of the preliminary prospectus on file with the SEC. Prior to accessing the Internet roadshow, viewers would be required to agree that they would not download or distribute the electronic roadshow presentation. Interestingly, Net Roadshow argued in its letter that Internet roadshows like those it proposed would "level the playing field" by allowing all qualified investors the opportunity to see the roadshow, rather than only a select few money managers and institutions.

4. Net Roadshow II No-Action Letter; Rule 144A/Private Placement Roadshow.

In a subsequent no-action letter issued to Net Roadshow, Inc. ("Net Roadshow II"), available January 30, 1998, the SEC rendered no-action advice which in effect extended the use of electronic media to offerings relying on Rule 144A under the Securities Act. In Net Roadshow II, the SEC concluded that an electronic roadshow transmitted over the Internet on behalf of a seller of securities in connection with a private placement, solely to qualified institutional buyers ("QIBS") within the meaning of Rule 144A(a)(1), was consistent with Rule 144A(d)(1), which requires QIB status for reofferings of 144A securities in order to maintain the private placement exemption. As it had in its previous letters, Net Roadshow argued that it had employed sufficient safeguards to avoid broad dissemination of the roadshow materials. In its response, the SEC conditioned its no action position on Net Roadshow's compliance with specific safeguards, namely that: (1) Net Roadshow would deny access to its web site to non-QIBS; (2) the confidential password assigned to a QIB would be unique to a particular roadshow and would expire no later than the date of termination of the related offering; (3) each seller of securities would be a QIB and would have an adequate basis to believe that each entity assigned a password is a QIB and that the relevant offering would not be subject to registration under the 1933 Act; (4) Net Roadshow would have no knowledge or reason to believe that the seller or any entities assigned a password were not QIBS or that the relevant offering is subject to registration under the 1933 Act; and (5) Net Roadshow could not be an affiliate of any seller or issuer that is the subject of the particular roadshow.

5. CommScan LLC, No-Action Letter; Rule 144A Qualified Institutional Buyers.

In a related no-action letter dated February 3, 1999, the SEC approved the use of CommScan LLC's ("CommScan") Internet web site listing of institutions that have certified to CommScan that they are QIBs (the "QIB List"). The SEC advised CommScan that a seller of securities and any person acting on its behalf may rely on the QIB List as a method of establishing a reasonable belief that a prospective purchaser is a QIB (as required under Rule 144A), provided that the information underlying the inclusion of an entity in the QIB List is as of a date within 16 months preceding the date of the sale of securities in the case of a U.S. Purchaser, and within 18 months preceding such date of the sale for a foreign purchaser.

6. Thomson Financial Services, Inc. No-Action Letter.

In a no-action letter available September 4, 1998, the SEC staff rendered no-action advice similar to its prior letters that Thomson Financial Service, Inc.'s ("TFS") transmission of an issuer's roadshow presentation over either the Internet or its existing private network would not constitute the dissemination of a prospectus under Section 2(10) of the Securities Act. TFS proposed to transmit either taped or live roadshow presentations for public offerings to qualified investors through TFS' Virtual Roadshow service in a manner substantially similar to the electronic roadshow services of Private Financial Network, Bloomberg L.P. and Net Roadshow, Inc. Only institutional parties would have access to the index of roadshow offerings, and only those parties authorized by the lead underwriters would be able to view actual roadshows. Virtual Roadshow's users would be able to view a roadshow for an unlimited number of times for a 24-hour period only. Similar to the other services which had received no-action relief, TFS would present its roadshows in such a way that an electronic viewer would have as similar an experience as possible to a viewer of a live roadshow, and editing would be allowed in very limited circumstances only for misstatements or mistakes.

7. Activate.net Corporation No-Action Letter.

In a no-action letter available September 21, 1999, the SEC staff agreed that it would not recommend enforcement action against Activate.net Corporation's ("Activate") internet transmissions of live and recorded road shows for public securities offerings. Activate's argument was based substantially on the no-action positions taken by the SEC with respect to similar services offered by Thomson Financial Services, Inc., Private Financial Network, Bloomberg L.P. and Net Roadshow, Inc. Similar to the services offered by Thomson Financial and Net Roadshow, Activate's service is designed to limit the audience of viewers solely to the types of investors who would customarily be invited to attend a traditional road show, such as institutional investors, securities firms, trading and sales personnel from participants in an offering and research analysts. Similarly, Activate restricts access to the road shows through the use of passwords given out by the managing underwriter. A password allows viewing a live road show an unlimited number of times for a 24 hour period, and limits viewing a recorded road show to a 24 hour period. Once the registration statement is declared effective and the distribution for any offering commences, the road show is closed. In addition, the road show may not be copied, downloaded or redistributed, although printing and downloading prospectuses may be allowed. Activate added that it is not affiliated with any broker-dealer, and that its compensation will not be tied to the size or success of an offering. Finally, Activate stated that what distinguishes its road show service from prior no-action letter services is that Activate will use text-based streaming technology to permit authorized viewers to electronically transmit questions during a live road show. Activate argued that because this technology will facilitate greater communication by and among the issuer, the managing underwriters and authorized viewers, this feature should be viewed by the SEC staff as an advancement over current electronic road show practices.

issuer, the managing underwriters and authorized viewers, this feature should be viewed by the SEC staff as an advancement over current electronic road show practices.

8. Charles Schwab & Co., Inc. No-Action Letter.

In its most recent no-action letter, the SEC took certain steps towards reducing the "dual-track" disclosure scheme which had been perpetuated by the SEC's previous no-action advice limiting access to electronic roadshows to sophisticated institutional investors (see Thomson Financial Services, Inc., Net Roadshow, Inc., and Activate.net Corporation no-action letters discussed above). In a no-action letter available November 15, 1999, the SEC staff advised that it would not recommend enforcement action if Charles Schwab & Co., Inc. ("Schwab") transmits roadshows over the internet to the limited audience of Schwab retail customers, independent investment advisers and specified eligible customers of such advisers. Schwab argued that based on the previous line of no-action advice of the SEC that had limited access to electronic roadshows to sophisticated institutional investors, retail investors represented the only class of participants in public offerings that are discriminated against by being excluded from road shows. Schwab argued that road show information should not be reserved for a select few, but should be more broadly available to investors who are considering participation in a given offering, regardless of their individual size or market power. In its no-action request, Schwab proposed making road shows available to retail investors only (a) through its public offering website, which is available only to accounts that qualify at the Schwab Signature Services Gold level (or above) and which is password protected, and (b) to independent registered investment advisers, or advisers exempt from registration, and certain clients of these independent investment advisers whose access to the internet presentation would also be password protected. Schwab proposed to follow certain specified guidelines similar to the procedural safeguards adopted by Private Financial Network, Bloomberg and Net Roadshow under prior no-action precedent relating to electronic roadshows, except that Schwab would permit its qualified retail investors, not just sophisticated institutions, to participate.

The SEC staff in granting no-action treatment emphasized that its position is limited to registered initial public offerings underwritten on a firm commitment basis in which Schwab is a member of the underwriting syndicate or selling group. In that context, the staff noted that Schwab would be responsible as a Securities Act seller with respect to the content of each roadshow that it transmits, regardless of whether another broker-dealer participating in the distribution or the issuer is primarily responsible for the roadshow content. Finally, the no-action letter indicated that the staff did not address the issue of whether Internet-based or other electronic communications should be treated as "written" or "oral" for purposes of Securities Act regulations. The SEC staff stated that its position rested on policy considerations alone, including the SEC's goal of reducing selective disclosure of material typically provided during roadshows.

9. Schwab Letter Updated

On February 9, 2000, the Division issued a further clarification of the original Schwab letter. It stated that the November 15, 1999 letter applied only where: (1) material information, such as earning projections, intended to be included in another presentation of the roadshow is not excluded; (2) only one version of the roadshow is used for electronic transmission; and (3) the roadshow is consistent with the content of the statutory prospectus.

The SEC is in a difficult position. It wants to accommodate innovation and Internet roadshows offer the potential to save money and provide information to a broader audience. On the other hand, the staff is confronted with a statute that deems every "writing," and every radio and television broadcast, as a potentially illegal prospectus. They are worried that the more widespread the dissemination of the video roadshow, the more like a broadcast it becomes. Yet, a widespread dissemination of a roadshow, ultimately to retail customers, would address selective disclosure issues. Selective disclosure will only get worse, in the staff's mind, if retail customers are allowed to see an Internet roadshow, but not the same roadshow shown to institutional investors. Their worst fear is that institutional shareholders will see a Wall Street version of a roadshow while a retail customer sees a Hollywood version.

The second Chas. Schwab letter was an attempt to address this fear. Until this SEC staff fear is overcome it will slow down the eventual and inevitable progress to open roadshows for all investors.

10. Current SEC Position on Electronic Roadshows as Prospectuses.

For the time being, the Bloomberg L.P., Net Roadshow, Inc., Private Financial Network, Thomson Financial Services, Inc., Activate.net Corporation and Schwab no-action letters will stand for the proposition that roadshow presentations may be disseminated electronically, including over the Internet, and even in a private placement, to selected recipients, provided that adequate safeguards are implemented. Although the no-action letters provide valuable guidance, they leave open for further refinement two key issues. First, what constitutes roadshow content? A videotape of a traditional roadshow presentation before a live audience of institutional investors clearly falls within the type of presentation that the SEC would consider permissible under the no-action letters. What if there is no live audience, or if the presentation consists simply of the reading of a prepared text with no question and answer session? The SEC staff has expressed concern about the possibility that issuers may stretch the meaning of the term "roadshow" by eliminating any live element and substituting pre-recorded marketing presentations or by editing video or audio tapes before retransmission. In the SEC's view, although the no-action letters do not address the point directly, the no-action advice was intended to apply to a traditional "roadshow-like" presentation by management to investors, and to the extent that an issuer eliminates too many attributes of a live traditional presentation -- for example, by eliminating the audience and/or by editing the presentations beyond what is necessary to correct errors or misstatements-- the no-action advice may not apply. In practice, issuers and underwriters will continue to test the limits until the SEC provides more definitive guidance.

Second, even after the Schwab no-action letter, it appears that the SEC's position depends in part on the limitation of access to "qualified" (albeit, sometimes retail) investors. In the Schwab no action request, it was emphasized that only retail investors who qualified for Schwab's Signature Gold Services Gold account (persons with $500,000 in household investment positions or who executed at least 24 trades per year) would be given access to electronic roadshows. Although the SEC gives no guidance in the no-action letters as to precisely what criteria should be applied to screen out

"non-qualified" investors, the staff's position appears to endorse some screening process in an effort to limit roadshow disclosure to sophisticated persons. In short, although the Schwab letter represents a major step in the democratization of the road show process, the no-action letters at a fundamental level still seem to perpetuate the dual track disclosure scheme that was criticized by the Disclosure Task Force, while leaving the door open to issuers and underwriters to test the limits of the staff's position pending more definitive guidance. In the future, if the advice of the Disclosure Task Force is followed, the SEC may be forced to address the dual track disclosure issue more directly. On the other hand, to the extent that certain elements of the Aircraft Carrier Proposal are implemented, including the free-writing concepts, the SEC may ultimately abandon the regulation of "offers," as opposed to "sales," of securities during the waiting period, in which event, roadshow materials may be disseminated freely to all investors and the policy of dual track disclosure may be eliminated altogether.

F. Electronic Sales Literature Used in the Post-Effective Period

During the post effective period, an issuer is permitted to disseminate written sales literature to prospective investors, so long as such material is accompanied by, or preceded by, a final prospectus. In the electronic context, this means that an issuer may include electronic sales literature on its website during the post-effective period, provided that certain safeguards are satisfied. In the October Interpretive Release, the SEC stated in a series of hypotheticals that including sales literature on a website is permitted if the sales literature is in close proximity to, or directly linked to, a final prospectus. For example, sales literature that appears on the same website as a final prospectus is acceptable, so long as both can be accessed from the same menu and are in close proximity to one another on the menu. Sales literature that is placed separately on a website or an electronic bulletin is acceptable if the sales literature contains a direct hyperlink to the issuer's final prospectus. In short, in the SEC's view, electronic sales literature will be deemed "accompanied by, or preceded by" a final prospectus so long as there exists close proximity or a direct link that would enable the final prospectus "to be viewed directly as if [the prospectus] were packaged in the same envelope as the sales literature."

G. Tombstone Advertisements

Rule 134 under the Securities Act permits an issuer, during the waiting period and/or after effectiveness, to publish a written advertisement (or "tombstone") announcing a public offering, provided that the advertisement includes only limited information about the offering (principally, the identity of the issuer, the securities to be offered and the persons from whom a prospectus may be obtained). In the October Interpretive Release, the SEC confirmed that a tombstone advertisement that otherwise complies with Rule 134 may be posted on an issuer's website. The October Interpretive Release also permits an issuer to include in its tombstone advertisement a website location at which prospective investors can access and download an electronic prospectus.

H. Video, Graphics and CD-ROM Disclosure

The October Interpretive Release confirmed that an issuer may include graphics, video and audio information within an electronic prospectus. Graphic demonstrations of business systems or product distribution channels, for example, may be included in a prospectus posted on a website. Video displays of manufacturing, warehouse or retail facilities may be included in a video-based prospectus or on a CD-ROM. The development of Internet technologies may someday allow issuers to prepare electronic disclosure that provides investors with a much clearer understanding of a business's operations and components through the use of video, sound and graphics than is possible with a conventional paper-based prospectus.

To the extent that an issuer uses both an electronic prospectus and a paper prospectus and is unable to include an element of its electronic prospectus (for example, a video clip) in its paper-based prospectus, the accepted view had been that the issuer must endeavor to include equivalent disclosure in both prospectuses -- which would require that the excluded portion of the electronic prospectus be summarized in narrative form and included in the paper version. Taking the contrary view, in its May Technical Release, the SEC expressly acknowledged that where electronic disclosure cannot be reproduced on paper, the issuer is not required to prepare a narrative summary of the electronic disclosure in order to achieve equivalent disclosure in the paper and electronic versions of its prospectus. Nonetheless, the SEC made clear that, whenever more than one version of a prospectus is made available to investors, "each version must contain all information required by, and otherwise comply with, the requirements of the applicable form and other provisions of the federal securities laws." The burden is on the issuer to ensure that each version of the prospectus meets the requirements of the Securities Act, and the issuer must satisfy itself that any information omitted from the paper version does not constitute a material omission.

As helpful as the SEC's guidance has been on these issues, the SEC's EDGAR rules continue to require that any video, audio and graphic presentations that cannot be filed on the EDGAR system must be summarized in narrative form. Notwithstanding the SEC's stated desire to encourage the use of electronic disclosure, the requirement to summarize electronic data on EDGAR may create a disincentive for issuers to develop creative new uses for electronic media in the capital raising process. In response to requests from practitioners that it modify its EDGAR rules to allow filings of electronic documents in formats that are not compatible with EDGAR, the SEC on May 17, 1999 released amendments to the EDGAR rules to permit filings in HyperText Markup Language (HTML). The revised EDGAR format (nicknamed "EDGAR II") went live on May 24, 1999 when the SEC began accepting filings in HTML format; and the SEC is currently evaluating the possibility of requiring that all filings be made in the future using HTML. During the implementation phase, however, the SEC limited the use of some of the more user friendly features available in HTML format pending further evaluation. For example, the SEC did not accept graphic or image files in HTML documents and did not permit filings to include hypertext links to external documents. The SEC has recently adopted final rules expanding the EDGAR system to accept and display such graphic files and to provide hypertext links to documents previously filed on EDGAR. EDGAR II is not able to accommodate multimedia materials, such as videos, CD-ROMs, streamed video or audio files that can be played over the Internet, and, to the extent that multimedia disclosure is not compatible with EDGAR II, a written transcript of the disclosure would have to be filed. The new rules providing further modernization of EDGAR do not provide for the inclusion of these multimedia materials on EDGAR. Some of the issues considered by the SEC with respect to new media include, as discussed in the release proposing the rule changes: security; development and maintenance costs of the system; the size of data files submitted by filers and the costs of database storage; how these materials should be disseminated to the public; whether investors would have as ready access to these materials as to the current electronic filings; how to meet archival requirements for storage of electronic documents; wide divergence in industry standards for multimedia formats; how to assure that filed documents continue to be readable in the future.

documents; wide divergence in industry standards for multimedia formats; how to assure that filed documents continue to be readable in the future, since applications that can present these media may change or even disappear over time.

I. Private Placements on the Internet

1. Private Placements Generally

A private placement is a difficult concept to fit within the structure of the Internet. A principal requirement of limited offering exemptions under both federal and state law is the absence of any general solicitation or general advertising. Although general solicitation is a substantial limitation on offerings and has been criticized on both legal and policy grounds -- particularly because it may serve to impede the efforts of small business capital formation -- the SEC has, in the past, steadfastly upheld and followed the prohibition. An offering undertaken by means of posting a prospectus or solicitation materials on the World Wide Web would certainly involve a general solicitation or general advertisement, unless some restrictive access measures were implemented to allow access only to permitted offerees. Absent legislative revision or SEC and state exemptive action or interpretive relief, an offering via the Internet, therefore, would likely violate the manner of offering limitations included in Regulation D and most state limited offering exemptions, as well as case law interpretations of the private placement exemption available under Section 4(2) of the Securities Act.

IPONET No-Action Letter. In July 1996, the SEC issued a no-action letter to IPONET in which it approved of a procedure for private placements to accredited investors over the Internet. Most significantly, the SEC found that the posting of a notice of a private offering in a password protected page of IPONET's website, accessible only to IPONET members who have previously qualified as accredited investors, would not constitute a general solicitation or advertisement within the meaning of Section 502(c) of Regulation D. In reaching its conclusion, the SEC relied upon the following representations from IPONET:

(1) IPONET would solicit individuals who meet the accredited investor or sophisticated investor standards of Regulation D to register as IPONET members; and the solicitation would be independent of, and would not be linked to, any pending or proposed private offering.

(2) Only persons who qualify as accredited or sophisticated investors would become IPONET members with access to the password-protected section of IPONET containing private offering materials.

(3) A period of time would elapse between member registration and participation in any private offering, and IPONET members would not be permitted to invest in private offerings that were posted on IPONET before they registered as accredited or sophisticated investors.

(4) Each issuer desiring to list a private offering with IPONET would be required to covenant to issue securities only in compliance with Regulation D.

The SEC found support for its position in a prior no-action letter, H.B. Shaine Co., Inc., in which the SEC staff indicated that a distribution of questionnaires to pre-qualify prospective accredited and sophisticated investors to participate in private offerings would not constitute a "general solicitation" provided that (i) the questionnaire is generic (with no reference to any particular offering) and (ii) a sufficient period of time elapses between the completion of the questionnaire and the commencement of any private offering to the pre-qualified investors. In the SEC's view, the only distinction between the IPONET investor pre-qualification procedure and the H.B. Shaine & Co. procedure was the media used to pre-qualify investors and disseminate offering materials -- a distinction that the SEC has stated should have no bearing on the question of the legality of an offering.

Lamp Technologies, Inc. No-Action Letter. The SEC subsequently confirmed its position through two no-action letters issued to Lamp Technologies, Inc. The SEC stated that Lamp Technologies' posting of private fund information on its website would not constitute general solicitation or advertising within the meaning of Section 502(c) of Regulation D nor would it constitute a public offering of securities by the investment funds listed on its website within the meaning of Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act. Lamp Technologies proposed to use several safeguards, including password protection, limiting access to its website to accredited investors and limiting the information posted on its website to information related to the private funds. The SEC indicated in its May 1998 no-action letter that Lamp Technologies need not require a subscription fee nor limit access to its website to "qualified eligible participants" as defined in Rule 4.7 of the Commodity Exchange Act to obtain no-action relief.

The Lamp Technologies, Inc. and IPONET no-action letters, by providing guidance with respect to the "no general solicitation" requirement, may allow electronic media to serve as a useful adjunct to a more conventional private placement, allowing the issuer and/or its investment banker to rely on Regulation D while achieving relatively broad dissemination of offering materials to pre-qualified individuals. For public issuers, as noted earlier, another historic barrier to Internet offerings, state Blue Sky regulation, has been eliminated for most "covered securities" as a result of the adoption of the NSMIA. With the position of the SEC in the IPONET letter and the pre-emption of blue sky regulatory authority provided by the NSMIA, public issuers may now find in some circumstances that private offerings over the Internet represent a viable alternative to a registered public offering. However, the SEC continues to express concern over certain practices that would constitute general solicitation in connection with a private placement.

2. Use of the Internet for Rule 144A

As noted above, the Commission staff has extended this approach to Rule 144A offerings in the Net Roadshow II no-action letter (available January 30, 1998), discussed above. In addition, the SEC stated in a response letter to CommScan LLC dated February 3, 1999 that sellers may rely upon CommScan's publication on its website of a list of institutions that have certified to CommScan that they are qualified institutional buyers as defined in Rule 144A(a)(1). CommScan would compile its list based upon responses to questionnaires that conform to the requirements of certification in Rule 144A(d)(1)(iv).

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J. Dividend Reinvestment and Stock Purchase Plans ("DRSPP") Bulletin Boards

In a no-action letter dated November 10, 1997, the SEC indicated that a service provider that is unaffiliated with issuers may operate an Internet bulletin board which makes available information about DRSPPs without violating Section 5 of the Securities Act. Prodigy Services Corporation's wholly-owned subsidiary, Electronic Wall Street, Inc. ("EWSI"), proposed to operate an Internet information service that would make available information regarding registered and unregistered DRSPPs. The site would allow members to download DRSPP materials, submit enrollments to administrators and transmit payments for DRSPP purchases. EWSI would not contact the issuers whose securities are the subject of unregistered DRSPPs. Instead, EWSI would contact and execute contracts with DRSPP administrators. The SEC concluded that EWSI would not be treated as an underwriter so long as EWSI's fees do not come from the issuers.

In addition, in a no-action letter dated March 26, 1998, the SEC indicated that a company may provide investors with online access to certain DRSPP prospectuses and allow investors to transact purchase and sale orders directly with bank transfer agents without registering as a broker-dealer. StockPower Inc. proposed to work with issuers who planned to register DRSPPs with shares that could be purchased directly by investors. StockPower Inc. would supply the software to be downloaded by the investor at the DRSPP website that would enable the investors to purchase and sell shares online through a bank transfer agent. In reaching its conclusion, the SEC noted that: (1) StockPower would not receive any compensation related to investors orders or securities transactions effected using the StockPower software; and (2) StockPower would not recommend or endorse specific securities or describe the merits of any particular style or method of investing to induce investors to purchase or sell a particular security. Similarly, in a no action letter dated July 13, 1998, the SEC confirmed that the companies which would use StockPower Inc.'s software would not be required to register as broker-dealers.

K. On-line Trading Sponsored by Issuers

1. Issuer Bulletin Boards

"Issuer bulletin boards" are Internet-based electronic bulletin boards that provide stockholders with the ability to converse electronically with others regarding their interest in buying or selling securities of the issuer sponsoring the bulletin board. Generally on-line trading facilities that are not sponsored by broker-dealers or SROs have been sponsored by issuers of the securities. The SEC has responded to several no-action requests by issuers that proposed to operate such bulletin boards seeking advice from the SEC that operating the bulletin boards does not require registration as a broker-dealer or an exchange. Thus far, the SEC has granted no-action advice with respect to those issuer bulletin boards that provide a forum for information about prospective buyers and sellers but do not actually process transactions or accept funds. Instead, the parties contact each other directly to conduct the transactions. The SEC has noted with approval the issuers' agreements to retain records of transactions arranged through the bulletin boards. In the Internet Release, the SEC requested comments regarding internet discussion forums.

2. Spring Street's "Wit-Trade"

The first Internet-based initial public offering was accomplished in 1995 by Spring Street Brewing Company, which raised $1.6 million. Spring Street's shares thereafter were not traded on any established market and the company created an electronic Internet bulletin board ("Wit-Trade") to establish a trading outlet for its securities. The SEC issued an advisory letter with respect to the operations of Wit-Trade, in which it made several suggestions. First, the SEC suggested that Spring Street eliminate the control it has over the funds provided by investors by using an independent agent such as a bank or escrow agent to receive the checks from investors. The SEC next suggested that Spring Street inform investors about the risks inherent in investing in illiquid securities, including a note that these shares are not traded on any major market. Third, Spring Street was advised to also inform investors that by posting simultaneous quotations on both the Buyer and Seller Bulletin Boards, they may be considered a "dealer" under the broker-dealer requirements of the federal securities laws. Finally, the SEC advised Spring Street that it should include on Wit-Trade a recent history of transactions in the company's stock such as the price and number of shares recently sold through the system.

L. Electronic Media May Give Rise to Expanded Liability

The offering of securities by an issuer directly to investors over the Internet may give rise to securities liabilities that the issuer might not otherwise face in a traditional underwritten offering.

1. Section 12(2) Privity Requirement

Section 12(2) of the Securities Act prohibits materially false or misleading oral or written statements in connection with any solicitation to sell securities. Unlike Section 11 of the Securities Act, Section 12(2) liability is not limited to misleading statements or omissions contained in the prospectus, but extends to any sales or marketing materials used in connection with the offering, and, in an electronic offering context, could extend to sales materials and other information linked to or otherwise associated with a prospectus posted on the Internet. In a traditional underwritten offering, a number of cases have held that an issuer cannot be found liable to an investor under Section 12(2) for misleading statements or omissions contained in the prospectus or marketing materials where the investor purchases from the underwriter and lacks privity with the issuer.

In a direct offering to investors over the Internet without the assistance of an underwriter, however, the issuer makes sales directly to investors, and the privity requirement for causes of action under Section 12(2) would be satisfied. As a result, an issuer in a direct Internet offering may face liability under Section 12(2) that would not otherwise apply, both with respect to misstatements and omissions in the prospectus as well as any ancillary sales literature linked to or otherwise associated with the electronic prospectus. Liability under Section 12(2), however, could only arise pursuant to a public offering

ancillary sales literature linked to or otherwise associated with the electronic prospectus. Liability under Section 12(2), however, could only arise pursuant to a public offering.

2. Reliance on Electronic Disclosure in After-Market Trading

More generally, the posting of a prospectus on the Internet may raise the specter of expanded liability to persons who acquire securities in the market following completion of the public offering. Again, in a traditional offering context, an issuer has no privity with subsequent market purchasers and, under traditional securities law principles, should not face liability for investment decisions made by such purchasers in reliance on information contained in a Securities Act prospectus after completion of the distribution. Among other things, in addition to the lack of privity, the purchaser would face the burden of proving actual reliance on the prospectus and would be required to overcome defense arguments that prospectus disclosure is time sensitive and becomes stale at some point following completion of the prospectus delivery period. With the posting of a prospectus on the issuer's website, however, the issuer may face a heightened risk that purchasers in the market may access, and rely upon, the prospectus even after completion of the prospectus delivery period. The mere availability of a prospectus on the issuer's website following completion of an offering may both bolster a plaintiff's reliance argument and imply the issuer's ongoing endorsement of the prospectus disclosure. Accordingly, issuers should delete electronic prospectuses from their websites following expiration of the post-closing prospectus delivery requirements of the Securities Act. Other information contained in the issuer's website outside of the prospectus, to the extent that it contains information that may be deemed to be directed toward investors, may increase an issuer's exposure if not properly monitored.

3. Duty to Update

The posting of information about a company on the Internet raises concerns generally regarding whether a public company has an affirmative duty to update its website. In recent years, it has become common for public companies to include vast amounts of information on their websites, including product descriptions, product release dates, growth strategies and stock trading histories. As that information goes stale over time, there is a concern that its continual broadcast over the Internet may give rise to a special duty to update.

Under generally accepted interpretations of federal securities laws, there is currently no affirmative duty on the part of an issuer to update prior disclosure that becomes stale or out of date. The exceptions to this rule are generally limited to circumstances in which (i) a prior statement was false or misleading when made or (ii) the issuer has a special disclosure obligation imposed as a result of its offering of shares or trading in its shares or by virtue of a specifically mandated filing obligation (for example a Current Report on Form 8-K).

However, some commentators have expressed a belief that *Weiner v. The Quaker Oats Company* changes the landscape with respect to the disclosure of merger negotiations. In *Quaker Oats*, plaintiffs claimed that during negotiations for the acquisition of Snapple, the senior management of Quaker knew the company's debt to total capitalization ratio would likely far exceed its publicly stated forecast target, and therefore, the company had a duty to update such disclosure. The court agreed, but carefully explained that, in this case, the *merger negotiations* themselves need not have been disclosed. Instead, Quaker could have communicated the anticipated rise in the ratio in a manner that did not alert investors to the potential acquisition. The court pointed out that the year before, the company had predicted a rise in the debt to total capitalization ratio without discussing acquisitions, even though it ultimately acquired four businesses based, in part, on the increased debt.

As it is sometimes described, a public company is only required to make available to the public a series of snapshots of its business, not a real-time motion picture. The phenomenon of the Internet may challenge these accepted principles, however. A public issuer posting information on a website is constantly broadcasting that information to the world, and, some may argue, is continuously endorsing each item of disclosure on its site. In some respects, disclosure on the Internet is more like a motion picture than a snap shot.

The courts and the SEC have not yet directly addressed these issues in the context of the Internet, and the better argument would appear to be that the existing rules should continue to apply. The prospect of having to continually update all factual statements on a website would be a tremendous burden for a public company, and could have the effect of discouraging the use of the Internet for public disclosure. In the October Interpretive Release, the SEC stated that electronic documents must be "prepared, updated and delivered consistent with the provisions of federal securities laws in the same manner as paper documents," which should mean that existing concepts of disclosure will be extended to Internet disclosure. Nonetheless, until more direct guidance is given, issuers should take special care with respect to these issues. At a minimum, factual statements regarding a company's business, products and plans should include a notation identifying the date of the information, and, in some cases, a legend affirmatively disclaiming any duty to update. Issuers should periodically, and with some frequency, "scrub" their websites of outdated and incorrect information or archive such information in a separate section of their website.

M. The New SEC Internet Release

The growing popularity of the Internet as a means of communication for issuers, market intermediaries and investors has prompted the SEC to recently issue the Internet Release, providing further guidance on the use of electronic media in three areas: (1) electronic delivery of corporate communications; (2) website content; and (3) online offerings. The Internet Release expands upon and clarifies interpretations articulated in previous releases addressing the use of electronic media under the federal securities laws. The Internet Release also requests comment on certain issues to assist the SEC in determining whether, as technology evolves, future regulatory action may be required with respect to those issues.

1. Summary of Interpretive Guidance

- Compliance with delivery requirements using electronic means will continue to be assessed in light of the framework set forth in the SEC's previous releases on the subject, which established the concepts of notice, access and evidence of delivery as the standards against which compliance should be measured. The Internet Release clarifies, among other things, issues regarding investor consent to electronic delivery and the circumstances under which information posted on an issuer's website will be considered part of its

electronic delivery and the circumstances under which information posted on an issuer's website will be considered part of its prospectus.

- The federal securities laws apply in the same manner to the content of an issuer's website as to any other communications. Where an issuer hyperlinks to information on a third-party website, liability may arise if the issuer has "adopted" or endorsed the information. The Internet Release establishes a non-exclusive list of factors that the SEC considers relevant in determining whether an issuer has adopted hyperlinked information. These factors are (1) the context of the information, (2) the risk of investor confusion and (3) the presentation of the hyperlinked information.

- Information posted on the website of an issuer in registration is subject to the same restrictions as other types of communications under Section 5 of the Securities Act of 1933. Ordinary business communications, such as advertisements, reports required under the federal securities laws, proxy statements, annual reports and dividend notices, press releases about business and financial developments, answers to telephone inquiries about business matters from securities and financial analysts, shareholders and participants in the communications field having a legitimate interest in the issuer's affairs and shareholder meetings continue to be permitted.

- Procedures governing registered online offerings will continue to be examined in the review process and future regulatory action is possible. Online private offerings under Regulation D may not involve general solicitation or advertising. In addition, website operators involved with even an exempt securities offering must consider whether they need to register as broker-dealers under Section 15 of the Exchange Act.

2. Electronic Delivery

The October Interpretive Release guidelines established that information distributed electronically satisfies the delivery or transmission requirements of the federal securities laws if the distribution results in delivery of information substantially equivalent to what the intended recipients would have received in paper form.

In the Internet Release, the SEC states that issuers and market intermediaries should continue to assess their compliance with the delivery requirements of the federal securities laws in light of the notice, access and delivery considerations established in the October Interpretive Release. The SEC believes that these guidelines continue to work well in the context of current technology.

(a) Telephonic Consent

The SEC clarifies in the Internet Release that telephonic consent to electronic delivery of issuer communications is permitted within certain parameters. In its October Interpretive Release, the SEC indicated that one means of securing evidence of electronic delivery is to obtain an investor's informed consent to receive information through a particular electronic medium. The October Interpretive Release further indicated that a consent is considered informed where the investor is told that a document will be delivered through a particular electronic medium and that there may be costs associated with delivery, such as the cost of online time, and where the investor is informed of the duration of, and types of documents covered by, the consent. The SEC indicated in its October Interpretive Release that informed consent can be obtained by written or electronic means.

The Internet Release clarifies that an issuer or market intermediary may also obtain consent telephonically as long as a record of the consent is retained. The record should provide the same level of detail as a written consent, meaning that it should specify the medium of electronic delivery and indicate whether the consent is "global." A global consent applies to all documents of any issuer in which an investor owns or buys stock through a broker-dealer or other intermediary. As with any written or electronic consent, a telephonic consent also must be obtained in a manner that assures its authenticity. This would occur where an investor is well-known to the broker seeking the consent or the investor consents using an automated system accessed with a PIN number.

(b) Global Consent

The Internet Release clarifies that investors may give global consent to the electronic delivery of all documents of any issuer, so long as that consent is informed. Because of the breadth of a global consent, the SEC notes that it is particularly important that the consent identify the types of electronic media to be used. While this information need not be given on an issuer by issuer basis, investors cannot be required to accept delivery by additional media at a later date without additional consent. Investors also should be advised of their right to revoke a global consent at any time and to receive all documents covered by the consent in paper form. Intermediaries may require revocation on an "all-or-none" basis if this policy is disclosed at the time the investor's consent is obtained.

The SEC also provides guidance to intermediaries and to issuers that may rely on consents obtained by others. While an issuer or broker-dealer can rely on consents obtained by a third-party document delivery service, the issuer or broker-dealer bears ultimate responsibility for ensuring that the consent is authentic and that all required documents are delivered.

The Internet Release cautions intermediaries to ensure that investors understand the global nature of the consent. A consent included as one provision in an agreement that an investor must sign to obtain other services might not fully inform the investor. According to the SEC, to best inform investors, broker-dealers should obtain the consent of a new customer through an account-opening agreement with a separate electronic delivery authorization or through an entirely separate document. The SEC expressly states that, *except in the case of brokerage firms doing business exclusively online*, if the opening of a brokerage account is conditioned upon an investor providing global consent, the consent would not be considered informed and evidence of delivery would not be established.

(c) Use of Portable Document Format

(c) Use of Portable Document Format

The Internet Release confirms that Portable Document Format ("PDF") may be used to deliver documents if it is not so burdensome as to prevent access. In practice, this means that issuers and intermediaries may use PDF to deliver documents to investors provided that they: (1) inform investors of the requirements for downloading PDF at the time of obtaining consent to electronic delivery, and (2) provide investors with necessary software and technical assistance free of charge. An issuer could satisfy the latter requirement by providing a hyperlink to a website where the software could be downloaded and a toll-free telephone number for technical assistance.

(d) Clarification of the "Envelope Theory"

The SEC's October Interpretive Release included examples suggesting that documents in close proximity to each other on the same website and documents hyperlinked together will be considered delivered together as if they had been sent in the same envelope. This is known as the "envelope theory" of electronic delivery and has been a source of concern for issuers in registration.

The Internet Release clarifies that information on a website will be considered part of a prospectus only where an issuer acts to make it so. Where an issuer includes a hyperlink in its prospectus, the SEC believes that it is appropriate for the issuer to assume responsibility for the information because the issuer has exhibited an intent to make the hyperlinked information part of its communication with the market. The hyperlinked information becomes part of the prospectus, must be filed with the SEC as part of the prospectus and will be subject to liability under Section 11 of the Securities Act. An issuer may include the website address (the uniform resource locator or "URL") of the SEC's website or its own website without these websites being considered part of the issuer's prospectus provided the issuer: (1) takes steps to ensure that the URL is inactive (that is, that an investor cannot reach the website by clicking on the address included in the prospectus); and (2) includes a statement to the effect that the URL is an inactive textual reference.

The Internet Release also clarifies that the posting of information on a website in close proximity to a prospectus, without more, does not constitute impermissible "free writing." An issuer's website content must be examined in its entirety to determine whether it contains "free writing," without regard to whether, or where on the website, the prospectus is posted.

3. Website Content

While the SEC provides guidance as to two issues regarding website content in the Internet Release, it states as a preliminary matter that the federal securities laws apply in the same manner to website content as to any other statements made by an issuer.

(a) Issuer Responsibility for Hyperlinked Information

The SEC indicates in the Internet Release that an issuer may be liable under Section 10(b) of the Exchange Act and Rule 10b-5 thereunder for third-party information to which the issuer hyperlinks on its website. Liability may arise where an issuer "adopts" or endorses information on a hyperlinked website. Once the threshold question of adoption is answered, liability will be determined in accordance with the standards of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

The SEC declines in the Internet Release to adopt a bright-line rule for determining whether an issuer has adopted hyperlinked information. Instead, it sets forth a non-exclusive list of factors that it would consider relevant in making such a determination. These factors include (1) the context of the hyperlink, (2) the risk of confusion, and (3) the presentation of the hyperlinked information.

(i) Context of the Hyperlink

The context of the hyperlink includes what the issuer says about the hyperlink and what is implied by the context in which the hyperlink is placed. For example, an issuer that hyperlinks to a website that it describes as providing the best description of the issuer's business would be viewed as endorsing the hyperlinked information on that site. The SEC states in the Internet Release that when an issuer embeds a hyperlink in a document required to be filed or delivered under the federal securities laws, the issuer will be deemed to have adopted the hyperlinked information. Where an issuer in registration establishes a hyperlink from its website to information that meets the definition of an "offer," "offer to sell," or "offer for sale" under Section 2(a)(3) of the Securities Act, a "strong inference" will arise that the issuer has adopted the hyperlinked information.

(ii) Risk of Confusion

A determination as to the risk of confusion will be affected by the presence or absence of cautionary statements informing an investor about the source of hyperlinked information. An issuer is less likely to be viewed as having adopted such information where the information is accessible to an investor only after viewing an intermediate screen that clearly indicates the investor is leaving the issuer's website and that the hyperlinked information is not the issuer's. Statements disclaiming responsibility for and/or endorsement of hyperlinked information may also minimize the risk of confusion, although disclaimers will not be sufficient where the circumstances otherwise indicate that the issuer has adopted the hyperlinked information.

(iii) Presentation of the Hyperlinked Information

With regard to the presentation of hyperlinked information, the selective use of hyperlinks will be relevant in determining whether an issuer has adopted the information. For example, an issuer may be viewed as having adopted hyperlinked information where the issuer hyperlinks only to certain information that is not representative of the universe of information available or establishes and terminates hyperlinks to particular websites depending on the nature of the information available on those sites. The depiction of a hyperlink on an issuer's website will also be relevant. Any

actions to differentiate a hyperlink from other information or hyperlinks on an issuer's website, by altering the size, color or font size of the hyperlink, may be seen as an improper attempt to influence an investor's decision to view the hyperlinked information and as evidence of the issuer's endorsement of the information.

(b) Issuer Communications during a Registered Offering

Due to the increasing use of websites in ordinary business communications, issuers have sought guidance from the SEC as to the types of website communications that are permissible when they are in registration.

The Internet Release indicates that information posted on the website of an issuer in registration, including hyperlinked information, is subject to the same restrictions as other types of communications under Section 5 of the Securities Act. Ordinary-course business communications are permitted as provided for in earlier releases on the subject. In addition, the release indicates that ordinary-course business and financial information includes advertisements, reports required to be filed under the Exchange Act, proxy statements, annual reports and dividend notices, press releases regarding business developments, answers to unsolicited telephone inquiries about business matters from securities analysts, financial analysts, shareholders and participants in the communications field that have a legitimate interest in the issuer's affairs and shareholder meetings. Information permitted under the safe harbors established by Securities Act Rules 134 and 135 also may be posted on a website.

The SEC also notes that non-reporting issuers should comply with its guidance on ordinary-course business communications. Non-reporting issuers with a history of making such communications over their websites should be able to continue providing business and financial information on their websites while preparing to do an IPO. On the other hand, a non-reporting issuer that establishes a website in anticipation of or in conjunction with its IPO may need to apply the SEC's guidance more strictly. Such an issuer would not have a history of making ordinary-course business communications through its website. In the absence of such a history, the issuer's website communications may condition the marketplace and investors may be less able to distinguish an offer to sell the issuer's securities from the issuer's business or financial information or promotional activities.

4. Online Offerings

(a) Online Public Offerings

The increasing use of the Internet, email and other electronic media to solicit investor interest in public offerings of securities has afforded individual investors greater access to investment opportunities. While the SEC views this as beneficial, it expresses concern in the Internet Release that investors still lack sufficient information to understand fully the online public offering process and that, as a result, they may be making hasty and uninformed investment decisions.

The Internet Release does not set forth procedures to be followed by issuers and broker-dealers conducting registered offerings online. Rather, the release indicates that the SEC will analyze this area in connection with its review of filings and may take future regulatory action. Nevertheless, the SEC restates two fundamental legal principles, which it indicates should guide the development of such procedures.

The first of these principles is that participants in a registered public offering are prohibited from selling or making contracts to sell securities prior to the effectiveness of the registration statement. Likewise, no offer to buy can be accepted, and no part of the purchase price can be received, prior to effectiveness. The second fundamental legal principle is that written, television and radio offers may not be made outside of a prospectus meeting the requirements of Section 10 until delivery of the final prospectus has occurred. Once a registration statement is filed, limited written communications are permitted under Securities Act Rules 134 and 135; oral offers are permitted as well. Once a registration statement is effective, an issuer may distribute sales literature or other written or broadcast materials provided they are accompanied or preceded by a final prospectus.

Until further regulatory action has been taken, issuers also may look to the procedure blessed by the SEC in its no-action letter to Wit Capital Corporation (July 14, 1999) addressing the use of the Internet in IPOs. Under this procedure, once a registration statement is filed, a dealer circulates an email including information permitted under Rule 134 and a hyperlink to a preliminary prospectus posted in a segregated area, or "cul de sac," on the dealer's website. Investors having accounts with the dealer can make offers to buy using subscription documents posted in the cul de sac. Approximately two days before effectiveness, the dealer sends an email notice to investors requesting affirmation of offers to buy. After effectiveness but before pricing, the dealer sends an email notice to investors who have affirmed their offers to buy indicating that the offer is about to price and that, unless the investors withdraw, the dealer can accept their offers. Once the offer is priced and allocations are made, notices of acceptance are sent, followed by confirmations and the final prospectus.

(b) Online Private Offerings under Regulation D

The Internet Release also addresses the SEC's concern that the use of the Internet in a private offering of securities under Regulation D may involve general solicitation or advertising, in contravention of Regulation D. In its October Interpretive Release on electronic delivery, the SEC indicated that the placement of offering materials on a website that is publicly available would involve a general solicitation and disqualify the offering from being "private" within the meaning of Regulation D. One means of avoiding a general solicitation is to establish the existence of a "pre-existing, substantive relationship" with prospective investors.

In 1996, the SEC offered additional guidance in the area of online private offerings in a no-action letter issued to IPONET (July 26, 1996). Since issuing the IPONET letter, the SEC has observed a number of practices that it characterizes in the Internet Release as potentially involving general solicitations. These include websites that allow investors to certify themselves as accredited or sophisticated by checking a box and websites operated by third-party service providers that are not registered as or affiliated with broker-dealers.

solicitations. These include websites that allow investors to certify themselves as accredited or sophisticated by checking a box and websites operated by third-party service providers that are not registered as or affiliated with broker-dealers.

The Internet Release highlights the existence of a "pre-existing substantive relationship" as a means of avoiding a general solicitation. The role of the typical broker-dealer in making recommendations to its customers implies the existence of such a relationship. According to the Internet Release, where a broker-dealer is not used, and in particular, where an issuer permits prospective investors to self-accredit, the issuer not only runs the risk of engaging in a general solicitation in violation of the requirements of Regulation D, but also raises doubts as to whether it can form a reasonable belief that prospective investors are qualified to participate in an offering. The Internet Release suggests that, in the absence of facts that strongly point to the existence of a "pre-existing, substantive relationship," broker-dealers should be involved in online offerings under Regulation D.

The Internet Release also cautions website operators to consider whether their activities require them to be registered as broker-dealers. It notes that website operators involved in securities offerings under Regulation D are not exempt from having to register as broker-dealers even though the securities being offered are exempt from registration under the Securities Act.

(c) Broker-Dealer Capacity

The SEC has indicated that broker-dealers must have adequate facilities and personnel to execute and consummate securities transactions promptly. In the context of electronic media, the Internet Release suggests that broker-dealers ensure they have sufficient operational capability to handle periods of high-volume trading.

5. Technology Concepts

The SEC also requests comment on specific issues that it anticipates may arise as technology continues to evolve. The issues are described in brief below. The full text of the questions with respect to which the SEC is seeking comment is set forth in the Internet Release.

- *Access Equals Delivery*. Whether there are circumstances under which, consistent with investor protection, investors could be presumed to have Internet access, so that electronic delivery could be accomplished solely by posting a document on a website.

- *Electronic Notice*. Whether posting a message in an investor's account on the website of the investor's broker-dealer provides sufficient notice of the availability of disclosure documents or whether the SEC should continue to require electronic delivery of documents directly to individual investors.

- *Implied Consent.* Whether there are circumstances under which issuers should be permitted to use electronic delivery if they notify investors in advance of their intention to do so and investors fail affirmatively to object.

- *Electronic-Only Offerings*. In its October Interpretive Release, the SEC stated that, as a matter of policy, an investor that chooses electronic delivery must be given documents in paper form if the investor specifically requests it. The October Interpretive Release also expressly permitted "electronic-only" offerings, that is, offerings in which participation is conditioned upon investors consenting to electronic delivery of all documents in connection with the offering. The Internet Release requests comment on whether, and under what circumstances, paper copies should be required in electronic-only offerings.

- *Access to Historical Information*. It has been suggested that a statement posted on an issuer's website is republished every time it is accessed by an investor or each day that it appears on the website. Each republication could be viewed as potentially giving rise to liability under Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. The SEC is seeking comment on some of the ways to facilitate the availability of historical information over the Internet consistent with concerns about liability under the federal securities laws.

- *Communications When in Registration*. The SEC is seeking comment on some of the ways in which issuers whose websites are their business can maintain ordinary business communications while in registration and also comply with their obligations under Section 5 of the Securities Act.

- *Internet Discussion Forums*. The Internet provides a forum for chat rooms, bulletin boards and other interactive discussions about issuers and their securities. The SEC has requested comment on issues relating to Internet discussion forums, including whether and how Internet discussions affect an issuer's stock price; whether issuers and broker-dealers that host online discussions should adopt and maintain "best practices" for participation in these discussions and, if so, who should establish these practices and what should be included in them; and whether issuers have established policies governing employee participation in discussion forums.

6. What Companies Should Do Now

Given the rapid pace at which technology is evolving, the guidance offered by the SEC in the area of electronic media also will continue to evolve. Continued compliance with the positions previously articulated by the SEC in this area should be considered a first step for companies seeking to satisfy their obligations under the federal securities laws. The publication of the interpretive positions contained in the Internet Release offers companies a good opportunity to assess their electronic communications in light of the SEC's most recent thinking on the use of electronic media.

- *Electronic Delivery of Employee Benefits Documents*. The Internet Release confirms the SEC's previous statements with respect to the delivery of disclosure required in connection with employee benefits plans. The use of electronic media to deliver disclosure documents to employees has permitted many companies to achieve substantial savings on printing and other costs associated with delivery of hard

copies. In light of this, companies that do not now do so should consider using intranet websites and internal email systems, among other electronic media, to deliver plan documents to employees.

- *Website Content and Communications of Issuers in Registration*. Companies in registration and companies considering public offerings should be careful about the content of their websites. Materials on a website should be dated, and the website should be reviewed on a regular basis to update and/or remove outdated information or place it in an archival section of the website. Companies in registration can continue to post ordinary business communications on their websites, provided they have established a history of providing such communications over the Internet. Before filing a registration statement, companies should review information, both on their own websites and on any websites to which they offer hyperlinks, to ensure that there is nothing on the websites that might constitute an impermissible offer under Section 5 of the Securities Act. Companies wishing to post prospectuses on their websites should segregate the prospectus in a separate area of the website. Companies also should be mindful of the ramifications of inserting hyperlinks in a prospectus. A company that includes a hyperlink in its prospectus adopts the hyperlinked information for purposes of determining liability under Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

- *Use of Hyperlinks on Company Websites*. Even when not in registration, companies should consider carefully the use of hyperlinks on their websites. Some suggestions on the use of hyperlinks are listed below.

- Avoid hyperlinking selectively to websites that contain only positive statements about the company and its business or websites that, when viewed in the aggregate, would not present a fair and accurate picture of the company.

- Avoid using language around the hyperlink that suggests that the company is endorsing the statements on the hyperlinked website.

- Use a combination of "click-through" screens and disclaimers. "Click-through" screens will inform investors that they are leaving the company's website and proceeding to another site. An appropriate disclaimer will inform investors that a hyperlinked website is not under the company's control, that the company is not responsible for and does not endorse information on the hyperlinked site, and that investors choosing to access third-party websites through a hyperlink do so at their own risk.

- Avoid framing or inlining information from a third-party website. Framing imports information from a third-party website into the website being accessed and displays it within an on-screen border, or frame. Inlining functions in a similar manner, but with no visible border. Both of these practices may obscure the fact that the information being viewed on a company's website is not that of the company, but rather information located on the website of a third party.

- *Website Addresses*. Where companies do not intend to provide hyperlinks to third-party websites, they should take care to ensure that third-party website addresses (also known as uniform resource locators or "URLs") included on their own websites are not active. Many word processing programs automatically convert URLs into active hyperlinks.

- *Online Offerings*. Companies seeking to conduct registered offerings online should be aware that the SEC will be carefully scrutinizing the procedures employed in these offerings. Companies should consider clearing any proposed procedures with the SEC in advance.

- *Private Placements*. Companies doing private placements online should be mindful that the SEC has expressed concern that certain practices relating to the use of the Internet in private placements may give rise to a general solicitation in violation of Regulation D. Issuers using the Internet in connection with private placements should consider the regulatory status (*i.e.*, broker-dealer registration) of those entities involved in the process of certifying investors as accredited or qualified under the federal securities laws.

- *Website Operators*. Service providers operating websites in connection with exempt offerings under the Securities Act should consider whether they are required to register as broker-dealers under the Exchange Act.

III. "Plain English" Rules

A. Introduction

Since October 1, 1998, new rules and amended existing rules of the Commission have mandated the use of plain English in preparing prospectuses. The plain English rules require issuers, including small business issuers and investment companies, to write the cover page, summary, and risk factors section of prospectuses according to the plain English guidelines summarized below. The purpose of these rules is to make the prospectus more accessible so that investors will be fully advantaged by mandated disclosure.

The Commission expects documents drafted in plain English to use:

- Short sentences;
- Definite, concrete, everyday language;
- Active voice;
- Tabular presentation of complex information;
- No legal or business jargon; and
- No multiple negatives.

In connection with the plain English rules, the Commission is required to consider, when presented with a request for acceleration, whether the issuer has made a bona fide effort to satisfy the plain English rules in drafting the front part of the prospectus. Thus, the registration statement will not become effective until all rules, including those regarding plain English

In connection with the plain English rules, the Commission is required to consider, when presented with a request for acceleration, whether the issuer has made a bona fide effort to satisfy the plain English rules in drafting the front part of the prospectus. Thus, the registration statement will not become effective until all rules, including those regarding plain English, have been satisfied.

B. Summary of New Rules and Amended Rules

1. New Rule 421

Rule 421 provides that the text of prospectuses should follow the six basic principles listed above. In addition, the design of the cover page, summary, and risk factors section must be easy to read and formatted in a manner designed to highlight important information to investors. The Commission permits the use of pictures, charts, and graphics in this process so long as they are drawn to scale. The rule also provides that the entire prospectus must be clear, concise, and understandable. To this end, the drafter should present information in clear concise sections, paragraphs and sentences, and use short explanatory sentences, bullet lists, descriptive headings and subheadings whenever possible. The drafter should avoid legal and highly technical business terminology, legalistic or overly complex presentations, vague boilerplate explanations, complex information copied directly from legal documents without clear and concise explanation, repetitive disclosure and reliance on glossaries or defined terms as the primary method of explanation of information.

2. Regulations S-K and S-B

(a) Item 501: Forepart of Registration Statement and Outside Front Cover Page of Prospectus

Item 501 now provides that the front cover of the prospectus may not exceed one page, focusing on key information, but the Commission has not formally structured it to require a uniform presentation. The Item also sets forth requirements with respect to the presentation of legends, the presentation of distribution information and information to be provided regarding the market for securities, trading symbol, underwriters, and type of underwriting arrangements. The cover should identify and note the number of shares of any underwriters' overallotment option and should include a cross-reference to the risk factors section, including the page number on which the risk factors begin.

(b) Item 502: Inside Front and Outside Back Cover Pages of Prospectus

Much of the information formerly required for these pages has been moved to other sections. Only two items must be included, a table of contents and notice of dealers' prospectus delivery requirements.

(c) Item 503: Summary Information, Ratio of Earnings to Fixed Charges, and Risk Factors

The Commission mandates that summaries be brief and in plain English. Issuers should write summary descriptions of the company's business operations and financial condition in plain English whether or not they are captioned as summaries. In response to liability concerns expressed through comment letters on the plain English proposals, the Commission reiterated its stance that the summary need not disclose everything, and that a court examining a company's disclosure should look beyond the summary to the entire document.

If the issuer includes a risk factors section in its prospectus, the issuer must draft the section in plain English and not include standard generic boilerplate risk factors. The risk factors must be concise, organized logically, and set forth individually under subcaptions that adequately describe the respective risk. The factors must place the risk in context so that investors can understand the effects upon the company and its operations.

3. Forms S-2, S-3 and S-4

When incorporating information by reference, the Commission requires that the issuer state that such information may be obtained upon written or oral request at no cost to any individual to whom a prospectus has been delivered. The phone number and address to which such requests are to be made must be included. The issuer must also publish information as to where members of the public may access and copy any materials filed with the SEC.

C. Practical Guidelines

Even good faith filings by experienced practitioners typically receive several plain English comments in their comment letters. Contrary to earlier indications that comments would often be sui generis, the majority of the SEC plain English comments have been focused on a limited number of conceptual and drafting errors. The errors most frequently cited by the SEC are discussed in Appendix A hereto. Additional information regarding the plain English rules, including many sample comments on various portions of the prospectus, is set forth in "Staff Legal Bulletin No.7 - Plain English Disclosure," summarized in Section XIII.G. below. Some suggestions from the Staff Legal Bulletin on plain English disclosure are also summarized in Appendix A.

IV. The Aircraft Carrier That Did Not Sail: The SEC's "Aircraft Carrier" Proposal

On November 13, 1998, the Commission proposed extensive changes to the securities regulation process, known as the "aircraft carrier" proposal due to its size and scope. The comment period for the "aircraft carrier" was extended from April 5, 1999 to June 30, 1999. The comments were critical of most aspects of the proposal, and the Commission is expected to move forward, at least initially, only with limited aspects of the proposed integration rules and possibly the 1934 Act reporting disclosure enhancements. Nevertheless, the aircraft carrier release proposed the most significant changes to the public offering process in decades and so its key provisions are summarized below.

A. Reform of the Registration System

1. Large Seasoned Issuers

The proposals would have created a new Form B to may be used by large, seasoned issuers, which are estimated to comprise the top 25% of public companies in size and 38% of all listed companies. There were five new reforms proposed for large, seasoned issuers:

(a) *No mandatory prospectus disclosure requirements.* With the exception of a securities term sheet, issuers would be free to create offering documents they deem appropriate. However, the term sheet would have to be in the hands of all purchasers before they make a binding commitment to purchase. This proposal presents practical problems.

(b) *Issuers control timing of offerings*. In contrast to the current system where the Commission staff has control of the timing, offerings could be conducted quickly as issuers control the timing because there would be no SEC staff review of Form B filings.

(c) *Delayed registration statement filing.* Large, seasoned issuers would have been permitted to delay filing the Form B registration statement until immediately before the first sale of securities.

(d) *Expanded due diligence guidance for underwriters.* Under a proposed expansion of Rule 176 under the 1933 Act, the Commission would issue modest additional guidance and expanded rules in anticipation of new considerations facing underwriters and the due diligence process with an increase of Form B offerings completed on an expedited basis.

2. Certain offerings by smaller "seasoned" issuers

Form B would also be available for some offerings by smaller issuers that are considered "seasoned." These offerings would include:

a. Rule 144A offerings to qualified institutional buyers;
b. offerings to certain existing security holders;
c. offerings of investment grade, non-convertible securities; and
d. market making transactions by broker-dealers affiliated with the issuer.

3. Medium-size issuers

Form A, which was proposed to replace Form S-1, would be the typical registration form for initial public offerings and would be the registration form for those issuers not meeting the requirements for Form B.

Form A would allow smaller seasoned issuers to incorporate company disclosure from their Exchange Act periodic reports two years sooner than is currently allowed. Additionally, medium-sized seasoned issuers using Form A would control timing of their offerings, as would smaller issuers whose periodic reports have undergone recent review by the Commission staff.

4. Small Business Issuers

Small business issuers who already have the benefit of providing less extensive disclosure if they meet the criteria of a "small business issuer" would have an extra benefit under the proposal: an increase in the annual revenue requirement to qualify from the current $25 million level to $50 million and a drop in the minimum $25 million public float requirement. This amendment would provide three primary benefits to "small business issuers": (1) an increased number of small business issuers (by about 1,100, initially); (2) incorporation by reference of Exchange Act periodic reports for certain seasoned small business issuers; and (3) delayed payment of registration fees until shortly before effectiveness.

B. Communications During the Offering Process

The Commission's proposals concerning restrictions on communications were intended to lift those restrictions which create a "quiet period" during the registration process, when issuers are reluctant to communicate with the market.

The Commission proposed to establish a bright-line communications safe harbor for all communications made by or on behalf of an issuer during certain periods before it files a registration

The Commission proposed to establish a bright-line communications safe harbor for all communications made by or on behalf of an issuer during certain periods before it files a registration statement. For Form B offerings, the Commission proposed to remove all restrictions on offering communications before the registration statement is filed. However, such communications, subject to exceptions for factual business communications if made within 15 days of the first offer, would still be subject to federal anti-fraud and civil liability laws and would have to be filed as offering communications or free writing materials. Additionally, analysts would be given wider latitude than presently to continue to publish routine research reports without interruption, even though the analyst may be related to the underwriters. With respect to non-Form B offerings, all communications made more than 30 days before a registration statement is filed would be permitted.

With two exceptions, communications during the 30-day period prior to the filing of the registration statement would remain restricted. Safe-harbor exceptions would be made for factual business communications and regularly released forward looking information by reporting companies. Once the registration statement is filed, issuers would be free to communicate and would not be required to meet the content requirements of a statutory prospectus, but would be required to file all communications, except factual business communications, as free writing materials subject to the anti-fraud and civil liability provisions of the federal securities laws.

1. Bright-Line Communications Safe Harbor During the Pre-Filing Period

Under the Commission's proposals, issuers using Form B and those acting on the issuers' behalf, would have the benefit of a safe-harbor pursuant to which they could freely communicate before the offering period begins. During the pre-filing period, the proposed rules would remove the restrictions in Section 5 of the Securities Act for the offering communications of Form B issuers, allowing them to freely communicate during the "offering period" (defined as the period beginning 15 days before the first offer until the filing of a registration statement). Offers by these issuers would be permitted during the pre-filing period but any written materials used within the 15-day period preceding the offer would have to be filed at the time the registration statement is filed. During the waiting period, Form B issuers would be able to continue to communicate freely. If such issuers comply with the applicable delivery rules and also file with the Commission the information necessary to satisfy Section 10(a) prior to the first sale, any such communications would not themselves have to satisfy Section 10. However, such communications would still have to be filed with the Commission before the date of first use.

Offerors participating in registrations under Forms C, SB-3, F-8, F-80 or F-10 (registrations in connection with a business combination) would be able to freely communicate prior to the first communication related to the offering (except for communications among the participants in the offering).

All other issuers (such as Form A issuers) and those acting on the issuer's behalf would be able to freely communicate prior to the 30-day period before a registration statement is filed.

Under the bright-line communications safe harbor, all issuers, underwriters and participating dealers would be required to "take all reasonable steps" within their control to prevent further distribution or re-publication of communication during those periods in which free communication is not permitted. As an example, an issuer which posts information on its Internet website during a free communication period but fails to remove such information during a limited communications period would fall outside the bright-line communications safe harbor. However, such issuers could be exempt under the other proposed safe harbors relating to factual business communications or regularly released forward-looking information, discussed below.

2. Communications During the Waiting Period

Under the Commission's proposals, companies would be able to make offers and disseminate offering information during the waiting period in any form without each communication being subjected to the requirements of Section 10, thus allowing for presentation and disclosure of information in a variety of formats, such as an Internet road show. The Division of Corporate Finance has already issued several no-action letters permitting issuers and underwriters to conduct road show presentations over the Internet and through other electronic media.

Larger seasoned issuers, including issuers eligible to use Form B, that have no restrictions on pre-filing communications would be allowed to communicate freely after filing a registration statement. Under Proposed Rule 165, these issuers could engage in post-filing free writing if they comply with the preliminary prospectus delivery requirements in Proposed Rule 172, file free writing materials under Proposed Rule 425 and file a final prospectus meeting the requirements of Section 10(a) before the first sale. Smaller issuers would also be able to engage in post-filing free writing under the same conditions. These materials would need to be filed with the Commission but not delivered to potential investors.

C. Prospectus Delivery Requirements

1. Introduction

The Commission's proposals would require delivery of prospectus information (through the delivery of preliminary prospectuses) before the making of an investment decision. Final prospectuses would no longer have to be delivered to each investor in a public offering (other than in a business combination or exchange offer). As a condition to the exemption from the requirement to deliver a final prospectus, investors would be told where to obtain the final prospectus, and would be provided with the prospectus promptly and without cost, upon request. The proposed information delivery requirements would vary for different issuers, depending primarily on whether the offering is registered under Form A or B.

2. Form A Issuers

Form A issuers would be required to deliver a preliminary prospectus in advance of the pricing date or date of signing subscription agreements, and to update that information at least 24 hours before that time if there were any material changes regarding the offering or the issuer. The time in which a red herring must be delivered would depend on whether the issuer had been an Exchange Act reporting company for more than one year. Issuers which had been reporting for less than one year would be required to deliver the red herring at least seven days prior to the pricing date or date of signing subscription agreements. Issuers which had been reporting for more than one year would be required to deliver the red herring at least three days prior to the pricing date or date of signing subscription agreements.

3. Form B Issuers

The Commission has set forth two alternate proposals for Form B issuers. Under the first proposal, Form B issuers would be required to deliver a securities term sheet. The term sheet would contain the material terms, contact person information, names of any other sellers of the securities and their relationship to the issuer and a legend advising the reader to read the issuer's documents on file with the Commission prior to making an investment decision. Under the second proposal, Form B issuers would be required to deliver a prospectus containing the transactional disclosure currently required in Form S-3. Under both proposals, the required information would be filed with the Commission prior to the first sale. Delivery of other information would not be mandated under the Proposed Rules.

D. Integration of Registered and Unregistered Offerings

The Commission proposed to clarify the circumstances under which issuers would be able to convert initiated private offerings to public offerings and vice versa. The proposed changes largely reflect a codification of the staff's current positions, but they would set more realistic and shorter "safe harbor" guidelines. The revisions would be implemented primarily through the expansion of Rule 152, a safe harbor against the integration of unregistered offerings with subsequent registered offerings. Integration is a doctrine that prevents issuers from avoiding the registration process by artificially splitting an offering, for which no exemption from registration is available, into offerings for which exemptions are available. If no exemption is available for the "integrated offering" and if the integrated offering is not registered, then the transaction would be in violation of Section 5 of the Securities Act.

These proposed changes in integration standards, which are summarized below, were favorably received by commentators. The Commission staff currently is working on the adoption of these proposals, which is anticipated some time during 2000.

1. Changing from a Private to a Public Offering

Currently, issuers generally cannot initiate a private offering and then convert it into a public one because the Securities Act prohibits the making of offers prior to the filing of a registration statement. The proposed rules would enable Form B issuers to convert a private offering to a public one without difficulty because Form B issuers would not be required to file a registration statement until the time of sale and thus offers could be made prior to filing. The Commission proposed to expand Rule 152 to give the same flexibility to Form A issuers as long as the following conditions are met:

- The issuer notifies all offerees in the private offering that the private offering is abandoned.
- No securities were sold in the private offering.
- There was no general solicitation or advertising of the private offering.
- The issuer does not file the registration statement until at least 30 days after it notifies all offerees of abandonment if securities were offered in the private offering to any non-accredited person.
- The issuer either files any selling materials used in the private offering as part of the registration statement or it informs all private offerees that the filed prospectus replaces the prior selling materials and that any indications of interest are rescinded.

2. Changing from a Public to a Private Offering

The Commission also proposed a safe harbor to permit issuers to convert a public offering to a private one. Currently, this transition is difficult to make because the filing of a registration statement is viewed as a general solicitation for the offering so that, once the public filing is made, a private offering exemption normally is not available. Subject to the following conditions, the safe harbor would permit issuers to offer and sell securities to persons eligible to buy under the private offering exemption, even if those investors had expressed interest in the registered offering:

- If a registration statement was filed, the issuer withdraws it under Rule 477.
- If no registration statement was filed, the issuer notifies all offerees in a public offering that it is abandoning the public offering.

- If no registration statement was filed, the issuer notifies all offerees in a public offering that it is abandoning the public offering.
- No securities were sold in the public offering.
- Either (1) if the issuer first offers the securities in the private offering more than 30 days after abandonment or withdrawal of the public offering, the issuer notifies each purchaser in the private offering that the offering is not registered, that the securities are restricted, and that investors do not have the protections of Section 11 of the Securities Act, or (2) if the issuer first offers the securities in the private offering within 30 days of abandonment or withdrawal, the issuer and any underwriter agree to accept liability for material misstatements or omissions in the offering documents used in the private offering under the standards of Section 11 and Section 12(a)(2) of the Securities Act.

3. Definition of Private Offering Under Rule 152

Currently, Rule 152 provides a safe harbor only for transactions under Section 4(2) of the Securities Act. The Commission proposed to expand the rule's scope to cover offerings under Section 4(6), which exempts certain transactions not exceeding $5 million where offers or sales are made only to accredited investors, and Rule 506, a safe harbor that treats certain types of offers and sales of securities as not involving any public offerings for purposes of Section 4(2) of the Securities Act. Section 4(6) prohibits advertising or public solicitation in any transaction under that section. Rule 506 prohibits offers or sales by any form of general solicitation or advertising.

4. Completed Offerings

(a) Issuer Transactions

The Commission proposed to clarify through the revised Rule 152 safe harbor the circumstances in which a completed private offering will not be deemed part of a subsequent public offering. These revisions would eliminate the current requirement that the private and public offerings not occur within 6 months of each other.

The private offering would be considered "completed" if the following conditions are met:

- All purchasers fully pay the purchase price for the securities; or
- If all purchasers do not fully pay the purchase price, the following additional conditions must be met:
  - The transaction may not be re-negotiated.
  - Either the purchasers must be unconditionally obligated to pay for the securities, or the obligation to purchase the securities must depend on a condition not within the direct or indirect control of any purchaser.
  - The purchase price in the private offering must be fixed and not contingent upon market prices.

The Commission also proposed to include within Rule 152 private offerings of convertible securities or warrants made concurrently with registered offerings; thus, during the period that the securities or warrants are convertible or exercisable, the issuer would not be deemed to be conducting an offering of the underlying securities that could be integrated with the registered offering. Under the proposed rule, the offering of the underlying securities would be considered completed when the offering of the convertible securities or warrants is completed.

Finally, where a private offering is made solely for the purpose of modifying the issuer's capital structure, the private offering would not be integrated with a later registered offering, as long as the private offering was not a roll-up transaction under Item 901(c) of Regulation S-K.

(b) Resale Transactions

The Commission proposes to clarify that Rule 152 permits an issuer to register the resale of securities that originally were sold by the issuer in a completed bona fide private offering. Resales by affiliates of the issuer or broker-dealers who purchased the securities directly from the issuer or an affiliate would be excluded from the safe harbor because, according to the Commission, such an offering may not be a true resale transaction but, instead, a primary offering by the issuer.

The definition of "affiliate" would be taken from Rule 144. The Commission previously has proposed to narrow the Rule 144 definition of "affiliate" (Release No. 7391, Feb. 28, 1997).

E. Exchange Act Disclosure Enhancements

The Commission has proposed several potentially far-reaching changes to Exchange Act disclosure requirements aimed at enhancing the quality and timeliness of information in the periodic reports filed by reporting companies. The proposed changes would require issuers to include and update risk factors disclosure in their Exchange Act reports, to report annual and quarterly financial results sooner, to accelerate the due dates for certain Form 8-K reports, to expand the list of events which must be reported on Form 8-K, and to require persons signing Exchange Act filings to review and certify as to the accuracy of the disclosure. While no timetable has been set, it is possible that the Commission will also move forward with some or all of these proposals apart from the other proposals in the aircraft carrier. The proposals are summarized as follows:

1. Risk Factor Disclosure

The Commission proposed to extend risk factor disclosure to Exchange Act registration statements and periodic reports of all issuers. The Commission also proposed that such disclosures be written in plain English. Annual risk factor disclosure would have to contain an itemization of the most significant risk factors pertaining to the company's business, operations, industry or financial position. Quarterly reports would have to disclose any risk not disclosed in the registrant's most recent Securities Act registration statement or Exchange Act periodic report, as well as any risk that had changed. Reporting companies would be permitted to incorporate risk factor disclosure from their periodic reports into Securities Act registration statements. Thus, not just representative risk factors, as required by the Private Securities Litigation Reform Act of 1995 "safe harbor," but all of the "most significant risk factors" would have to be described.

2. Accelerated Reporting of Earnings

In the aircraft carrier release, the Commission applauded the extensive use of press releases by issuers to release their annual and quarterly results, but expressed some concerns about the disadvantages of disseminating information this way. Accordingly, it proposed to expedite the filing of such information with the Commission. It proposed two alternatives. First, the Commission proposed to require domestic reporting companies to report selected financial data (Item 301 of Regulation S-K) on Form 8 K on the earlier of the date the company issues a press release containing earnings or either the date that is 30 days after the end of each of the first three quarters of the fiscal year or 60 days after the end of the fiscal year. Alternatively, the Commission proposed to require companies to file quarterly reports on Forms 10-Q within 30 (instead of 45) days after their first three fiscal quarters and annual reports on Form 10-K within 60 (instead of 90) days after the fiscal year end.

3. Changes to Form 8-K

The Commission proposed to accelerate the due dates on Form 8-K filings and expand the items of disclosure that reporting companies must report on Form 8-K to include:

- material modifications to the rights of security holders (within 5 days of the event);
- departure of the CEO, CFO or COO (within 1 day);
- material defaults on senior securities (within 1 day of default);
- certain auditor notifications (within 1 day of notification); and
- company name changes (within 5 days).

4. Signatures and Certification Requirements

The Commission proposes to revise the signature section of all registration statements and periodic reports to require that the persons required to sign also certify that they have read the registration statement or report and that they know of no untrue statement of a material fact or omission of a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading. The Commission also proposes to expand the list of persons required to sign Forms 8-A, 10, 20-F, 40-F, and 10-Q (but not Forms 8-K and 6-K), to include the principal executive officers of the registrant and a majority of the board of directors of the registrant. Moreover, the Commission proposes to require that a copy of all Form 8-K filings be delivered to directors.

5. Treating Quarterly Information as "Filed"

The Commission proposes to treat financial statements and MD&A disclosure in forms 10-Q and 10-QSB as "filed" (it would continue to treat market risk disclosures as not filed) and would, thereby, subject such disclosures to the liability provisions of Section 18 of the Exchange Act.

6. Management Report to Audit Committee

The Commission is soliciting comments on whether or not to require the filing of a management report to the audit committee of the board of directors, which report would disclose the procedures established to assure the accuracy and adequacy of Exchange Act reports. The report would be filed as an exhibit to the Form 10 K and would be refiled only if a material change occurred.

F. The Fate of the "Aircraft Carrier"

F. The Fate of the "Aircraft Carrier"

In a speech in November 1999, Brian Lane, the departing Director of the Division of Corporation Finance at the SEC set forth his views on the seven steps (or compromises) necessary to "sail" the aircraft carrier:

1. address the board certification requirement apart from this project (subsequently addressed in the Commission's audit committee project);
2. revise pre-delivery of prospectus requirement to focus on IPO context and some secondary offerings by unseasoned issuers, permit last minute sales to accredited investors and institutional buyers, and make the obligation part of Rule 15c2-8 rather than a Section 5 requirement;
3. rather than requiring Form B to be filed on the day of the transaction, require a Form 8-K to be filed notifying the market about the transaction;
4. to deal with issue of whether to require filing of roadshow materials, require issuer or underwriter to open up roadshows to the public by putting materials on their website (it would not be a part of the prospectus);
5. to deal with concerns about the elimination of secondary shelf offerings for Form A issuers, permit such offerings but require a minimum time period subsequent to the private placement or tag such offerings so they do not go effective without staff review or remove some of the regulatory incentives for engaging in a two-step financing
6. rather than totally getting rid of Exxon Capital transactions, extend Form B to QIB-only offerings of non-reporting issuers, but only for debt; and
7. delete the "bad boy" provisions from eligibility for Form B and revise the provision relating to outstanding staff comments to limit it to those comments specifically identified by the staff.

Other commentators, including a group of sixty securities lawyers, have suggested keeping intact most of the rules governing the offering process and its forms, but opening up communications significantly

The new Director of the Division of Corporation Finance, David Martin, has more recently stated that the aircraft carrier, as proposed, will not be adopted, but that elements of the proposals relating to communications and integration issues may be adopted.

V. Regulation M-A: Regulation of Takeovers and Shareholder Communications

A. Introduction

Regulation M-A was adopted on October 26, 1999 and is effective as of January 24, 2000. Set forth below is a brief summary of some of the key provisions of Regulation M-A. These amendments stemmed from a review of all SEC rules connected to corporate change of control ("M&A") transactions and shareholder communications, including rules under the Securities Act and the Exchange Act with respect to registration of securities issued in the deal, solicitation of proxies, the making of tender offers, and going-private transactions. The Commission's stated purpose is to adapt the regulatory process to the realities of the marketplace while enhancing investor protections.

B. Reducing Restrictions on Communications

With recent advances in technology and the changing economics underpinning business combinations, companies are desiring improved and increased communications with shareholders. In response to these advances, the Commission aims to reduce regulatory restraints on communications to promote more informed voting and investing decisions. The amendments are aimed at providing full and fair disclosure to all investors, rather than just financial analysts and sophisticated market participants. In addition, the amendments apply to all parties to a business combination, regardless of their size or status. The following proposals have been adopted:

a. free communications before the filing of a registration statement in stock mergers or stock tender offers;
b. free communications before the filing of a proxy statement, whether or not a takeover transaction is involved;
c. free communications about a planned tender offer without triggering the commencement of the offer;
d. harmonization of various communications principles applicable to business combinations under the Securities Act, tender offer rules, and proxy rules; and
e. continuing to require that security holders receive a mandated disclosure document before being able to vote or tender the securities.

Once written communications are first used, such communications would need to be filed, thus providing access to all security holders. Furthermore, any written or oral communications would be subject to liability under the federal securities laws. Additionally, since parties to the transaction would no longer be subject to the current restrictions on communications, the proposals substantially curtail the confidential treatment now available for merger proxy statements.

C. Leveling the Playing Field Between Cash and Stock Tender Offers

The Regulation M-A amendments bring stock tender offers in line with cash tender offers as bidders are now allowed to commence stock tender offers as soon as a registration statement is filed. Under the prior rules, cash and stock tender offer deals were treated differently, as cash tender offers could commence as soon as the bidder filed the cash tender offer schedule with the Commission, but stock tender offers could not commence until a registration statement was filed and became effective. This regulatory delay enhanced the differences in the structures of competing deals where a cash tender offer had a significant timing advantage over the stock tender offer, even if the value of the stock is equal to or greater than the value of the cash offered. The amendments level the playing field between cash and stock and increase the ability of bidders to use stock. However, shares tendered cannot be purchased until after the registration statement becomes effective, the minimum 20 business day tender offer period expires, and all material changes have been disseminated to security holders with time for them to review and act on the information.

D. Updating and Harmonizing Disclosure Requirements

The Regulation M-A amendments clarify and harmonize the unnecessary differences in disclosure requirements for different kinds of business combinations in a separate regulation. Most importantly, the amendments:

a. permit a subsequent offering period, similar to that available in many United Kingdom tender offers, during which security holders can tender their shares without withdrawal rights for a limited period after completion of a tender offer;
b. require a plain English summary term sheet in all tender offers, mergers and going-private transactions except when the transaction is already subject to the plain English rules under the Securities Act;
c. combine the current schedules for issuer and third-party tender offers into a single schedule, "Schedule TO";
d. require disclosure of pro forma financial information to be given earlier to security holders by requiring such disclosure in cash tender offers where the bidder intends to engage in a back-end stock merger;
e. update and generally reduce the financial statement requirements for business combinations; and
f. clarify Rule 10b-13 (which prohibits purchases outside a tender offer); codify interpretations of exemptions from the rule; and redesignate that rule as Rule 14e-5.

VI. Selective Disclosure — Proposed Regulation FD

A. Introduction.

Chairman Levitt has increasingly been concerned with what he perceives as the growing incidence of "selective disclosure" of material corporate information in conference calls and private meetings that are open only to selected securities analysts and/or institutional investors. On December 20, 1999 the Commission took a major step toward ending the practice by proposing Regulation FD (for "Fair Disclosure") under the Exchange Act. In the proposing release, the SEC identified three primary issues associated with this practice: (1) it undermines the fairness of markets by giving an information advantage to analysts to which companies selectively disclose material nonpublic information; (2) it creates an incentive for managers to "hoard" information and parcel it out to curry favor and bolster credibility with particular analysts or institutional investors; and (3) it creates conflicts of interest for analysts, who are likely to feel pressure to report favorably about particular issuers to avoid being cut off from access to the flow of nonpublic information from that issuer.

The newly proposed Regulation FD does not address the issue of selective disclosure through the insider trading laws, but instead focuses on the disclosure process. It would be adopted pursuant to the reporting provisions of the Exchange Act rather than the antifraud provisions (e.g. Section 10(b)), so no private liability would arise. It draws a distinction between intentional and unintentional disclosures, and would require the following:

- whenever an issuer (or any person acting on its behalf) intentionally discloses material nonpublic information to any other person outside the issuer, it must simultaneously make public disclosure of the same information, and
- whenever an issuer learns that it (or any person acting on its behalf) has made an unintentional material selective disclosure, it must make prompt public disclosure of that information.

The proposed regulation would apply to all issuers with securities registered pursuant to Section 12 of the Exchange Act and to those issuers required to file reports under Section 15(d) of the Exchange Act, including closed-end investment companies but not including other investment companies. All disclosures of material nonpublic information made by officers, directors, employees or agents of an issuer to persons outside the issuer (with whom no confidentiality agreement is in place) while acting within the scope of their authority would be covered.

B. Timing and Mechanics

The timing of required disclosures under proposed Regulation FD depends on whether the disclosure of material nonpublic information was intentional or unintentional. If an issuer makes an intentional disclosure of material non-public information, the proposed regulation would require that it simultaneously publicly disclose the same information. Alternatively, if the disclosure was unintentional, there must be prompt (but no later than 24 hours) public disclosure "as soon as reasonably practicable" after a senior official knows (or is reckless in not knowing) of the unintentional disclosure. For purposes of the proposed regulation, a "senior official" is any director, any executive officer, any investor relations or public relations officer or any person with

similar functions. The "recklessness" element means that senior officials will need to institute procedures that will make it reasonably likely that they will be notified in the event of an unintentional disclosure.

There is a certain amount of flexibility in what types of public disclosure will satisfy the requirements of the proposed regulation. In all cases, the filing of a Form 8-K that contains the information will be sufficient. Alternatively, an issuer could satisfy the proposed regulation if it either disseminated a press release containing the information through a widely circulated news or wire service such as Dow Jones, Bloomberg, Business Wire, PR Newswire or Reuters, or if it made public disclosure in another way that was reasonably designed to provide broad public access — such as an announcement at a press conference to which the public is granted access and for which notice has been provided in a form that is reasonably available to investors. One method that the SEC specifically states will not be sufficient, however, is the mere posting the information on the issuer's website (although the proposing release does suggest that such posting is good practice).

C. Materiality

According to the Commission, the new rules do not alter the traditional federal securities law definition of "material". In the proposing release, however, the SEC notes the potential difficulty of determining whether a specific disclosure would rise to the level of "materiality". The release identified four practices already in use that can mitigate the difficulty: (1) issuers can designate a limited number of people who are authorized to make disclosures to or field questions from analysts, investors or the media; (2) issuers can institute a system by which records are kept of the substance of private communications with analysts or investors — such as recording conversations or having more that one person present; (3) issuer personnel can refrain from answering questions until they have a chance to consult with others; and (4) issuer personnel can require analysts to agree not to make use of disclosed information until the personnel have had chance to make a materiality determination. The SEC staff's recent issuance of Staff Accounting Bulletin No. 99, which takes a tough line on materiality and emphasizes that the test is not an objective quantitative one, will have to be considered in the context of making the decisions required by the proposed regulation.

D. Safeguards

At the December 15th meeting in which the SEC announced the proposed rules, outgoing General Counsel Harvey Goldschmid expressed a concern with the potential chilling effect that the selective disclosure rules might have on corporate communications. This concern is also reflected in the proposing release. To address these concerns, he identified four safeguards that would reduce the risk. First, the proposed regulation is not an anti-fraud rule and is not intended to create duties under Section 10(b) of the Exchange Act. Thus, there will be no private liability from an issuer's failure to comply. Noncompliance could, however, subject the issuer to an SEC enforcement action and could also result in an enforcement action against the personnel at the issuer who are responsible for noncompliance. Second, non-public dissemination of material information is still permitted as long as it is made under a confidentiality agreement. For example, the adopting release specifically contemplates the disclosure of material nonpublic information to other parties to a business combination or with purchasers in a private placement transaction without the necessity of public disclosure if the party receiving the information agrees to hold the information in confidence. Third, the distinction between intentional and unintentional disclosure should give issuers comfort that an inadvertent disclosure can be remedied. Finally, the wide range of mechanisms for disclosure should give issuers sufficient flexibility to meet the regulation's requirements.

E. Relationship with the Securities Act

The interplay between the requirements of the proposed regulation and the Securities Act is complex. Because Regulation FD would only apply to issuers that have securities registered under Section 12 of the Exchange Act or that are required to file reports under Section 15(d) of the Exchange Act, the regulation would not apply during an issuer's initial public offering. A reporting issuer, however, would be subject to the regulation's requirements even during a pending registration. The regulation would thus apply to oral disclosure of material nonpublic information during the "roadshow" for an offering — if such disclosure occurred, the issuer would be required to publicly disclose the same information, a result that differs markedly from current practice which treats oral and written communications around the time of an offering differently.

The SEC also notes that the disclosure required under the proposed regulation could be considered an "offer" of securities for purposes of Section 5 of the Securities Act and a "prospectus" for purposes of Section 2(a)(1) of the Securities Act. Thus, an issuer could violate Sections 5(c) or 5(b)(1) of the Securities Act by making the required disclosures under the proposed regulation — that is, the disclosure could be considered an offer or prospectus that did not comply with the requirements of the Securities Act. To ameliorate such a result, the SEC has proposed new Rule 181 under the Securities Act which would except any public disclosure that is both required by, and compliant with, the proposed regulation from the prospectus requirements of Section 10 of the Securities Act for an issuer that has already filed a registration statement. When a reporting company plans an offering, but has not yet filed a registration statement, however, the Commission views the circumstances as different. Accordingly, it has not extended the exemption in proposed Rule 181 to this situation, but solicits comment on the issue.

VII. Clarification of Insider Trading Prohibitions — Proposed Rules 10b5-1 and 10b5-2

A. Introduction

In the same proposing release discussed in Section VI.A above, the Commission also released proposed rules to clarify and enhance existing prohibitions against insider trading. The first is a new Rule 10b5-1, which sets up a framework for clarifying the use/possession distinction in insider trading law, and the second is a new Rule 10b5-2 which clarifies the scope of insider trading liability relating to familial relationships.

B. Use/Possession

Currently, courts are split on whether insider trading liability requires trading merely while in "knowing possession" of material nonpublic information or actual proof that the trader "used" the information while trading (i.e., traded on the basis of). One of the leading cases, SEC v. Adler, 137 F.3d 1325 (11th Cir. 1998), required use of the inside information, but also invited the SEC to engage in rulemaking on the subject. The Commission has long adhered to the position that liability for insider trading attaches under Section 10(b) and Rule 10b-5 of the Exchange Act whenever a person "possesses" material nonpublic information about an issuer when trading in that issuer's stock. In response to Adler, the SEC has proposed Rule 10b5-1 which states the general principle that insider trading liability arises when a person trades while "aware" of material nonpublic information. Tempering this, however, are four carefully enumerated exceptions discussed below.

Proposed Rule 10b5-1 begins with a general prohibition on insider trading that, according to the Commission, codifies existing caselaw — it is illegal to trade "on the basis of material nonpublic information about that security or issuer, in breach of a duty of trust or confidence that is owed directly, indirectly, or derivatively, to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the material nonpublic information." The rule then defines trading "on the basis of" material nonpublic information as a trade in which the trader "was aware of" the information when such person made the purchase or sale. Finally, the proposed rule sets forth four affirmative defenses to liability:

(1) if, before becoming aware of the material nonpublic information, the trader entered into a binding contract to trade in the amount, at the price, and on the date at which the trade was ultimately made;

(2) if, before becoming aware of the material nonpublic information, the trader had provided instructions to another person to execute the trade in the amount, at the price, and on the date at which the trade was ultimately made;

(3) if, before becoming aware of the material nonpublic information, the trader had adopted and had previously adhered to a written plan specifying purchases or sales of the security in the amounts, and at the prices, and on the dates at which the person purchased or sold the security; or

(4) from purchases or sales that result from a written plan for trading securities that is designed to track or correspond to a market index, market segment or group of securities.

A trade "in an amount" must specify either the aggregate number of shares or other securities to be purchased or sold, or the aggregate dollar amount of securities to be purchased or sold. A trade "at a price" includes a purchase or sale at the market price for a particular date.

In all cases, the affirmative defenses would only be available if the contract, plan or instruction was entered into in good faith, and not as part of a scheme or plan to evade the prohibitions of the rule. Likewise, any change to the contract, plan or instruction initiated after becoming aware of the material nonpublic information negates the defense. Finally, a person would lose the benefits of the defense if he or she entered into or altered a "corresponding or hedging transaction or position" with respect to the planned trade. This would prevent a person from setting up a hedging transaction and then canceling execution of the unfavorable portion of the hedge. An additional, separate affirmative defense exists for entities that trade. The additional defense requires demonstration that the individuals making the decision on behalf of the entity were not aware of the inside information, and that the entity had implemented reasonable policies and procedures, such as informational barriers and restricted lists, to prevent insider trading.

Interestingly, at the December 15 meeting, General Counsel Goldschmid only referred to one defense. The four defenses in the proposed rule perhaps suggest some last minute maneuvering on the rule prior to its release. In addition, at the meeting Commissioner Unger raised the question as to whether the SEC's new rule, if adopted, would be recognized in a criminal action after United States v. Smith, 155 F.3d 1051 (9th Cir. 1998), where the Court indicated, in dicta, that a criminal fraud prosecution must meet a higher standard. Mr. Goldschmid indicated that he thought the rule could support such a prosecution.

C. Misappropriation Based on Family or Personal Relationships

The second rule proposal regarding insider trading involves the scope of "misappropriation" liability for insider trading in the context of a family or personal relationship. In essence, it would treat persons with specified familial or personal relationship as constructive insiders. Proposed Rule 10b5-2 provides a nonexclusive definition of the circumstances under which a person has a duty of trust or confidence for purposes of the "misappropriation" theory of insider trading. It is expressly not intended to modify the scope of insider trading law in any other way.

Under the proposed rule, whenever a person agrees to keep information in confidence, a duty of trust or confidence would exist. This principle is designed to pick up the idea that a reasonable expectation of confidentiality can be created by agreement between parties, regardless of whether such agreement is express and written or, instead, an implicit understanding. Second, the proposed rule provides that a "history, pattern or practice of sharing confidences" which gives a person communicating material nonpublic information a reasonable expectation that other

the proposed rule provides that a "history, pattern or practice of sharing confidences" which gives a person communicating material nonpublic information a reasonable expectation that other person would maintain its confidentiality also creates a duty of trust or confidence in the other person.

The second part of the proposed rule creates a "facts and circumstances" test that is derived from United States v. Reed, 601 F. Supp. 685 (S.D.N.Y.), rev'd on other grounds 773 F.2d 447 (2d Cir. 1985), which recognizes that, in certain situations, a legitimate and reasonable expectation confidentiality on the part of the confiding person may be created by a past pattern of conduct between two parties.

Finally, the third part of the proposed rule creates a bright line liability rule, subject to affirmative defenses, for spousal, parent-child and sibling relationships. Under the proposed rule, even if such a familial relationship does exist, liability would not attach if the person receiving or obtaining the information can demonstrate that no duty of trust or confidence existed under the facts and circumstances of that particular family relationship. The party asserting the defense must show that the disclosing family member did not have a reasonable expectation of privacy by establishing the absence of any a history, pattern or practice of sharing confidences and the absence of any agreement or understanding to maintain the confidentiality of the information.

With the exception of Chairman Levitt, the Commissioners generally seemed skeptical about the wisdom of the Commission involving itself in issues that turn so closely on matters of familial relationship. This reluctance indicates that comments on the proposed rule may be especially influential

VIII. Financial Reporting Initiatives — New SEC and SRO Rules Governing Audit Committees and Auditor Independence

A. Introduction

In a speech delivered in September 1998, SEC Chairman Arthur Levitt criticized the increasing tendency of companies to engage in inappropriate "earnings management," the practice of distorting the true financial performance of a company to meet expectations of the investing community. At Chairman Levitt's urging, the NYSE and the NASD formed the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees ("BRC"). In February 1999, the BRC issued its report and recommendations. Following up on the BRC report, the SEC and the NYSE, Amex and the NASD issued proposals to implement the BRC report and recommendations in October 1999.

As expected, and soon after the close of the abbreviated comment period, on December 22, 1999, the SEC adopted its new rules on audit committees. According to the SEC, the new rules are intended "to improve disclosure relating to the functioning of corporate audit committees and to enhance the reliability and credibility of financial statements of public companies." The Commission also has approved, substantially as proposed, the amendments to the NYSE, Amex and the NASD listing standards. Chairman Levitt continues to focus on the issue of auditor independence and to propose further rulemaking with respect to auditor independence.

The new SEC rules require companies to engage independent auditors to review interim financial statements prior to filing with the SEC and add a number of disclosures relating to audit committees that will be required in proxy statements. The amendments to the listing standards of the major securities markets implement heightened independence standards and "financial literacy" tests for audit committee members. The listing standard amendments also require companies to adopt written audit committee charters that include specified items. Finally, also in response to the BRC report, the American Institute of Certified Public Accountants ("AICPA") has amended the Statements on Auditing Standard Nos. 61 and 71. These amendments require auditors to discuss information relating to the quality of the company's accounting principles with the audit committee and be satisfied that matters identified in connection with interim financial reporting have been communicated to the audit committee.

B. The SEC Rules

The SEC adopted its rules relating to audit committees substantially as proposed with two significant exceptions. First, the audit committee report, which each listed company will be required to include in its annual proxy statement, will not include the proposed "negative assurance" language. Instead, each audit committee will be required to disclose whether, based on the committee's meetings with management and the independent auditor, it has recommended to the board of directors that the audited financial statements be included in the annual report on Form 10-K or 10-KSB. Importantly, the SEC's modification in this respect eliminates the certification role envisioned for the audit committee under the Blue Ribbon Committee recommendations and the proposed rule. The revision in the SEC's final rule more appropriately reflects the oversight role of audit committees, and should reduce the concern raised by the original proposal with respect to potential new liability exposure for audit committee members.

Second, the final rules modifies the proposed transition period to permit companies an additional period of time to implement the rules. In particular, the review by the independent auditor of quarterly financial statements, in accordance with SAS 71, will not be required until the fiscal quarter ending after March 15, 2000. Compliance with the audit committee disclosure requirements will not be mandatory until fiscal years ending after December 15, 2000 (e.g., for calendar-year companies, the 2001 proxy statement).

1. Auditor Review of Quarterly Financial Statements

The new SEC rule (amending Rule 10-01(d) of Regulation S-X and Item 310(b) of Regulation S-B) requires that company interim financial reports filed on Form 10-Q or 10-QSB must be reviewed by an independent auditor prior to filing. The new rule does not require an audit of the interim financials, but it does require independent auditors to follow the SAS 71 procedure for conducting the limited quarterly review. This new requirement applies to all public companies regardless of size.

In adopting the final rule, the SEC also extended the requirements of Item 302(a) of Regulation S-K relating to selected quarterly financial data to a broader range of companies. Under the new rule, all companies, except small business issuers filing on small business forms, will have to provide appropriate fiscal year-end reconciliations and descriptions of adjustments to quarterly information provided in a Form 10-Q.

2. The Audit Committee Report

The Commission's new rules (adopting new Item 306 of Regulations S-K and S-B and Item 7(e)(3) of Schedule 14A) require that each audit committee provide a report in the company's proxy statement disclosing whether the audit committee has reviewed and discussed certain matters with the independent auditors. The audit committee's report will have to disclose the following:

l whether the audit committee has reviewed and discussed the audited financial statements with management;

- whether the audit committee has discussed with the independent auditors certain matters required under SAS 61 auditing standards and whether they have received and discussed the information required by Independent Standards Board Standard No. 1 regarding the auditors' independence; and
- whether, based on any such reviews, the audit committee recommended to the board of directors that the audited financial statements be included in the company's Annual Report on Form 10-K or 10-KSB.

In response to concerns about increased liability, the SEC modified its proposal such that audit committees will not be required to provide negative assurances that, in their meetings with auditors and company management, nothing came to the attention of audit committees members to indicate that there are material misstatements or omissions in the company's financial statements. Instead, the audit committee must provide a statement in the proxy statement indicating whether it recommended that the audited financial statements be included in the company's Annual Report on Form 10-K or 10-KSB. As adopted, the new rule provides that the audit committee's disclosure must appear over the printed names of each member of the audit committee.

3. Audit Committee Charter

The new rule (adopting Item 7(e)(3) of Schedule 14A) requires that companies disclose in their proxy statements whether their board of directors has adopted a written charter for the audit committee. If so, the new rule requires the company to include a copy of the audit committee charter as an appendix to the company's proxy statements at least once every three years. (As noted below, new listing standards of each of the major markets require that a charter be adopted and specify some required provisions for the charter.)

4. "Independence" Disclosure

The new SEC rule also requires that each company traded on the NYSE, Nasdaq, or Amex, including small business issuers, disclose in its proxy statements whether its audit committee members are "independent" as defined under the applicable listing standards. This aspect of the disclosure requirements has been modified from the proposed rule. Specifically, the SEC's proposal only provided that companies disclose if audit committee members were not "independent" under the applicable listing standards. As proposed, the new rule also requires that if a company has an audit committee member who is not "independent" pursuant to the applicable listing standards, then the company must disclose the nature of the relationship which makes that director "non-independent." Companies whose securities are not traded on the NYSE, Amex or the Nasdaq must disclose in their proxy statements whether the members of their audit committee are independent under any one of the listing standards and which listing standard definition was used.

5. Safe Harbor Provision

The SEC adopted, as proposed, "safe harbors" for the new disclosures. The SEC's safe harbors (adopted in new Item 306(c) of Regulations S-K and S-B and paragraph (e)(v) of Schedule 14A) state that information provided by the audit committee will not be considered "soliciting material," "filed" with the Commission, subject to liability under Regulation 14A or 14C or Section 18 of the Exchange Act. These safe harbors track existing safe harbor provisions for compensation committee reports.

6. Transition Periods

The SEC has provided a transition period to allow companies some time to implement the new requirements. First, all companies must obtain independent auditor review of their interim financial information starting with their Forms 10-Q or 10-QSB to be filed for the fiscal quarter ending on or after March 15, 2000. Second, companies must comply with the new proxy disclosure requirements for all proxy materials filed after December 15, 2000 (i.e., for calendar-year companies, the March 2001 filing of 10-K reports and the Spring 2001 proxy materials).

The SEC has provided a transition period to allow companies some time to implement the new requirements. First, all companies must obtain independent auditor review of their interim financial information starting with their Forms 10-Q or 10-QSB to be filed for the fiscal quarter ending on or after March 15, 2000. Second, companies must comply with the new proxy disclosure requirements for all proxy materials filed after December 15, 2000 (i.e., for calendar-year companies, the March 2001 filing of 10-K reports and the Spring 2001 proxy materials).

C. NYSE Listing Standard Amendments

The SEC approved, substantially as proposed, the amendments to the NYSE listing standard governing audit committees. These amendments mandate heightened "independence" requirements for audit committee members and "financial literacy" for each member of the audit committee and financial management "expertise" for at least one audit committee member. The amendments also require that each listed company adopt a formal written audit committee charter that meets certain prescribed standards.

1. Transition Periods

The amendments to the NYSE listing standard, which became effective December 14, 1999, include a transition period whereby all current audit committee members are "grandfathered" until they are re-elected or replaced. Since many audit committee members will be re-elected or replaced in the upcoming proxy season, companies listed or traded on the NYSE have only a limited period in which to comply with the new independence and financial literacy requirements. The approved transition period does allow NYSE issuers 18 months to comply with the requirement that each audit committee have at least three members and this 18 month period appears to also apply to the financial literacy requirements. Issuers listed on the NYSE will have six months from the effective date of the amendments to adopt a written audit committee charter (i.e. until June 14, 2000).

2. Definition of "Independence"

The NYSE listing standard amendments require that each audit committee member demonstrate the absence of four separate relationships in order to be qualified as "independent."

- Former employees of the company or its affiliates may not serve on the audit committee until three years after their separation from the company.
- An outside director who is a partner, controlling shareholder, or executive officer of an organization that has a business relationship with the company, or who has a direct business relationship with the company, may serve on the audit committee only if the company's board determines that the relationship does not interfere with the director's independent judgment. "Business relationships" can include commercial, industrial, banking, consulting, legal, accounting and other relationships.
- A director who is employed as an executive at another corporation where any of the company's executives serve on that company's compensation committee may not serve on the audit committee.
- A director who is an immediate family member -- a spouse, parent, child and/or, sibling -- of an individual who is an executive officer of the company or its affiliates cannot serve on the audit committee until three years after the family member terminates his or her employment with the company.

3. Composition of Audit Committees

Each audit committee member of a company listed on the NYSE must be financially literate, a qualification to be interpreted by the board of directors in its business judgment. Also, at least one member of each audit committee must have accounting or related financial management expertise, as interpreted by the board in its business judgment.

In addition, each audit committee must have at least three independent directors, but the rules permit a board "override" for one director where the director is a former employee or an immediate family member. Under this exception, the board may exercise its "override" if it determines that an otherwise "non-independent" director should serve on the audit committee because such service is required in the best interests of the corporation and its shareholders.

4. Adoption of Written Charter

The NYSE's amended listing standard requires that each audit committee adopt a written charter that must be approved by the entire board of directors. Each audit committee charter must include the following: (1) a description of the audit committee's responsibilities, including its responsibility for selecting, evaluating, and replacing the outside auditor and ensuring the outside auditor's independence; and (2) a statement specifying the ultimate accountability of the outside auditor to the board and audit committee. In addition, the audit committee must undertake an annual evaluation of its charter's adequacy.

5. Reporting Requirement

The NYSE's amended listing standard also provides that as part of the initial listing process, and approximately once each year otherwise, each company must provide written affirmation to the NYSE of the following: (1) any determination the company's board has made regarding the independence of the audit committee; (2) the financial literacy of the audit committee members; (3) determination that at least one of the audit committee members has expertise in accounting or financial management; and (4) the annual review and reassessment of the adequacy of the audit committee charter. The NYSE plans to circulate to its listed companies a form to be completed and returned that will satisfy the "written affirmation" requirement.

D. Nasdaq Listing Standard Amendments

As with the proposed amendments to the NYSE listing standards, the SEC approved substantially as proposed the amendments to the Nasdaq audit committee requirements. (The SEC also approved, substantially as proposed, the amendments to the American Stock Exchange listing standard, which are the same as the Nasdaq amendments.)

1. Transition Periods

Unlike the NYSE transition period, the Nasdaq transition period gives issuers 18 months to comply with the new audit committee composition and membership requirements. Therefore, unlike their NYSE counterparts, current audit committee members of Nasdaq-listed companies who are re-elected in the 2000 proxy season do not need to meet the independence and financial qualification requirements. Like the NYSE, Nasdaq issuers have six months from the effective date of the amendments to adopt a formal written audit committee charter (i.e., until June 14, 2000).

2. Definition of "Independence"

The amendments to the Nasdaq listing standard impose a heightened independence standard that will apply not only to audit committee directors, but also in all cases where its rules require "independent" directors. The more rigorous standard identifies five relationships that would disqualify a director from being considered independent.

- A current employee or former employee whose relationship with the company or any of its affiliates ended within the past three years.
- Any director who accepts compensation from the company or any of its affiliates in excess of $60,000 during the prior year, unless the compensation is for board service or is in the form of a benefit under a tax-qualified retirement plan.
- A director who is a member of the immediate family of an individual who is, or has been within the past three years, employed by the company or any of its affiliates as an executive officer.
- A director who is a partner in, or a controlling shareholder or an executive officer of, any for-profit business organization to which the company made or received payments that exceed five percent of the company's or other business organization's annual gross revenues or $200,000, whichever is more, in any of the past three years.
- A director who is employed as an executive of another entity where any of the company's executives serve on that entity's compensation committee.

Some of these criteria will result in an independence standard that is more objective, and potentially more demanding, than that of the NYSE.

3. Composition of Audit Committees

The amendments to the Nasdaq listing standard also differ from the NYSE amendments in that "financial literacy" is specifically defined as a requirement that each member of the audit committee must be able to read financial statements, including balance sheets, income statements and cash flow statements. Unlike the NYSE amendments, the Nasdaq amendments effectively remove the determinations of financial literary from the board of director's discretion. The amendments also provide that at least one member of the audit committee must have "past employment" in finance or accounting.

The Nasdaq amendments also require that, instead of the two directors which are now required, audit committees must be comprised of at least three independent directors. Similar to the NYSE amendments, the Nasdaq amendments permit a board "override" such that one non-independent director might serve on the audit committee. Unlike the NYSE override, however, the Nasdaq "override" is not permitted where the director is or was an employee or an immediate family member is or was an employee. It does, however, permit an "override" if a director is not independent under any of the other independence criteria.

Companies that file under SEC Regulation S-B (companies that have annual revenues of less than $25,000,000) are exempt from the changes to the Nasdaq audit committee composition rules. Instead, these small business filers must comply with the existing Nasdaq rule for audit committee composition, which requires an audit committee of at least two members, a majority of whom must be independent directors.

4. Adoption of Written Charter

The amendments to the Nasdaq listing standard require that each audit committee adopt a written charter. This charter must specify the scope of the audit committee's responsibilities, including in particular its responsibilities vis a vis the outside auditor and ensuring the outside auditor's objectivity and independence. In addition, the charter must specify the outside auditor's ultimate accountability to the board of directors and the audit committee. The charter must also specify the composition and membership requirements of the audit committee.

The amendments to the Nasdaq listing standard require that each audit committee adopt a written charter. This charter must specify the scope of the audit committee's responsibilities, including in particular its responsibilities vis a vis the outside auditor and ensuring the outside auditor's objectivity and independence. In addition, the charter must specify the outside auditor's ultimate accountability to the board of directors and the audit committee. The charter must also specify the composition and membership requirements of the audit committee.

5. Reporting Requirement

Finally, the Nasdaq listing standard amendments provide that each Nasdaq issuer must certify that it has adopted a written audit committee charter and that its audit committee satisfies the applicable composition, independence and financial qualification requirements.

E. AICPA Amendments

On December 16, 1999, the AICPA adopted amendments to the Statement of Auditing Standards ("SAS") No. 61, "Communicating with Audit Committees," and SAS No. 71, "Interim Financial Information." These amendments largely track, and implement, recommendations of the BRC relating to changes in generally accepted auditing standards.

The amendment to SAS 61 requires outside auditors to discuss certain information relating to the auditor's judgments about the quality, not just the acceptability, of the company's accounting principles with the audit committee of SEC clients. This language is modified from the BRC terminology which used the terms "degree of aggressiveness" and "conservatism." The required discussion will include such matters as the consistency of application of the company's accounting policies and the clarity, consistency and completeness of the company's accounting information contained in the financial statements and related disclosures. The amendment is intended to encourage a three-way discussion among the auditor, management and the audit committee. Significantly, the amendment will *prohibit* auditors from communicating in writing the auditor's judgments, purportedly to "help facilitate... open and frank discussion." However, the amendment requires documentation that the required discussion took place, the date, and the participants.

The amendment to SAS 71 clarifies that the outside auditor should communicate to the audit committee or be satisfied, through discussions with the audit committee, or at least its chairman, that the matters described in SAS 61 have been communicated to the audit committee by management when they have been identified during the interim financial reporting process. Further, the accountant is to attempt to discuss the matters described in SAS 61 prior to the filing of the Form 10-Q, or if applicable, prior to a public announcement of interim information.

F. Proposed Auditor Independence Rules and Proxy Statement Disclosures

On June 30, 2000, the SEC proposed comprehensive revisions to its rules governing auditor independence. In connection with such release, the SEC emphasized its desire for a vigorous public dialogue on the proposals and that the proposed rule includes possible alternatives for consideration by interested parties during the upcoming 75 day comment period. The proposed rules follow an agreement by all Big 5 Accounting Firm to participate in a voluntary program to address auditor independence violations.

As summarized in materials prepared by the SEC staff, under the proposed rules, the current restrictions on accounting firm employees and their immediate family members owning stock in audit clients would be liberalized and would permit, under limited circumstances, immediate family members to be employed by audit clients. Additionally, the proposals would restrict the scope of services accounting firms may offer their audit clients. Accounting firms and their audit clients would have a two year grace period to adjust their practices in order to conform to the new restrictions. The proposals also would require all public companies to disclose in their annual proxy statements information relating to the services and fees provided by their outside auditors.

If the proposals are adopted, the SEC would measure auditor independence based on four broad principles. An accountant is not independent when the accountant:

- has a mutual or conflicting interest with the audit client;
- audits his or her own work;
- functions as management or an employee of the audit client; or
- acts as an advocate for the audit client.

Under the proposals, accounting firms would be restricted from offering the following services to audit clients:

- bookkeeping or similar services,
- financial information systems design and implementation,
- appraisal or valuation services, fairness opinions or contribution-in-kind reports,
- actuarial services,
- internal audit outsourcing,
- temporary or permanent management services,
- human resource services,
- broker-dealer, investment advisor or investment banking services,
- legal services, and
- expert opinion services.

The proposals would provide accounting firms with a limited exception for independence violations where the violation is by an individual, not by the firm itself, is inadvertent, corrected promptly, and the accounting firm has adequate quality controls in place at the time of the violation.

The proposals would also require proxy statement disclosure of each professional service provided by a public company's principal independent public accountant where the fees exceed $50,000 or 10 percent of the audit fee, whichever is less. The disclosure also would indicate whether a company's audit committee or board of directors considered the effect each disclosed service could have on the auditor's independence.

The SEC has established a 75 day comment period, recognizing that the proposals, particularly the proposed limitations on the scope of services that may be provided to audit clients, are controversial.

IX. International Offerings

A. Revisions to Regulation S

On February 10, 1998, the SEC adopted significant amendments to Regulation S to eliminate perceived abuses. The amendments to Regulation S became effective on April 27, 1998. The changes affect offshore offers and sales of equity securities by U.S. public companies. Among the changes adopted are the following:

a. Lengthen the restricted period (now called the "distribution compliance period") under Regulation S from 40 days to one year to align Regulation S more closely with the provisions of Rule 144;

b. Classify equity securities sold offshore by Regulation S issuers as "restricted securities" under Rule 144, which means that resales of such securities into the United States will be restricted (in the absence of registration) even after the distribution compliance period;

c. Create certain additional requirements relating to certifications, legends and other matters that currently apply only to the sale of equity securities by non-reporting issuers;

d. Require purchasers to agree that their hedging transactions with respect to purchased securities will be conducted in compliance with the Securities Act; and

e. Allow issuers, for any sales under Regulation S after January 1, 1999, to report such sales on its next Form 10-Q (or Form 10-K) rather than requiring a Form 8-K to be filed within 15 days of the sale as was required previously.

The SEC also clarified that offshore resales under Regulation S of Rule 144 restricted equity securities of U.S. issuers will not affect the restricted status of such securities.

Certain proposed changes were not adopted. To avoid undue interference with the offshore offering practices of foreign companies, the amendments to Regulation S do not apply to the offshore offerings of equity securities of foreign issuers. Nor do the amendments apply to sales of non-convertible debt securities of domestic issuers. In addition, the restricted period under Rule 903 of Regulation S was extended to one year instead of the proposed two years to align Regulation S with Rule 144 resale restrictions. Finally, contrary to the proposed amendments, promissory notes are permitted in Regulation S transactions but must satisfy Rule 144 tolling conditions before resale is possible.

B. Safe Harbors for Offshore Press Activities

B. Safe Harbors for Offshore Press Activities

The SEC has adopted two safe harbors which will facilitate U.S. press access to offshore press activities related to present or proposed offerings of securities or tender offers by a foreign issuer.

1. Under the safe harbor of Rule 135e of the 1933 Act, which became effective November 10, 1997, a foreign issuer or its representatives may provide foreign and U.S. journalists with access to offshore press conferences, meetings conducted offshore, or press-related materials released offshore without being viewed as making an "offer" for purposes of Section 5 of the Securities Act provided that certain conditions are satisfied. To qualify for Rule 135e, the following conditions must be satisfied: (a) the press activity is outside the U.S.; (b) at least part of the offering is outside the U.S.; (c) access is provided to both U.S. and foreign journalists; and (d) where at least part of the offering is conducted in the U.S., written press related materials pertaining to the offering contain a prescribed cautionary statement. The scope of the safe harbor also covers representatives of the issuer and the selling security holders, such as underwriters and public relations firms. However, the safe harbor does not cover paid advertisements.

2. The SEC also adopted a tender offer safe harbor by amending Rule 14d-1 of the Exchange Act, for transactions involving a target company which is a foreign private issuer. Under the amended Rule 14d-1, a U.S. or foreign bidder for the securities of a foreign private issuer, as well as the foreign target company, or their representatives would not be subject to the filing and procedural requirements of the Williams Act by virtue of providing U.S. or foreign journalists with access to offshore press conferences, meetings, or press-related materials released offshore. To satisfy Rule 14d-1, the following conditions must be met: (a) access is provided to both U.S. and foreign journalists, and (b) written press-related materials relating to a tender offer of equity securities registered under Section 12 of the Exchange Act contain a prescribed cautionary statement.

C. Cross-Border Tender and Exchange Offers

On October 26, 1999, the SEC adopted rules which exempt certain cross-border tender and exchange offers, mergers and similar transactions from the registration (but not the anti-fraud) requirements of federal securities regulation.

1. Exchange Act and Tender Offer Rules Exemptions

The new provisions exempt: (1) tender offers for foreign private issuers from *most* provisions of the Exchange Act and tender offer rules when U.S. security holders hold 10 percent or less of the foreign private issuer's securities; (2) tender offers for foreign private issuers from *certain limited* provisions of the Exchange Act and tender offer rules when U.S. security holders hold 40 percent or less of the foreign private issuer's securities; and (3) tender offers for foreign private issuers from new Rule 14e-5 of the Exchange Act when U.S. security holders hold 10 percent or less of the foreign private issuer's securities.

2. Securities Act Registration Exemptions

New Rule 801 exempts rights offerings of foreign private issuers from Securities Act registration when U.S. security holders hold 10 percent or less of the foreign private issuer's securities. New Rule 802 exempts securities issued in an exchange offer, merger or similar transaction for a foreign private issuer from Securities Act registration and qualification requirements under the Trust Indenture Act when U.S. security holders hold 10 percent or less of the foreign private issuer's securities. Importantly, however, these tests are based on the percentage of publicly held "float", excluding 10 percent shareholders from the calculation.

D. International Disclosure Standards

On September 28, 1999, the SEC adopted revisions to improve the comparability of information provided to investors and securities markets by issuers offering or listing securities in multiple markets. The final rule revises the disclosure requirements for foreign private issuers to conform with the international disclosure standards endorsed by the International Organization of Securities Commissions in September 1998. Under the new rule, the international disclosure standards replace most of the non-financial statement disclosure requirements of Form 20-F, the basic disclosure document for foreign private issuers. The final rule also changes the registration statements used by foreign private issuers to reflect the revisions in Form 20-F. Finally, the new rule revises the definition of "foreign private issuer" to give clearer guidance on how foreign companies should determine whether their shareholders are U.S. residents.

X. Recent Staff Accounting Bulletins.

A. Introduction.

As recently expressed in speeches by the Chairman and Chief Accountant of the SEC, the SEC has been focusing on accounting issues in recent months in response to "new services and new technologies . . . creating new questions and challenges that must be addressed." The recent Staff Accounting Bulletins are intended to address attempts by companies to disclose the value of assets that are increasingly intangible and for which there is not sufficient guidance in the traditional financial reporting model. In addition to the guidance already provided by the recent Staff Accounting Bulletins, the SEC will continue to look at accounting issues in connection with internet activities and international accounting standards and has proposed new rules to provide better disclosure regarding such accounting areas as changes in valuation and loss accrual accounts.

B. Staff Accounting Bulletin No. 99: New Commission Guidance on Materiality

In response to recent concerns that some companies have avoided disclosing information that investors may deem significant by using an "objective" percentage test, the SEC has released Staff Accounting Bulletin No. 99. Staff Accounting Bulletin No. 99 rejects the notion that materiality may be measured solely on a quantitative basis. An issuer or an auditor may not assume the immateriality of items that fall below a percentage threshold set by management or the auditor to determine materiality. "[E]valuation of materiality requires a registrant and its auditor to consider *all the relevant circumstances*. . ."

The SEC staff also suggested that any small intentional misstatement of financial statements should be presumed to be material, because management would not have bothered unless it believed it to be significant. A misstatement may be material if, for example:

- the misstatement will mask a change in earnings or other trends;
- the misstatement will hide a failure to meet analysts' consensus expectations;
- the misstatement changes a loss into income or vice versa;
- the misstatement is significant to a portion of the business which has been highlighted as significant to the company;
- the misstatement affects compliance with regulatory requirements;
- the misstatement affects compliance with loan covenants or other contractual requirements;
- the misstatement has the effect of increasing management compensation, bonuses or incentive compensation;
- the misstatement involves concealment of an unlawful transaction; or
- the company's stock price is volatile and reacts strongly to small changes in reported results.

The staff indicated that the demonstrated volatility of the price of an issuer's securities in response to certain types of misstatements may provide guidance as to whether investors regard quantitatively small misstatements as material. Therefore, the potential market reaction should be taken into account in considering whether a misstatement is material. Finally, the SEC staff also discouraged "netting" offsetting misstatements that may cancel each other out and suggested that potential misstatements should be considered both individually and in the aggregate.

C. Staff Accounting Bulletin No. 100: New Commission Guidance on Restructuring Charges

On November 24, 1999, the SEC released Staff Accounting Bulletin No. 100 to provide guidance regarding accounting for and disclosing certain expenses and liabilities commonly reported in connection with restructuring and exit activities and business combinations, and the recognition and disclosure of asset impairment charges. The bulletin is intended to address the concern expressed by Chief Accountant Lynn E. Turner that restructuring charges and other loss accruals be adequately disclosed and supported by GAAP at the time they are established. This typically may require purchase price adjustments to record such liabilities and loss accruals at fair value. The staff also discusses criteria found in existing accounting materials, providing examples of how such material should be applied, and discusses additional disclosures that are requested to enhance the transparency of financial statements. Finally, Staff Accounting Bulletin No. 100 provides the staff's position that depreciable lives, amortization periods and salvage values of long-lived assets need to be continually evaluated and changed, if appropriate, on a timely basis and discusses the staff's view on assessing and measuring enterprise level goodwill for impairment.

D. Staff Accounting Bulletins Nos. 101, 101A and 101B: Commission Guidance on Revenue Recognition Issues

Staff Accounting Bulletin No. 101, released on December 3, 1999, expresses the views of the SEC staff regarding the application of generally accepted accounting principles to the recognition, presentation and disclosure of revenue in financial statements filed with the SEC. The staff has continued to encounter questionable and inappropriate revenue recognition practices and therefore, purportedly applying existing accounting rules, provides the following criteria for when revenue is realized and earned:

- Persuasive evidence of an arrangement exists,
- Delivery has occurred or services have been rendered,
- The seller's price to the buyer is fixed or determinable and
- Collectibility is reasonably assured.

- Collectibility is reasonably assured.

Using these criteria and transaction specific rules developed by the staff by analogy, the staff provides various examples of specific fact patterns not addressed by the rules. Staff Accounting Bulletin No. 101 also provides guidance on the disclosures required with respect to revenue recognition policies and revenue recognition in the context of a Management Discussion and Analysis On March 24, 2000, the SEC staff released Staff Accounting Bulletin No. 101A, which delays for three months the implementation date of Staff Accounting Bulletin No. 101 for companies with fiscal years beginning between December 16, 1999 and March 15, 2000. In addition, on June 26, 2000, the staff released Staff Accounting Bulleting No. 101B, which further delays the implementation date of Staff Accounting Bulletin No. 101 until no later than the fourth fiscal quarter of fiscal years beginning after December 15, 1999. These two extraordinary extensions are an implicit recognition by the SEC staff that, in many instances, Staff Accounting Bulletin No. 101 in fact applies new, stricter revenue recognition requirements in several areas.

XI. Recent Amendments to Form S-8

Form S-8 was amended in February, 1999 to allow use of the form for transfer of options to family members and related entities, and to deal with abuses of the form. Prior to these amendments to Form S-8, transferability of options had also been allowed under Section 16 of the Exchange Act. In addition, the IRS has released several rulings regarding the taxability of option transfers, and in 1998, the IRS made such transfers less attractive by ruling that transfers of unvested options are not completed gifts until the options vest.

A. Use of Transferable Options

1. Purposes of Transferable Options; Impact of Section 16 of the 1934 Act

Until recently, companies rarely granted transferable stock options as part of their employee benefit plans. Instead, companies awarded non-transferable options that could only be exercised by the employee or by the employee's estate. During the last several years, however, increasing numbers of companies have authorized transferable stock options (generally limiting a transfer to the employee's immediate family or to a trust for the benefit of a member of the employee's immediate family), thanks to favorable private letter tax rulings and amendments to Rule 16b-3. In addition, recent amendments to Form S-8 now allow issuers to use Form S-8 for exercises of options transferred to family members and related family planning entities.

Transferable stock options can be a valuable estate planning asset. For instance, employees could as much as triple the amount received by their heirs by gifting the options to family members or a trust, thus minimizing the gift tax and avoiding the estate tax. Unfortunately, as noted below, the IRS has made transfers of unvested options less attractive.

(a) Section 16(b) of the Exchange Act and Rule 16b-3

Section 16(b) of the Exchange Act calls for the forfeiture of any profits realized by "insiders" arising from the purchase or sale of an issuer's registered securities within a six month time frame. A purchase or sale is matched against any other sale or purchase, respectively, within a six month period to determine the profit. This forfeiture provision is premised on the belief that insiders have both specialized knowledge and a bargaining advantage concerning their company's securities, and, in order to protect the public interest, they should not be allowed to profit from their position in this manner. Generally, insiders of a reporting company are executive officers, directors and greater than 10% stockholders. Insiders are subject to § 16(b) forfeiture only if they engage in a "purchase" and "sale" within a six-month period. Consequently, the definition these terms is critical.

(b) Rule 16b-3

The Commission adopted Rule 16b-3 under the Exchange Act in order to exempt certain transactions between an insider and the company from the forfeiture provisions of § 16(b). Rule 16b-3 applies not only to certain employee benefit plans but also to other arrangements under which insiders purchase or sell stock, stock options or other issuer securities to or from the issuer or a plan sponsored by the issuer. The premise of Rule 16b-3 is that, unlike the situation where insiders are speculating on the open market using inside information, transactions pursuant to employee benefit plans (and related types of transactions) are issuer initiated and intended to reward service or provide performance incentives.

(i) Option Transferability Under Rule 16b-3 Before 1996

Prior to amendments made in 1996, Rule 16b-3 expressly exempted the grant or award of stock options from § 16(b) only if they were non-transferable. Additionally, the grant or award of the stock option remained exempt from § 16(b) only if at least six months had elapsed from the date of the grant to the disposition date of its underlying security. Because of the non-transferability requirement, most companies did not award transferable stock options under their qualified employee benefit plans.

(ii) Option Transferability Under Rule 16b-3 After 1996

Amendments made in 1996 removed the non-transferability requirement as a condition for exempting stock options from section 16(b). Today, any grant or award of transferable or non-transferable stock options is exempt if:

a. The stock option grant is approved by the issuer's board of directors or a committee of the board of directors that is composed solely of two or more "non-employee directors;"

b. The stock option grant is approved or ratified by a majority of the issuer's security holders; or

c. At least six months passes from the date of the grant of the stock option and the disposition of the stock option (except by exercise of the option by the employee) or its underlying stock.

As a practical matter, the last prong is the least helpful to those employees who wish to transfer stock options because many gift or transfers of stock options will take place during the first six months of its award in order to take advantage of a lower gift tax valuation.

2. Private Letter Tax Rulings

While Section 16 rule changes were being considered, the IRS issued a favorable ruling concerning transferable options that, unfortunately, has been limited by a subsequent IRS Revenue Ruling. The private letter ruling begins by concluding that there is no taxable income upon either grant of the transferable option or transfer of the option to a family member. This conclusion was based on the premise that typical employee stock options do not have a readily ascertainable fair market value on the date of the grant, and transfer of the options to a family member is not an arm's length transaction. Additionally, the ruling goes on to affirm that the transfer of the stock options to the family member will be treated as a completed gift, and the family member's basis upon exercise will be the fair market value at exercise.

In a later related ruling, however, the IRS reduced the attractiveness of transferring nonstatutory stock options that are only exercisable upon the performance of additional services by the transferor (i.e., non-vested options). The IRS concluded that the transfer to a family member of a nonstatutory stock option is a completed gift upon the later of: (i) the transfer; or (ii) the time when the donee's right to exercise the option is no longer conditioned on the performance of services by the transferor. At the same time, the IRS released a revenue procedure ruling that established the guidelines for valuing compensatory stock options. The IRS listed the following factors to determine the value for transfer tax purposes of compensatory stock options: (1) expected life of the option or maximum remaining term of the option; (2) expected volatility of the underlying stock; (3) expected dividends on the underlying stock; and (4) the risk-free interest rate. These factors must also be used in conjunction with a generally recognized option pricing model such as the Black-Scholes model or an accepted version of the binomial model. These rulings greatly reduced the benefits of making gifts of transferable options, since the gift cannot be valued unless and until the option becomes exercisable by the donee, thus eliminating the ability to use a low value for a gift made soon after grant by an employee option holder. Some companies are ameliorating this limitation by providing for immediate vesting of options upon transfer to family members or family trusts of employees.

The IRS has also provided guidance on the treatment of donations of transferable stock options to charities. The aforementioned private letter rulings involved company stock option plans that allowed employees to contribute their stock options to certain charitable organizations. The IRS concluded that the transfer of the options to a charity would not be a taxable event until the organization exercises the options. Upon the exercise of the options by the charity, the donor would be taxed on the excess of the fair market value of the optioned shares on the date of exercise over the exercise price of the option. Consequently, an employee receives no additional tax benefit from transferring options than if he or she had exercised the options, paid taxes on the spread, and then donated the remaining funds. Moreover, it may be disadvantageous to the employee to transfer options to a charity because the value of the charitable gift deduction may be lower than the fair market value of the options on the date of exercise since the value of the deduction is calculated at the time of the transfer, rather than at the time of exercise, unless the employee retains a veto power over the exercise of the options.

3. Transferable Options under Form S-8

As part of the Form S-8 amendments, the Commission amended the term "employee" to include immediate family members and family trusts of employees. The argument for amending Form S-8 in this fashion is that immediate family members or family trusts are the very same persons whose exercises of inherited stock options would be covered by Form S-8 if the employee died without having exercised the options. With the amendment, Form S-8 becomes the only registration form needed for exercises of transferable or non-transferable stock options issued pursuant to qualified employee benefit plans. As part of the amendments, if a plan allows for transferability of options, the Commission now requires that the material gift and estate tax consequences to an optionee/employee of such transfers be described in the applicable Form S-8 prospectus.

The Form S-8 Adopting Release also discusses the prospectus delivery requirements for option transferees. In discussing the prospectus delivery requirements for transferred options, the Commission noted:

- employees transferors do not have to provide a prospectus to the family member for a transfer as a result of a gift or domestic relations order; and
- existing prospectus delivery requirements apply to transferees, and the issuer must deliver a prospectus, updated if necessary, to the transferee at or before the transferee's exercise of the option.

B. Other Amendments to Form S-8

B. Other Amendments to Form S-8

In addition to allowing transferable options, the new amendments to Form S-8 and related rules and regulations also deal with abuses of Form S-8, and with new disclosure requirements for transferred options.

1. Limiting Use of Form S-8 for "Consultants" and "Advisors"

The Commission has been particularly concerned about two forms of abuse of Form S-8:

- some issuers and promoters have misused Form S-8 to engage in public distributions of securities without registering the distribution under Section 5 of the Securities Act; and
- some issuers have issued securities to "consultants and advisors" for promoting the issuer's securities.

As a result of these concerns, the Commission has limited the availability of Form S-8 to consultants and advisors who are natural persons, and who, in addition to the current restrictions, also do not directly or indirectly promote or maintain a market for the issuer's securities.

The Form S-8 Adopting Release provides some guidance as to who will now qualify as a "consultant or advisor." The Commission deems the following consultants and advisors to be providing services in connection with capital raising activities:

- brokers, dealers and persons who find investors;
- persons who arrange or effect mergers that take private companies public; or
- attorneys who represent the issuer, its underwriters or any participating broker-dealer in a securities offering.

The Commission considers the following consultants and advisors to be engaged in promoting an issuer's securities:

- consultants who provide investor relations or shareholder communication services; or
- persons who publish or disseminate information that reasonably may be expected to influence the price of the issuer's securities (i.e., hyping the issuer's securities in an internet newsletter).

The following services may fall within the new definition of consultant and advisor:

- consultants who publish legitimate scientific or medical research in publications generally circulated only within the scientific or medical community;
- consultants who provide product or corporate image advertising (as long as the purpose or effect of the advertising is not to promote or maintain a market for the issuer's securities);
- business development consultants retained to identify another company as a potential partner;
- consultants who advise the issuer on business strategy or compensation policies;
- consultants who arrange a bank credit line that does not involve the issuance of any securities (whether equity or debt);
- attorneys who represent an issuer in matters that are not related to its securities, such as litigation defense or obtaining a patent;
- attorneys who prepare Exchange Act reports, whether or not such reports are incorporated into a Securities Act Registration Statement; or
- attorneys and other consultants who assist an issuer identifying acquisition targets, or in structuring mergers or other acquisitions in which securities are issued as consideration, unless the acquisition takes a private company public.

2. Amendments to Rule 401(g)

As part of the Commission's response to the abuse of Form S-8, the Form S-8 Adopting Release also amended Rule 401(g) of the Securities Act to provide that registration statements that become effective upon filing including Form S-8, no longer enjoy a presumption that the correct form was used. Consequently, if a form that is a sole purpose form (such as Form S-8) is used for a different type of transaction, the registration may not be valid, and can be challenged by the Commission after filing of the registration statement.

3. Executive Compensation Disclosure

As part of allowing issuers to register transfers options on Form S-8, the Commission has revised the executive compensation disclosure in Item 402 of Regulation S-K to generally provide that options transferred by named executive officers must be disclosed in the compensation tables as being beneficially owned by the named executive officer.

4. Remaining Issues

The Commission has also proposed an additional amendment to Form S-8 aimed at further reducing use of Form S-8 for capital raising purposes. The proposal would amend the instructions to Form S-8 to impose new qualification requirements for issuers using the form. Under the proposed rule, before filing a registration statement on Form S-8: (i) an issuer must have *timely* filed its Exchange Act reports during the 12 months prior to filing the Form S-8; and (ii) an issuer formed by merger of a nonpublic company into an Exchange Act reporting company with only nominal assets at the time of merger must wait until it has filed an annual report on Form 10-K or Form 10-KSB containing audited financial statements reflecting the merger. The Commission is also still considering expanded disclosure requirements relating to grants of securities to consultants and advisors.

XII. Amendments to Rule 701

In conjunction with the amendments to Form S-8 discussed in Section XI of this outline, the Commission amended Rule 701 of the Securities Act ("Rule 701") in February 1999, to expand the definition of "employee," limit the availability of the rule for consultants and advisors, and amend the limits for securities issuable under the rule. The amendments became effective on April 7, 1999.

A. Introduction

The Commission adopted Rule 701 in 1988 to provide employers an exemption from the registration requirements of the Securities Act for private companies who issued securities to employees under written agreements and benefit plans. As with Form S-8, the goal of Rule 701 is to ease the regulatory burdens on issuers who are issuing securities for compensatory, rather than capital raising, purposes. Prior to the 1999 amendments, the same restrictions on transferability of options discussed in connection with Form S-8 applied to Rule 701. In addition, the sales under the rule were limited to $5 million per year. The amendments, among other things, allow for transferability of awards, and remove the $5 million per year limit on sales under the rule. In addition, the Commission imposed disclosure requirements on issuers if they sell more than $5 million in a 12 month period.

B. Changes to Rule 701

1. Definition of Employee

The definition of employee has been expanded and amended so that it harmonizes with the definition of employee under Form S-8, with a few exceptions. For instance, Rule 701 is available to employees of brother-sister corporations, where Form S-8 is not.

2. Consultants and Advisors

As discussed in Section XI of this outline, the Commission is concerned about abuse of Rule 701 and Form S-8. As a result of the Commission's concern, it amended Rule 701 to provide that consultants and advisors may only receive awards under Rule 701 if they (a) are natural persons, (b) they provide bona fide services to the issuer, and (c) the services are not in connection with the offer or sale of securities in a capital-raising transaction, and do not directly or indirectly promote or maintain a market for the issuer's securities. This limitation mirrors the amendments to Form S-8, and the Form S-8 Adopting Release provides interpretive guidance as to who now qualifies as consultants and advisors.

3. Increase in Amount Issuable

Under Rule 701, as amended, an issuer can sell in any 12 month period the greater of

- $1,000,000;
- 15% of total assets; or
- 15% of outstanding shares.

In the case of stock options, sales are measured by the exercise price at the time of grant. This is a significant change from the prior version of the rule, which counted the amount

In the case of stock options, sales are measured by the exercise price at the time of grant. This is a significant change from the prior version of the rule, which counted the amount offered rather than sold. For instance, vested options counted as offers under the prior version of the rule, but non-vested options did not. The prior version of the rule thus caused employers to have to engage in a cumbersome tracking of option vesting so that the employer did not inadvertently go above the $5 million limit in any given year due to a large number of options vesting at one time. The new rule counts securities one time only, at the time of grant.

In meeting the assets test set forth above, a private subsidiary may use the assets of its public parent if the parent guarantees the payment of the subsidiary's securities that are issued under Rule 701.

4. Information Disclosure Requirements

For sales in a 12 month period of over $5 million, Rule 701 as amended requires that certain disclosures be given to participants in the plan. In addition to providing participants a copy of the plan, the issuer must deliver the following disclosure to plan participants:

- if the plan is not subject to ERISA, a summary of the material terms of the plan;
- information about the risks associated with investment in the securities sold pursuant to the benefit plan; and
- financial statements required to be furnished by Form 1-A.

The financial statement requirement described above can dampen issuer's enthusiasm to sell more than $5,000,000 in securities under the rule in a 12 month period, because private companies who consider their financial information to be proprietary will not want to distribute their financial statements to a potentially large number of plan participants. If the issuer has a public parent, however, that is guaranteeing payment of the securities, then the financial statements of the public parent will meet the financial statement disclosure requirement.

Issuers must deliver the required information a reasonable period of time before the date of sale of securities under the rule. For stock options, the requirement is satisfied if the information is delivered a reasonable period of time prior to exercise. For deferred compensation or similar plans, the information must be delivered a reasonable period of time before the date the irrevocable election to defer is made.

C. How to Count Prior Grants

One of the issues that has arisen under the amendments to Rule 701 is how to count prior grants under Rule 701 against the rule's limits. As noted above, prior to the amendments, issuers had to count offers, rather than sales, under the rule. Consequently, unvested options did not count against the limits until vested. Under new Rule 701, the limits on issuance are for a rolling 12 month period, and consequently can pick up securities that were issued under the old version of Rule 701. For example, under one approach options granted prior to April, 1999 are immediately counted at their exercise prices, whether vested or not. If issuers had to immediately count all unexercised options under the rule, issuers could inadvertently have too many sales in one 12 month period. The Commission has addressed this issue in two no-action letters.

In a letter to the American Bar Association, the Commission provided three transition methods for counting existing grants of securities under the old Rule 701 limits:

- the grant date method, which allows issuers to count unexercisable portions of options granted before April 7, 1999 against the old Rule 701 limits, assuming that the old Rule 701 limits would not be exceeded;
- the effective date method, which allows issuers to treat all unexercisable options outstanding on the effective date of the amendments as grants on that date. The new Rule 701 limits would apply. Any grants in the prior 12 months would also have to be considered in determining whether the new Rule 701 limits are exceeded; and
- the exercisable date method, which allows an issuer to exclude from Rule 701 calculations portions of any options granted before the effective date of the amendments that were not exercisable on the effective date. The issuer would count the unexercisable options as sales on the date they become exercisable.

In a subsequent no-action letter, the Commission clarified that issuers could combine the grant date and exercisable date methods. Consequently, an issuer could count its option grants under old Rule 701 up to the old Rule 701 limits, and then use the exercisable date method for the remainder of the options issued prior to the Rule 701 amendments.

XIII. Staff Legal Bulletins

To date, the staff of the Commission has issued nine Staff Legal Bulletins, a relatively new means of communication, the purpose of which are to communicate the staff's position on certain issues. All of the Staff Legal Bulletins (also known as "SLABs") are available on the SEC's Web Site <http://www.sec.gov> under the heading "Other Commission Notices and Information."

A. Staff Legal Bulletin No. 1 -- Confidential Treatment Requests

Staff Legal Bulletin No. 1, issued on February 28, 1997, states the staff's view of the requirements registrants must satisfy when requesting confidential treatment pursuant to Rule 406 or Rule 24b-2. The Bulletin reviews various substantive and procedural requirements of the rules and contains tips for facilitating the staff's review.

B. Staff Legal Bulletin No. 2 -- Reporting Obligation of Issuers in Bankruptcy

Staff Legal Bulletin No. 2, issued on April 15, 1997, sets forth the factors considered by the staff when reviewing requests for no-action regarding modified Exchange Act reporting for companies in bankruptcy.

C. Staff Legal Bulletin No. 3 -- Section 3(a)(10): Exemptions from Registration

Staff Legal Bulletin No. 3 issued on July 25, 1997, sets forth the staff's views regarding the exemption from registration contained in Section 3(a)(10) of the Securities Act. The bulletin reviews the factors considered by the staff when reviewing requests for no-action regarding the Section 3(a)(10) exemption. Staff Legal Bulletin No. 3 was revised on October 20, 1999 to provide the staff's views on the availability of the Section 3(a)(10) exemption after the enactment of Section 302 of the Securities Litigation Reform Act of 1998. Section 302 was a technical correction that exempts securities issued under Section 3(a)(10) from the definition of "covered securities." As a result, issuers may now rely on a state fairness hearing to perfect a Section 3(a)(10) exemption for securities that otherwise would be deemed covered securities.

D. Staff Legal Bulletin No. 4 -- Application of Securities Act to Spin-offs

Staff Legal Bulletin No. 4, issued on September 16, 1997, sets forth the staff's views regarding the application of Section 5 of the Securities Act to spin-offs and certain related matters. The bulletin indicates that the staff will no longer respond to requests for no- action letters concerning issues covered in the bulletin. In a spin-off, a parent company distributes shares of a subsidiary company to the parent company's shareholders. The bulletin indicates that a subsidiary would not have to register the spin-off if five conditions are met:

(i) the parent shareholders do not provide consideration for the spun-off shares (therefore, there is no "sale" under the Securities Act);

(ii) the spin-off is pro rata to the parent's shareholders (therefore, no relative ownership interests have changed and accordingly none of the parent's shareholders has provided any value or consideration);

(iii) the parent provides adequate information about the spin-off and the subsidiary to its shareholders and to the trading markets;

(iv) the parent has a valid business purpose for the spin-off; and

(v) if the parent spins off restricted securities, the parent must have held such securities for at least two years (but this provision does not apply where the parent formed, rather than acquired, the subsidiary).

Additionally, the staff addressed certain other related topics in the bulletin -- for example, it expressed the view that spun-off securities would not, under most circumstances, be deemed to be "restricted securities" under Rule 144 if the above five conditions were met. The staff also expressed its view that Rule 16a-9(a) exempts the receipt of securities in a spin-off from Section 16 of the Exchange Act if all holders of a class of securities participate in the spin-off on a pro rata basis.

E. Staff Legal Bulletin No. 5 and Year 2000 Interpretative Releases

Staff Legal Bulletin No. 5, issued on October 8, 1997, set out the staff's views regarding the disclosure of then anticipated costs, problems, and uncertainties associated with the Year 2000 issue by public companies, investment advisers, and investment companies. On January 12, 1998, the SEC staff issued a revised version of Staff Legal Bulletin No. 5, describing its views about the Year 2000 issue in greater detail.

Further, because in the staff's view, many companies were not providing the type of detailed disclosures that the Commission hoped for, the staff issued an additional interpretative release on July 29, 1998 superseding SLB No. 5. The staff stated its view that most companies had material Year 2000 issues that should be addressed in their MD&A disclosure.

Finally, in March 2000, the staff of the Division of Corporate Finance issued a second supplement to the Division's telephone interpretation manual dealing with post-January 1 Year 2000 disclosure issues. The telephone interpretation provides that companies need to continue to provide Year 2000 disclosure, including updates of prior disclosure, reports of what occurred on Y2K critical dates such as January 1, 2000 and disclosure regarding dates other than January 1, 2000, only if such disclosure deals with issues that had, or the company reasonably believes would have, a material effect on the company's business, financial condition or results of operations. Thus, the SEC joined the rest of the world in recognizing that the bite of the Y2K "bug" was far less severe than anticipated for most companies.

believes would have, a material effect on the company's business, financial condition or results of operations. Thus, the SEC joined the rest of the world in recognizing that the bite of the Y2K "bug" was far less severe than anticipated for most companies.

F. Staff Legal Bulletin No. 6 -- Disclosure Obligations Relating to Conversion to the Euro

Staff Legal Bulletin No. 6, issued on July 22, 1998, sets forth issues involving public issuers, broker-dealers, investment advisers, and investment companies concerning their disclosure obligations in connection with the January 1, 1999 conversion by eleven member states of the European Union to the "euro." These obligations may arise in connection with:

i. known trends or uncertainties related to the Euro conversion that an issuer reasonably expects will have a material impact on revenues, expenses or income from continuing operations;
ii. competitive implications of increased price transparency of European Union markets (including labor markets) resulting from adoption of a common currency and issuers' plans for pricing their own products and services in euro;
iii. issuers' ability to make any required information technology updates on a timely basis, and costs associated with the conversion (including costs of dual currency operations through January 1, 2002);
iv. currency exchange rate risk and derivatives exposure;
v. continuity of material contracts; and
vi. potential tax consequences.

G. Staff Legal Bulletin No. 7 -- Plain English Disclosure

Staff Legal Bulletin No. 7 was issued on September 4, 1998 in response to the "plain English" rule adopted on January 22, 1998 that became effective on October 1, 1998. The bulletin sets forth the staff's answers to 22 frequently asked questions in a Q&A format. Staff Legal Bulletin No. 7 was updated on June 7, 1999. In the update, the SEC: (1) eliminated the questions and answers that applied to the phase-in period, which ended October 1, 1998, and added a question and answer on when Form 3 post-effective amendments must comply with the plain English rule and amendments; (2) provided sample risk factor disclosures and subheadings; and (3) listed the most frequently issued comments. The plain English rules are summarized in Section III above and practical guidelines are provided in Appendix A.

H. Staff Legal Bulletin No. 8 -- Broker-Dealer Order Handling and Circuit Breaker Issues

Staff Legal Bulletin No. 8., issued on September 9, 1998, sets forth the Division's views on how broker-dealers should handle customer orders and notify customers when marketwide circuit breakers halt trading on exchanges. This bulletin was drafted in response to problems incurred in the execution of trades on October 27-28, 1997 when the markets experienced record trading volume and used circuit breakers to close the markets early. The staff advises broker-dealers, in the event circuit breakers halt trading, to handle pending orders and new orders in the same manner they handle orders for securities in which a SRO has imposed a regulatory trading halt. If the halt is intraday, broker-dealers should send pending orders and new orders to a market for execution upon the resumption of trading, unless the customer provides instructions to the contrary. In particular, orders that are pending when the circuit breakers are triggered should be treated as "Good Til Canceled" and should be held for execution at the reopening of the next session while "At-the-Close" orders should be canceled.

I. Staff Legal Bulletin No. 9 -- Frequently Asked Questions About Regulation M

Staff Legal Bulletin No. 9 was issued on October 27, 1999 and updated on January 4, 2000 and sets forth the Division of Market Regulation's views in response to questions raised about various provisions of Regulation M. The Division commented on 20 different topics including questions relating to affiliated purchasers, the restricted period, participation in a distribution and the definition of a "business day."

XIV. Other Corporation Finance Rules and Other Issues

A. Section 16 Update

1. Mergers and Acquisition

In January 1999, the Commission addressed application of the Section 16 rules in the merger and acquisition context. The *Skadden, Arps* no-action letter provides that dispositions or conversions of target securities in a merger or acquisition context can be exempt dispositions to the issuer if certain requirements are met. The Commission also stated that payment of acquisition consideration directly to the target officers by the acquiring company will not prevent the dispositions from qualifying as dispositions to the issuer. In looking at the other side of the transaction, the Commission stated that the issuance of securities of the purchaser to executive officers of the target company would qualify as an exempt grant under the Section 16 rules if certain requirements are met. To fall within these guidelines, the conversion or cancellation of the target company securities must be simultaneous with or immediately before the related transaction. Generally, the boards of directors or compensation committees of both the target and acquiror must take action for the conversion or cancellation by the executive officers of the target to be exempt. In addition, the approval conditions of Rule 16b-3 by both the target and the acquiror must be satisfied prior to the consummation of the merger. Specifically, the *Skadden Arps* letter notes the following:

- the approval of the disposition of the target securities must made by the target;
- the approval of the acquisition of the securities of the acquiror must be made by the acquiror; and
- the approvals must contain the following information:
  - the name of each officer or director;
  - the number of securities to be acquired or disposed of for each named person;
  - if derivative securities such as stock options are to be acquired, the material terms of the derivative securities; and
  - that the approval is granted for purposes of exempting the transaction under Rule 16b-3.

2. Grantor Retained Annuity Trusts

A conflict remains between the Commission and the federal courts over the treatments of Grantor Retained Annuity Trusts (GRATs). A GRAT is an estate planning tool used to give family members the benefit of increases in the value of the assets that are transferred to the trust. For example, a grantor who is subject to Section 16 would transfer shares of the issuer's common stock to a GRAT. The GRAT would then make fixed annuity payments for a specified period of time to the grantor. Following completion of the annuity payments, the grantor's minor children would be the beneficiary of the GRAT. In a no action letter issued in 1997, the Commission considered the transactions involved in creating a GRAT to be ones in which the grantor continued to beneficially own the shares until the end of the annuity period, after which the grantor was deemed to make a gift to his minor children, which would be exempt under § 16(b). In addition, as long as the children continued to live in the grantor's household, the grantor would continue to report beneficial ownership of the shares. In coming to this conclusion, the Commission focused on Rule 16a-13, which generally provides that a change in the form of beneficial ownership of securities, if the pecuniary interest does not change, will be exempt from the short swing trading restrictions of Section 16.

In contrast, in *Morales v. Quintiles*, 25 F. Supp. 2d 369 (S.D.N.Y. 1998), the court held that a grantor who set up a GRAT for his minor daughter was subject to the short swing trading restrictions of § 16(b) because of his withdrawal and subsequent sale of securities he had previously transferred to the GRAT. In withdrawing the securities from the GRAT, the grantor was required to replace the shares with assets which had a value equal to the fair market value of the shares at the time of withdrawal. Since he had to "pay" the then-present market price for the stock, the Court held that the withdrawal of the stock from the GRAT was a purchase, and that a subsequent sale of the stock within six months was a violation of the short swing trading restrictions of Section 16. In a motion for rehearing, the Court distinguished the *Peter J. Kight* no action letter, noting that in the no-action letter, the grantor represented that the creation of the GRAT would not provide an opportunity for abuse of inside information. In *Morales*, the Court held that the grantor's ability to withdraw the shares from the trust provided an opportunity for abuse of inside information. The Court did not discuss the applicability of Rule 16a-13. Consequently, the ability of insiders to use GRATs as an estate planning tool is still an open issue.

3. Open Market Stock Purchase Plans

In a no action letter to the American Bar Association, the Commission took the position that acquisitions of stock in an open market stock purchase plan using accumulated payroll deductions would qualify as an exempt transaction with "an employee benefit plan sponsored by the issuer" under Rule 16b-3(a), if the acquisitions meet the following requirements:

- the issuer deducts funds from compensation;
- deducted funds accumulate for a regular, specified interval no shorter than a pay period;
- accumulated funds are invested in issuer stock; and
- the open market plan restricts participation to employees of the issuer and its parents and subsidiaries who would be eligible to purchase the issuer's securities under a Form S-8.

4. Other Section 16 Issues

In a no action letter to the American Bar Association, the Commission dealt with several different issues about the application of Rule 16b-3. In the letter, the Commission noted that:

- transaction in the securities of an issuer by officers or directors of the issuer and a majority owned subsidiary of the issuer, or an employee benefit plan sponsored by

- transaction in the securities of an issuer by officers or directors of the issuer and a majority owned subsidiary of the issuer, or an employee benefit plan sponsored by the subsidiary, qualify for exemption under Rule 16b-3, assuming the requisite approval requirements are met by the issuer (rather than the subsidiary);
- for the purposes of Section 16 reporting, Section 16 insiders can aggregate exempt purchases of phantom stock under a non-qualified deferred compensation plan on Form 5, rather than having to list each separate purchase;
- the following plans will not qualify as Excess Benefit Plans under Rule 16b-3(b)(2);
  - any non-qualified plan that permits participants to defer a portion of their compensation into the plan; and
  - any supplemental plan that provides an employer matching contribution based on the employee's deferral of salary into a non-qualified plan; and
- an officer's or director's interest in an interested transaction can be exempted under Rule 16b-3. The Commission noted types of transactions that would be exempted:
  - a transaction between the issuer and a partnership or corporation in which the officer or director must report beneficial ownership of securities;
  - a transaction between the issuer and a member of the officer's or director's immediately family where the officer or director must report a pecuniary interest; or
  - a trust in which the officer or director is required to report holdings and transactions.

In such cases, the transactions must meet the conditions for approval set forth in Rule 16b-3, and the approval must specify the existence and extent of the officer's or director's indirect interest in the transaction, and that the approval is granted for purpose of making the transaction exempt under Rule 16b-3.

B. Rule 504 Revisions

On April 7, 1999, the SEC amended Rule 504 in an effort to eliminate fraudulent secondary transactions in the over-the-counter markets for securities of "microcap" companies. The amendments limit the circumstances where general solicitation is permitted and "freely tradable" securities may be issued in reliance on Rule 504 to transactions: (1) registered under state law requiring public filing and delivery of a disclosure document to investors before sale; or (2) exempted under state law permitting general solicitation and advertising so long as sales are made only to accredited investors.

C. Communications and the Securities Offering Process:

Over the last few years, some common practices used by issuers and underwriters to disseminate information about a security have attracted the attention of the SEC. Recent media reports documenting the delay of a highly anticipated IPO from Webvan.com, an Internet based grocery delivery service, suggest that the SEC is beginning to crack down on these common practices, particularly violations of the "quiet period".

1. Communications and the offering process under the Securities Act of 1933: There are three stages of securities offering process – what one can say and do during each of these periods varies. These periods are:

a. Pre-filing Period: the period before a registration statement is filed with the SEC.

b. Waiting Period: the period between the time the registration statement is filed with the SEC and the time the registration statement is declared effective.

c. The Post-effective Period: the period after the registration statement is effective.

2. During the pre-filing period the issuer may make no offers or sales, whether written or oral.

a. Offer is a broadly defined term and includes any statement which may arouse public interest in the issuer's securities prior to officially making a public offering. An issuer's release of offering information during the pre-filing period is often referred to as conditioning the market and is prohibited. Because of this prohibition against offers and sales, the pre-filing period is also often referred to as the "quiet period". Offers and sales during the "quiet period" are termed "gun-jumping" violations.

b. During the "quiet period" an issuer may not initiate any communication – including oral, broadcast, or written communications –with potential investors, if such communication may generate a buying interest in the public's mind.

(1) The only exception to this restriction is Rule 135, the exclusive means for making a pre-filing announcement of offers. Rule 135 allows an issuer, prior to the filing of a registration statement, to provide a notice of the pending offering as long as the notice only contains limited information, including the name of the issuer, the title of the issue, and the amount and the basic terms of the issue.

c. What Communications Are Allowed During the "Quiet-Period"?

(1) The "quiet period" creates a dilemma for firms that are required to periodically release information to the public – for instance a public firm required to file a 10K or 10Q – and for firms that want to advertise or communicate with shareholders.

(a) Recognizing this dilemma, the SEC has published guidelines which allow a company to continue to normally disseminate information of the type it did prior to contemplating registration. These forms of information include normal business advertising, periodic financial reporting, and factual announcements to the media. The guidelines, however, state that forecasts, projections, or predictions should be avoided.

d. Violation of the "Quiet Period": If a issuer violates the "quiet period", the SEC may require, among other things, a cooling off period, where the issue is delayed until the market no longer feels the effects of the communication.

(1) One recent example: According to press reports, Webvan.com – a highly publicized Internet grocer with well known underwriters and executives – recently attracted the attention of the SEC by making its principals available to reporters from BusinessWeek and Forbes magazines, despite the mandated "quiet period" and disclosing certain information at a roadshow.

(a) Both prior to filing its $345 million IPO, and after filing but before the statement became effective, Louis Borders, Webvan CEO, stated in BusinessWeek, among other things, that: (1) Webvan facilities will start making money within nine months of launch; (2) at peak performance the company expects to bring in $300 million in annual revenue per facility; (3) each facility will handle more than 8000 orders per day involving 225,000 items; and (4) Webvan would likely eventually go into dry cleaning, film processing, video rentals, and electronics. This is forward looking information that has the potential to condition the public and is typical of what is forbidden during the "quiet period".

(b) Concerns were also raised about disclosures at a roadshow reported on Street.com.

(c) Webvan subsequently delayed its IPO, agreeing to a cooling off period and amended its S-1 registration statement.

(2) What does Webvan Mean?

(a) The decision by Webvan to postpone its IPO signals that despite a perception by some that the rules have loosened a bit, the SEC is still taking the "quiet period" seriously.

e. Internet Communications and the "Quiet Period"

(1) Internet communications should follow the same general rules as other forms of communication. Thus, a public company maintaining a website should subject information it conveys using the Internet to the same level of scrutiny as an advertisement, press release, or other form of traditional communication.

(2) Tips to avoiding "gun-jumping" in the Internet age:

(a) Do not treat Internet related information sources any differently than traditional sources.

(b) Do not break routine by introducing an IPO website, increasing Internet presence through increased use of banner advertisements, or overhauling or creating a general non-IPO-related website during the "quiet period".

(c) Do not allow employees to participate in Web discussions or visit on-line chat rooms when the company is the topic of the postings.

(d) Create a policy preventing employees from posting company information on personal websites.

(e) Scrubbing your website prior to any securities offering.

3. Post-filing period: During the post filing or "waiting period", the outright prohibition on offers is removed. Oral offers are permitted, but, an issuer may only make written offers through a prospectus complying with Section 10. Because the term prospectus is broadly defined, any written material, or material broadcast over radio or television, falls under the definition Thus, Internet communications present many of the same uncertainties during the "waiting period" as are presented during the "quiet period"; hence, the same level of care is recommended.

4. What does the future hold?

a. Pre-Filing Period

a. Pre-Filing Period

(1) In a recent speech, Commissioner Unger stated the SEC recognizes "that the free availability of information in chat rooms, bulletin boards, and sites devoted to whispered earnings [estimates] has made it much harder for the Commission to continue advocating a 'quiet period' before an offering by a seasoned public company."

(2) The aircraft carrier proposal also recognizes that any communications seasoned companies make during the "quiet period" are "less likely to have a significant impact by conditioning the market or stimulating interest in a proposed offering." The proposal therefore contains a suggested exemption from the pre-filing period restrictions for large seasoned firms. The proposal also contains a limited number of safe-harbors for other forms of communications during the "quiet period". Even though adoption of the aircraft carrier proposal in its current form is unlikely, the proposal sheds some light on the SEC's views and may give rise to future rule revisions.

b. Post-Filing Period

(1) Although it will not proceed in its present form, the aircraft carrier proposal also sheds some light on the SEC's view toward the "waiting period" and electronic communications: "The proposed communications rules would enable issuers and market participants to take significantly greater advantage of the Internet and other electronic media to communicate and deliver information to investors [during the "waiting period"]. Most notably, the proposal would permit all issuers, underwriters and their representatives to communicate during the waiting period with potential investors without having to conform their communications to the informational requirements of Section 10 of the Securities Act."

(2) The proposed price for this greater communication freedom under the aircraft carrier would be a requirement that post-filing communications (other than routine business communications) be filed with the SEC and subjected to prospectus-type liability.

D. Other Current Issues

The SEC staff is giving greater scrutiny to two issues discussed in the SEC's Current Issues and Rulemaking Projects of the Division of Corporation Finance outline, revised on June 21, 2000: (1) tracking stock and (2) short sales by underwriting syndicates.

1. Tracking Stock

The SEC staff is concerned about situations where an issuer creates a new class of securities to track a particular business unit of the company, rather than spinning-off the business unit to shareholders. The staff is concerned that the style and content of disclosure regarding the business unit targeted by the class of common stock may give the inaccurate impression that the investor has a direct or exclusive financial interest in that business unit. In addition, the concern is that issuers are unduly emphasizing the financial performance of these units (usually the crown jewels of a company) and thereby creating confusion with shareholders about the performance of the entire company. The staff will object to non-GAAP measures and cost allocations that do not comport with GAAP. They are also suspicious of tracking stock whose performance is measured by a formula. The staff will ask the registrant to provide extensive disclosure/information to determine whether the formula is clear and is being applied appropriately.

2. Syndicate Short Positions

After decades of boilerplate disclosure about the possibility that the underwriting syndicate could engage in short sales during a distribution, the SEC is now worried that investors are unaware of the ramifications of such short-selling and their legal rights. The staff has held up a number of recent IPOs to address this issue. The securities industry was quite concerned about this and visited the staff to seek a compromise. The compromise is reflected in the Current Issues outline. In summary, the SEC staff views any syndicate short sales as being part of the related distribution. As such, the staff seeks to provide that purchasers of short sale securities get a prospectus and the same Securities Act protections (for example, protections provided by Section 11 and Section 12 of the Securities Act) as purchasers in the distribution.

The securities industry has not resisted the prospectus delivery aspect of this compromise because Rule 174 promulgated under the Securities Act already requires dealer prospectus delivery for 25 days after an IPO, but the industry is not ready to admit that a purchaser in the secondary market can bring a claim under Section 11 of the Securities Act against a syndicate member. The SEC and the securities industry have agreed to nine new disclosures about short-selling including a description of the practice, an explanation of the difference between covered short-selling (covered by exercising a "Green Shoe" over-allotment option) and "naked" short-selling (beyond the Green Shoe). The staff has also indicated how to register the indeterminate number of shares that may be attributable to short-selling.

APPENDIX A:
PLAIN ENGLISH COMPLIANCE

The Plain English rules, which mandate the use of simplified "plain" English in prospectuses, became effective October 1, 1998. Every prospectus filed since that date is subject to Plain English review by the SEC. Even good faith filings by experienced practitioners typically receive several Plain English comment letters. Contrary to earlier indications that comments would often be sui generis, the majority of the SEC Plain English comments have been focused on a limited number of conceptual and drafting errors. The errors most frequently cited by the SEC are discussed below.

The three most common conceptual errors to date are:

(1) Mistaking Form for Substantive Clarity. Plain English rules are not satisfied by merely changing the appearance of a document, e.g., by reformatting and adding Q&As.

(2) Mistaking Brevity for Substantive Clarity. Plain English rules are not satisfied by merely making the document shorter. In fact, while a Plain English document tends to be shorter overall because of reduced repetition, discussions of particular points may actually be longer.

(3) Failing to Rethink the Entire Document. Practitioners are unlikely to satisfy the rules by approaching the process as a line-by-line rewrite rather than rethinking the presentation of the document as a whole.

The 15 most frequently cited drafting errors to date are:

(1) Failing to Disclose Purpose. In addition to disclosing facts, practitioners must clearly describe how the facts contained in the disclosure may affect investors and shareholders.

(2) Focusing on Mechanics Rather than the Big Picture. Practitioners should clearly describe not only the mechanics of a particular transaction, but its end result in terms of the big picture. For example, "At the Closing Acquisition Sub will merge with and into Company," should read, "When the merger becomes effective, Company will become a wholly-owned subsidiary of the Acquirer."

(3) Inadequately Identifying and Describing Risk Factors.

a. Listing Overinclusive Risk Factors. Headings should describe risk factors specific to the registrant rather than general factors that might apply to any offering. For example, captions such as "competition" and "environmental" should be rewritten to clearly identify which competitors, or which environmental laws, may present a risk to the value of the offered security.

b. Listing Irrelevant Risk Factors. Practitioners should include only those risks which are relevant to the offering at issue. For example, "absence of a public market" should not be routinely included in NYSE approved offerings.

c. Failing to Clearly Identify Consequences Associated with Risk Factors. For any given risk factor, practitioners should identify the potential consequences of the risk in the heading or the first sentence. Mitigating factors should appear in the business discussion, and can be cross-referenced in the risk factors, but should not be included in the risk factor section.

(4) Repeating Information Unnecessarily. Plain English rules do not permit useless repetition. For example, sentences from the summary may be used to introduce discussions in the Business section, but should not be repeated where no elaboration is necessary.

(5) Failing to Group Like Information Together. Like material should be grouped together to avoid unnecessary repetition. For example, the section identifying interested parties should immediately precede the section discussing the nature of those interests.

(6) Creating Document-Specific Vocabulary Unnecessarily. Practitioners should avoid creating document-specific vocabulary that does not enhance the reader's understanding. For example, the SEC criticized the use of the term "RTO" to describe a rent-to-own business.

(7) Overusing Technical Language or Industry Jargon. The SEC interprets technical language and industry jargon broadly to include words such as "pooling" and, at least in the REIT context, "self-administered." To be safe, practitioners should insert an explanatory phrase following the first use of any term which may be unfamiliar to readers.

(8) Assuming the Readers' Knowledge of Events. Just as an issuer should not assume the reader's familiarity with industry-specific terminology, an issuer should also not assume the readers' familiarity with events not described in the document.

(9) Embedding Lists of Information in Dense Block-Lie Paragraphs. Where a sentence with a lengthy embedded list cannot be avoided, such as where it is necessary to quote a lengthy list from a contract, clarity may be enhanced by, (i) introducing the list with a sentence or two explaining why it is important and summarizing the categories of items included in the list, and (ii) breaking up the list with bullet points or little "i's".

(10) Using "Certain" in Place of Descriptive Language. The word "certain" in phrases such as "certain assets" or "certain liabilities" should be replaced be the word "material," or other descriptive language.

(11) Cover page. The cover page must be one page long and should include only information that is required or is essential to investors. For example, a stock's par value may not be

(11) Cover page. The cover page must be one page long and should include only information that is required or is essential to investors. For example, a stock's par value may not be important enough to appear on the cover page.

(12) Using Footnotes in the Summary or Capitalization Table. Footnotes generally should not appear in summary sections The footnote information should either be included in full text or omitted from the summary. Footnotes that apply to an entire table rather than an individual entry should be in the text introducing the table. Financial footnotes are permissible but must use appropriate font size. The SEC also closely scrutinizes footnotes on the cover page and in the risk factors section.

(13) Overusing Parentheticals. The staff closely scrutinizes the use of parenthetical statements because they tend to distract the reader. In general, material information should be included without parentheses and nonmaterial information should be excluded.

(14) Capitalizing Terms Unnecessarily. Practitioners should not capitalize words such as "Common Stock", "the Merger" or "this Prospectus" unless they are defined terms. In fact, in response to comments, some filers have even begun to eliminate the use of quoted and capitalized defined terms, by not defining common terms (such as Tax Code, IRS, SEC, NYSE), by defining terms upon initial use but not capitalizing them, or by using common language in place of defined terms.

(15) Using Q&As Improperly. Q&As should be limited to a single topic, should not be longer than one or two pages, should not repeat information that appears in the summary section, and should not replace substantive discussion. They are best when addressing procedural issues, such as how to vote or exchange shares.

Additional guidelines emphasized in connection with "Staff Legal Bulletin No.7 - Plain English Disclosure" are:

(1) Defined terms. Avoid referring to the issuer as "the Company." Avoid capitalizing terms used for their common meaning (i.e. Common Stock) and avoid defining terms in parenthetical phrases when their meaning is clear from the context (i.e. SEC).

(2) Avoid legalese. Avoid the use of the words "such" and certain" and avoid copying language directly from an indenture or agreement if it is written in legalese.

(3) Formatting and sentence structure. Avoid long lists in embedded form, break up paragraphs and minimize the use of footnotes in tables and charts. Avoid using all capital letters. Instead, use bold, italics or box information. Use charts and tabular presentations.

(4) Organization. Present information in the order of importance to the investor and avoid using the mechanics of the transaction as the basis of your presentation.

(5) Remove redundancy.

(6) Summary. The summary is not to meant be a mini-document. For example, when summarizing business strategy, list six or seven bullet points and then cross-reference to a later section of the document.

(7) Risk factors. Use meaningful headings, concrete terms and get to the risk factor by the second or third sentence under each caption.