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Recent Securities Disclosure Developments

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I. 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.[1] 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.[2] 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.[3] 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.[4]

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.[5]

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.[6]

D. Updating and Harmonizing the 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

(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.

II. 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.[7] 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.[8] 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.

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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.[9]

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

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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.

III. 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

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

"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 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.

IV. Financial Reporting Initiatives - New SEC and SRO Rules Governing Audit Committees

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.[10] 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.[11] Following up on the BRC report, the SEC[12] and the NYSE,[13] Amex[14] and the NASD[15] 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.[16] 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."[17] The Commission also has approved, substantially as proposed, the amendments to the NYSE,[18] Amex[19] and the NASD[20] listing standards.

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.[21] 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.[22] 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.[23] 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.[24] 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[25] and Item 310(b) of Regulation S-B[26]) 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.[27] 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[28] 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,[29] 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[30] and S-B[31] and Item 7(e)(3) of Schedule 14A[32]) 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:

- 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[33] 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,[34] 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[35]) 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.

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[36] and S-B[37] and paragraph (e)(v) of Schedule 14A[38]) state that information provided by the audit committee will not be considered "soliciting material," "filed" with the Commission, subject to liability under Regulation

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.[39]

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).

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.[40] 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."[41]

- 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

- 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.[42] 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.[43]

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).

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.[44] 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.[45] 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.[46]

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.[47] Similar to the NYSE amendments, the Nasdaq amendments permit a board "override" such that one non-independent director might serve on the audit committee.[48] 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.[49]

4. Adoption of Written Charter

The amendments to the Nasdaq listing standard require that each audit committee adopt a written charter.[50] 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.[51]

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."[52] 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.

FOOTNOTES 1 *Mergers and Acquisitions: SEC Adopts "Sweeping" Rule Changes, Eases Curbs on Communications During Mergers*, 31 Sec. Reg. & Law Rep. 1389 (Oct. 22, 1999); *Regulation of Takeovers and Security Holder Communications*, Release Nos. 33-7760 and 34-42055 (Oct. 26, 1999) (effective January 24, 2000) <http://www.sec.gov/rules /final/33-7760.htm>.

2 See *Regulation of Takeovers and Security Holder Communications*, Release Nos. 33-7760 and 34-42055 (October 26, 1999) (effective January 24, 2000) <http://www.sec.gov/rules /final/33-7760.htm>.

3 This is contrary to the Securities Act Reform Release where the proposals are conditioned on the size and seasoned status of the company seeking to communicate.

4 See *Regulation of Takeovers and Security Holder Communications*, Release Nos. 33-7760 and 34-42055 (October 26, 1999) (effective January 24, 2000) <http://www.sec.gov/rules

4 See *Regulation of Takeovers and Security Holder Communications*, Release Nos. 33-7760 and 34-42055 (October 26, 1999) (effective January 24, 2000) <http://www.sec.gov/rules /final/33-7760.htm>.

5 The confidential treatment currently available for preliminary merger proxy statements is retained under limited circumstances, such as communications outside the proxy statement that are limited to those specified in Rule 135.

6 *Id*.

7 *See, e.g.,* "Chats with Analysts May Give Unfair Edge," USA Today, March 9, 1998.

8 Releases Nos. 33-7787, 34-42259 and IC-24209 (December 20, 1999).

9 *See* Section X.B. below regarding Staff Accounting Bulletin No. 99.

10 "The Numbers Game," remarks of Chairman Arthur Levitt, Securities and Exchange Commission, NYU Center for Law and Business (Sept. 28, 1998). A copy of this speech can be found at the SEC's website at www.sec.gov.

11 Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (1999), *reprinted (without appendices) in* 54 Bus. Law. 1067 (1999).

12 Release No. 34-41987, 64 Fed. Reg. 55648 (Oct. 14, 1999).

13 Release No. 34-41980, 4 Fed. Reg. 55514 (Oct. 13, 1999).

14 Release No. 34-41981, 64 Fed. Reg. 55505 (Oct. 13, 1999).

15 Release No. 34-41982, 64 Fed. Reg. 55510 (Oct. 13, 1999).

16 Release No. 34-42266, 64 Fed. Reg. 73389 (Dec. 30, 1999).

17 *Id.* at 73389.

18 Release No. 34-42233, 64 Fed. Reg. 71529 (Dec. 21, 1999).

19 Release No. 34-42232, 64 Fed. Reg. 71518 (Dec. 21, 1999).

20 Release No. 34-42231, 64 Fed. Reg. 71523 (Dec. 21, 1999).

21 American Institute of Certified Public Accountants, Inc., *Statement on Auditing Standards No. 90* (January, 2000).

22 *See* Release No. 34-41987, 64 Fed. Reg. at 55652 (proposing that audit committee members disclose in the company's proxy statement whether anything came to its attention that would lead it to believe that there are untrue statements or omissions of material fact in the financial statements).

23 *See* Release No. 34-42266, 64 Fed. Reg. at 73390.

24 *See* 54 Bus. Law. at 1087-88.

25 17 C.F.R. 210.10-01.

26 17 C.F.R. 228.310.

27 SAS 71 provides guidance to independent accountants on performing reviews of interim financial statements.

28 17 C.F.R. 229.302.

29 A "small business issuer" is defined in Item 10(a)(1) of Regulation S-B, 17 C.F.R. 228.10(a)(1), as a company with less than $25 million in revenues and market capitalization.

30 17 C.F.R. 229.306.

31 17 C.F.R. 228.306.

32 17 C.F.R. 240.14a-101.

33 SAS 61 requires independent auditors to communicate specified matters related to the conduct of an audit to those who have responsibility for oversight of the reporting process (i.e., the audit committee).

34 Release No. 34-42266, 64 Fed. Reg. at 73391, n. 24 (citing letters from Stephanie B. Mudick, General Counsel, Citigroup, Inc., and Michael L. Conley, Executive Vice President and CFO, McDonald's Corporation).

35 17 C.F.R. 240.14a-101.

36 17 C.F.R. 229.306.

37 17 C.F.R. 228.306.

38 17 C.F.R. 240.14a-101.

39 See Instruction 9 to Item 402(a)(3) of Regulation S-K, 17 C.F.R. 229.402(a)(3).

39 *See* Instruction 9 to Item 402(a)(3) of Regulation S-K, 17 C.F.R. 229.402(a)(3).

40 The SEC and/or the NYSE is expected to issue guidance on this issue shortly.

41 *NYSE Listed Company Manual*, § 303.01(B)(3).

42 *Id.*, § 303.01(B)(2).

43 *Id.*

44 *Nasdaq Listing Standard*, Rule 4200(a)(15).

45 *Id.*, Rule 4320(e)(22)(B)(i).

46 *Id.*

47 *Id.*

48 *Id.*, Rule 4320(e)(22)(B)(ii).

49 *Id.*, Rule 4320(e)(22)(B)(iii).

50 *Id.*, Rule 4310(c)(26)(A).

51 *Id.*, Rule 4320(e)(22)(A).

52 American Institute of Certified Public Accountants, Inc., *Statement on Auditing Standards No. 90* (January, 2000).

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