107 Annual SEC Update for In-house Practitioners

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Faculty Biographies

Margaret M. Foran

Margaret M. Foran is vice president—corporate governance, and assistant secretary of Pfizer Inc. in New York.

Prior to joining Pfizer, she was associate general counsel and assistant secretary of ITT Corporation and vice president, assistant general counsel, and assistant secretary for J. P. Morgan & Co., Inc., as well as secretary of Morgan Guaranty Trust Company of New York, where she was employed for approximately 12 years. She was also an associate with Reid & Priest.

Ms. Foran is past chair of ACCA's Corporate and Securities Law Committee. She is a member of ACCA's New York Chapter and the recipient of ACCA's 1998 "National Committee Member of the Year" award. Ms. Foran is a former director and former treasurer of the American Society of Corporate Secretaries (ASCS). She is chair of the ASCS Securities Law Committee. She is also former president and an advisory committee member of the New York Chapter of the ASCS. Ms. Foran is chair of the Coordinating Committee of the Business Roundtable's Corporate Governance Task Force. She has served as a speaker and panelist for various professional associations, has written several articles on corporate governance and securities law issues, and has served on several regulatory task forces. She holds membership in the New York State and New York City Bar Associations.

Ms. Foran received BA *magna cum laude* and JD from the University of Notre Dame.

Stanley Keller

Stanley Keller is a partner with Palmer &Dodge LLP, engaged in business and securities law practice.

Mr. Keller is chair of the ABA's Business Law Section Committee on Federal Regulation of Securities. He currently cochairs the Boston Bar Association Task Force on Revision of the Massachusetts Business Corporation Law, having previously served as chair of its Business Law Section, Corporation Law Committee, and Legal Opinions Committee. He is a member of the TriBar Opinion Committee. Mr. Keller lectures for various continuing legal education organizations, and has authored and edited a number of articles and treatises on corporate and securities law matters, including "Massachusetts Business Lawyering," "International Securities Law Handbook" and "Massachusetts Limited Liability Company Forms and Practice Manual."

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Gregory H. Mathews

Gregory H. Mathews is senior vice president and assistant general counsel for First Union Corporation in the Philadelphia office of its legal division. His responsibilities include management of certain litigation against the organization including cases involving personal and corporate trust matters, securities, mutual funds, and class actions.

Mr. Mathews was previously lead counsel for litigation and outside legal services for CoreStates Financial Corp, a bank holding company which merged with First Union in 1998. Prior to going in-house, he was a partner with the law firm of Hoyle, Morris & Kerr in Philadelphia. He also served on the staff of the SEC's Division of Corporation Finance for four years.

This year, Mr. Mathews is the chair of ACCA's Corporate and Securities Law Committee. In addition, he is a past chair of the Philadelphia Bar Association's Business Law Section and its Securities Regulation Committee. He serves as treasurer of both the Philadelphia Bar Association and the Philadelphia Bar Foundation.

Mr. Mathews received a BA from the University of Florida, holds a master's degree in political communication from the State University of New York, and received his JD from the Antioch College School of Law.

Thomas C. Sanger

Thomas C. Sanger is corporate secretary of Sempra Energy, a San Diego-based Fortune 500 Energy services holding company whose subsidiaries provide electricity, natural gas, and value-added energy products and services. His responsibilities include coordinating all meetings of the company's board of directors and its committees, the annual meeting of shareholders, and the company's document retention policies and procedures.

Prior to joining Sempra Energy, Mr. Sanger was director of corporate communications for Pacific Enterprises, the parent company of Southern California Gas Company. His responsibilities at Pacific Enterprises included financial communications and public relations. Mr. Sanger also held a variety of communications and public affairs positions at Southern California Gas Company before joining the parent company.

He is the chair-elect of the American Society of Corporate Securities. Mr. Sanger has served the ASCS as a national board and committee member, a panel chair, and speaker at national conferences and workshops, and has held numerous positions with the society's Los Angeles and San Diego chapters. He also is an accredited member and fellow of the Public Relations Society of America.

Mr. Sanger holds a BA from California State University at Northridge.

Maryann A. Waryjas

Maryann A. Waryjas is a capital partner in the Chicago office of Katten Muchin Zavis. Ms. Waryjas focuses her practice in the areas of sophisticated corporate, securities, financial services, and venture capital transactions. She has extensive experience in mergers,

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acquisitions, divestitures, securities offerings, joint ventures, and structuring complex debt and equity investments.

Ms. Waryjas has represented Health Care Service Corporation in a number of strategic initiatives. She was principal corporate and securities counsel to Gateway 2000, Inc. in the $188 million initial public offering of its common stock. She represented General Dynamics Corporation in several of its divestitures, including the F-16 Division, the Space Systems Division, the Electronics Division and the Electronics Manufacturing Center. She has counseled Sara Lee Corporation regarding strategic corporate and securities matters. Prior to becoming a member of Katten Muchin Zavis, Ms. Waryjas was a partner of Jenner & Block, Chicago, and Kirkland & Ellis, Chicago.

Ms. Waryjas is president and a member of the board of directors of the Chicago Finance Exchange, and is the first person to serve a second term as president. She is a member of the Business Law Committee of the ABA, the Securities and Corporation Law Committees, and the Corporate Control Subcommittee of the Chicago Bar Association, the Business Women's Network, and the Industrial and Technology Subcommittee of The Executives' Club of Chicago. She has served as a member of the board of governors of The Mid-America Club.

She received her BS *magna cum laude* from Loyola University and her JD *cum laude* from Northwestern University Law School.

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SECURITIES REGISTRATION

Understanding The New Integration Safe Harbors Under Rule 155

The SEC has provided new safe harbors for converting a private offering to a public offering and for doing a private offering after terminating a public offering. These safe harbors bring some welcome certainty to the area. The safe harbor permitting a private offering to be done following an aborted public offering is particularly helpful in giving companies an important new alternative for addressing integration concerns in raising needed capital.

by Stanley Keller

An area of uncertainty under the federal securities law has been the ability of a company to convert from a private offering to a public offering and conversely to do a private offering after an aborted public offering . These uncertainties have been referred to as the "metaphysics of the integration of public and private offerings." This author first wrote about the issues in 1995 in an *INSIGHTS* article called "Basic Securities Act Concepts Revisited."[1] More recently, I discussed the latter situation in "What Can We Do Now That Our Public Offering Has Aborted?" (the July 2000 article).[2]

The Securities and Exchange Commission has sought to bring some certainty to these issues with the adoption on January 26, 2001 of Rule 155, which became effective on March 7, 2001.[3] Rule 155 is a scaled-back version of the amendments to Rule 152 proposed in the Commission's 1998 release known as "The Aircraft Carrier" that dealt with a proposed comprehensive revision of the regulation of the securities offering process.[4] Rule 155 establishes two safe harbors, one for doing a registered public offering after terminating a private offering (Rule 155(b)) and the other for doing a private offering after terminating a registered public offering (Rule 155(c)). It is important to recognize that these are non-exclusive safe harbors and therefore their adoption adds to, rather diminishes, the alternatives for avoiding integration in these situations that otherwise exist. In order to better understand Rule 155, this article will first summarize the integration problems the rule seeks to address and then review the existing alternatives. It will then analyze the rule, focusing on the conditions to each safe harbor and how the safe harbors fit with existing alternatives.

The Integration Problem and Existing Alternatives

The concept of integrating two apparently separate offering to test their compliance with Section 5 of the Securities Act of 1933 has existed almost as long as the Act itself. In recent years there has been an increased focus on the integration of public and private offerings.

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Private to Public

If an offering is commenced privately and then converted to or followed by a public offering, the integration of the private and public offerings could result in the private offering violating Section 5(c) of the Securities Act as involving offers made prior to the filing of the registration statement or even sales without an effective registration statement.

There have been several ways to avoid this treatment. One is the traditional integration five-factor test discussed further below,[5] which may permit concluding that the offerings are separate. Another is use of Rule 152, which, as interpreted by the SEC, provides that a completed (or abandoned) exempt private offering will not be integrated with a subsequently filed registered public offering. However, the SEC has taken the position that Rule 152 applies only to different offerings, so that you cannot commence a private offering and then convert and complete it as a registered offering.[6] Rather, the private offering must be terminated and a new registered offering commenced. What constitutes termination of the private offering has not been clear. This issue is addressed by the Rule 155(b) safe harbor.[7] There are other alternatives to avoid integration in this situation discussed further below, including a *Black Box* analysis, reliance on the 6-month safe harbor of Regulation D or conducting the offering off-shore pursuant to Regulation S.

Public to Private

If a registered offering has been commenced, the general solicitation from that offering could preclude a valid exempt private offering if the two offerings are integrated. The general solicitation might result from the mere filing of the registration statement[8] or from active marketing efforts during the public offering. This problem can arise when the registered offering is completed, while it is pending or when it is abandoned. The problem is most pronounced when a company commences a registered offering, such as an initial public offering, but finds that the public market is not there, and it still needs to raise capital.

There have been several alternatives available to companies in this situation. The company could complete the registered offering as a directed offering to a limited number of investors, but this is feasible only for public companies because the issuer would become subject to the reporting requirements under section 15(d) of the Securities Exchange Act of 1934. The company could wait six months and rely on the Regulation D integration safe harbor, but this often will not be practical. The company could make an off-shore offering under Regulation S. It also could rely on the *Black Box* policy position the permits an offering to qualified institutional buyers and two or three large institutional accredited investors concurrently with a registered offering so long as, standing alone, the offering would be a valid exempt private offering.[9] To qualify as an exempt private offering, no general solicitation can have taken place.[10]

Finally, and most importantly, the five factor test could be applied. This is an intensely factual analysis which generally would require, if the same security is involved, withdrawal of the registration statement to terminate the presumptive general solicitation arising from filing of the registration statement.[11] The July 2000 article discusses the various factors relevant to this analysis and their application to several typical situations. The facts and circumstances analysis required in applying the five factor test has resulted in uncertainty in many situations and unevenness in application.

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Rule 155 Safe Harbors

Rule 155 seeks to bring a measure of certainty to the two situations described above by providing two safe harbors.

General Provisions

Rule 155(a) limits the rule's relief to private offerings under Section 4(2) of the Securities Act, including pursuant to Rule 506 of Regulation D, and Section 4(6) of the Act. A Rule 144A offering qualifies as a private offering. The rule does not apply to limited offerings under Rules 504 or 505 of Regulation D because investors in those offerings may be neither accredited nor financially sophisticated. The rule also does not apply to the North American Securities Administrators Association Model Accredited Investor Exemption, such as the one adopted in California and recognized by the SEC in Rule 1001 under Regulation CE. The reason given in the Release is that this exemption permits general solicitation and is therefore not a private offering.

A preliminary note to the rule provides that the safe harbors are not available if they are used as part of a plan or scheme to evade registration. For example, Rule 155(b) may not be used for purposes of testing the waters to determine investor interest for a public offering. Rather, there must be a bona fide intention to conduct a private offering. Correspondingly, using a registered offering to generate publicity for the private offering would be such a plan or scheme.

Rule 155 does not deal with the general integration concept, the five factor test or the *Black Box* analysis. Nor does it deal with completed private offerings and so-called PIPE transactions involving filing of a resale registration statement or with completed public offerings. These areas remain unaffected. In addition, the Commission's action on Rule 155 does not deal with voting commitments in merger transactions, which Rule 159 proposed in the 1998 Release sought to address. This area may be dealt with separately by the Commission in the future.

Private to Public Safe Harbor

Rule 155(b) provides a safe harbor for an abandoned private offering followed by a registered offering if four conditions are met. The conditions are designed to insure that there is a separation in the two offerings and that investors understand this break.

The first condition is that no securities may be sold in the private offering. This sounds simple but it may not be. What if the private offering is being sold in tranches? If part of the same offering, the sale of some securities would make the safe harbor unavailable. However, even though the safe harbor of Rule 155(b) might be unavailable, Rule 152 could be available if the private offering is completed through a combination of the sale of securities in the first tranches[12] and the termination of the remainder of the offering. Similarly, a traditional integration analysis might result in an earlier offering being treated as part of the current offering, causing a loss of the safe harbor. But again, Rule 152 might apply.

Another issue involves how far you can go with the private offering before it is deemed "completed," making the safe harbor unavailable. For example, what if an investor orally

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commits to purchase in the private offering and another investor subsequently indicates it is prepared to invest only if the offering is registered Assuming that there was a bona fide intention to conduct a private offering and the first investor is not contractually committed, the company should be able to abandon the private offering and complete the transaction with these investors as a registered offering using the safe harbor. The Release indicates that providing this flexibility is one of the purposes of the safe harbor.

The second condition is that all offering activity in the private offering cease before the registration statement is filed. If the company is using agents to identify investors, it must make sure the activities of these agents cease. A question is whether a company can use the safe harbor to do a takedown from an existing shelf registration after terminating the private offering activity? The SEC staff has indicated that the rule does not apply to shelf registrations. Nevertheless, Rule 152 might be available since a company is not treated as being "in registration" because of a generic shelf registration when there has not been a takedown.

The third condition is that the preliminary and final prospectus disclose the size and nature of the private offering, the date it was abandoned, that any offers to buy or indications of interest in the private offering were not accepted and that the prospectus supersedes any offering material used in the private offering.[13] These disclosures need be made only to investors in the public offering entitled to receive a prospectus. They do not need to be furnished to the private offerees.

Finally, the registration statement may not be filed for 30 days after termination of all private offering activity unless all offerees were or were reasonably believed by the company to be accredited investors or financially sophisticated within the meaning of Rule 506. Although this would require keeping track of the status of offerees, the requirement applies only if the company wants to be able to file before waiting 30 days. In many controlled private offerings, it may not be difficult to identify who were offerees and their status as accredited or sophisticated.

The SEC staff will be monitoring the use of the Rule 155(b) safe harbor, and will likely be asking in comment letters on the registration statement for information about termination of private offering activity and, if the filing is within 30 days, about the private offerees.

Public to Private Safe Harbor

Rule 155(c) establishes a safe harbor for conducting a private offering after an abandoned registered offering. This safe harbor gives companies an important new alternative for doing an exempt private offering following an aborted public offering.

There are five conditions to be met for the safe harbor. These conditions are designed to assure that the private offering is separate and distinct from the registered offering and that offerees in the private offering are aware of the more limited legal protections they receive in the private offering. The first condition is that no securities be sold in the registered offering. The receipt of funds or placing funds in escrow will prevent this condition from being met.[14]

Second, the registration statement must be withdrawn. As discussed below, withdrawal has been made easier. A question is whether this condition can be met in the case of a shelf registration without withdrawal, for example by terminating the public offering and putting the securities back on the shelf? The SEC staff has indicated that the safe harbor would not be

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available in this situation. However, it might be possible to terminate the public offering from the shelf and conclude under a traditional integration analysis, including the five-factor test and the *Black Box* policy position, that an exempt private offering can be undertaken without reliance on the safe harbor.

Next, the private offering may not be commenced until 30 days after the withdrawal of the registration statement. This condition applies for purposes of the safe harbor regardless of the nature of the investors. However, if a company wants to undertake the private offering without waiting the 30 days, it may be able to do so using the existing alternatives, such as the *Black Box* analysis, described above.[15]

Fourth, each offeree in the private offering must be notified that the offering is not registered, that the securities are restricted, that purchasers do not have the protection of section 11 of the Securities Act and that a registration statement was filed and withdrawn, specifying the withdrawal date. Unfortunately, the Commission has reintroduced the concept of "offeree" that had been eliminated under Regulation D. Consequently, a determination of what constitutes an offer and the tracking of offering activity will be required. This condition adds unnecessary uncertainty to the availability of the safe harbor, and it would be helpful if the SEC interpreted it as applying to each purchaser and to each other investor furnished a private placement memorandum.[16]

The final condition is that any private placement memorandum that is used disclose any material changes in the company's business or financial condition since the registration statement was filed. This condition does not, by its terms, seem to require a disclosure document, although one might be used to comply with antifraud rules.

The SEC staff has stated that the rule provides a safe harbor only from integration and that the private offering must meet the requirements for a valid exemption, including the absence of general solicitation.[17] In a key paragraph of the Release, the Commission stated:

> We believe that ordinarily an issuer would not be inclined to incur the costs of preparing and filing a registration statement with the intention to withdraw it later and commence a private offering. Nevertheless, we wish to assure that issuers do not use this integration safe harbor merely as a mechanism to avoid the private offering prohibition on general solicitation and advertising. At the time the private offering is made, in order to establish the availability of a private offering exemption, the issuer or any person acting on its behalf must be able to demonstrate that the private offering does not involve a general solicitation or advertising. Use of the registered offering to generate publicity for the purpose of soliciting purchasers for the private offering would be considered a plan or scheme to evade the registration requirements of the Securities Act.

Absent a plan or scheme to evade registration, the question is the extent to which marketing activity in the public offering will affect the availability of the exemption for the subsequent private offering? It is clear that neither the presumptive general solicitation arising from the filing of the registration statement nor the fact that marketing activities, such as a roadshow, generally took place would defeat the exemption. Rather, the SEC staff has indicated that a facts and circumstances analysis would apply. Relevant factors should include the nature of the investors, when the marketing activity occurred, whether the issuer or an underwriter had a pre-existing relationship with the investor at the time of the marketing in the public offering or

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whether such a relationship existed at the time of the private offering. For example, if the securities were marketed in the public offering to the customers of the underwriter or to well known institutional investors, the sale of the securities to these investors in the subsequent private offering should not raise general solicitation concerns. On the other hand, if a list was compiled of potential retail investors with which neither the underwriter nor the company had a relationship and no relationship was then established, the inclusion of those investors in the private offering might raise concerns about general solicitation.

It is important that practitioners and the SEC Staff apply these factors in a way that fosters the Rule 155(c) safe harbor's purpose of enabling issuers to complete a private offering and reduce the financial risk of an abandoned public offering by permitting the two offerings to be separated.

Applying Rule 155(c) to Illustrative Situations

The use of Rule 155(c) can be illustrated by revisiting the situations discussed in the July 2000 article. The basic situation involved Company A filing a registration statement for its initial public offering and then having the offering stall because the IPO window closes, either before the roadshow or after it. Company A needs financing and plans to do a private offering.

Case 1. Company A, with the help of the lead underwriter, lines up several institutional investors, each of which qualifies under Black Box, to purchase its common stock.

The private offering could be undertaken with *Black Box* eligible investors either immediately relying on traditional integration principles or, after waiting 30 days following withdrawal of the registration statement, pursuant to the Rule 155(c) safe harbor. In either case, the company would have to determine that there was no general solicitation in the public offering or the private offering. Ordinarily, it should be easy to establish that there was no general solicitation of *Black Box* eligible investors, such as QIBs, because of a pre-existing relationship or otherwise.[18] It is likely that the company would choose in this situation to operate outside the safe harbor unless its conditions can easily be met.

Case 2. The investors include several other institutional investors who do not satisfy the Black Box standard.

The Rule 155(c) safe harbor would be useful in this situation, assuming there had been no general solicitation. It is possible in this situation that some interval less than six months would be sufficient to separate any general solicitation in the public offering from a subsequent private offering.

Case 3. The investors include a number of individuals, most of whom are accredited, but some of whom are not.

The safe harbor would still be available, assuming the non-accredited investors had the requisite financial sophistication to participate in an exempt private offering and there was no general solicitation.

Case 4. Instead of common stock, Company A issues convertible preferred stock.

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The safe harbor would be available for a private offering of convertible preferred stock after a withdrawn registered offering of common stock. A five-factor analysis outside the safe harbor might also apply depending on the facts.

Case 5. Assume that Company A is an existing public company that tried to do a follow-on public offering.

The safe harbor applies to both a private company that attempted an unsuccessful IPO and an existing public company. If the public company used a primary S-3 shelf registration, the safe harbor probably would not be available unless no securities were sold under it and the shelf registration were withdrawn. On the other hand, a traditional integration analysis might be used. The public company might also choose to convert its registration to a shelf registration instead of withdrawing it, but the safe harbor would not be available.

Withdrawal of Registration Statement

The Commission amended Rule 477 to permit an issuer to withdraw a registration statement before it becomes effective without SEC approval. The withdrawal is effective automatically upon filing unless the SEC objects within 15 days. This change will facilitate the ability of issuers to rely on Rule 155(c) without encountering administrative delays. If the registration became effective, the SEC has indicated that it will expedite its approval of the withdrawal. Withdrawal of the registration statement also withdraws any Form 8-A filed under the Exchange Act.

Rule 477 requires the issuer to state that no securities were sold in the offering and, if the issuer anticipates relying on Rule 155(c), that it may do so. However, the issuer may not discuss the terms of the anticipated private offering because that might result in a general solicitation. Importantly, stating an intention to rely on Rule 155(c) in the withdrawal application is not a condition to the safe harbor.

There is no refund of the filing fee on withdrawal. However, Rule 457 was amended to permit the issuer to apply the fee to any registration it, its majority-owned subsidiaries or its parent may file within five years.[19]

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Conclusion

The Commission has taken a helpful step to bring some clarity and certainty to the ability of companies to undertake a registered offering after abandoning a private offering and to commence a private offering following a terminated registered offering. The safe harbor for the latter situation is particularly useful in facilitating the ability of companies to raise capital after an aborted public offering by providing another alternative to avoid integration. The Rule 155 safe harbors are non-exclusive and therefore the existing alternatives for avoiding integration outside the safe harbors should continue to be available. It is important that both practitioners and the SEC apply the Rule 155 safe harbors so that their purpose of enabling a company to switch from a private offering to a registered offering, and vice-versa, in the face of changing market conditions is served, without reducing the usefulness of the other alternatives.

NOTES

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[1] *INSIGHTS*, May 1995, at p. 5.

[2] *INSIGHTS*, July 2000, at p. 3.

[3] *See* Release No. 33-7943 (the Release).

[4] Release No. 33-7606 (Nov. 6, 1998) (the 1998 Release). The proposed amendments are described by this author in "The SEC Integration Proposals", *INSIGHTS*, January 1999, at p. 23.

[5] *See* Release No. 33-4552 (1962).

[6] S*ee* "Current Issues and Rulemaking Projects" dated November 14, 2000, of the SEC's Division of Corporation Finance at § VIII.A.9.

[7] What constitutes "completion" of the private offering also is not clear. This issue was dealt with in the proposed 1998 amendments of Rule 152 but is not addressed by Rule 155.

[8] *See* Letter dated March 23, 1984, from John J. Huber, Director of the Division of Corporation Finance, to Michael Bradfield, General Counsel of the Board of Governors of the Federal Reserve System; SEC Litigation Release No. 10241 (Dec. 19, 1983) regarding Traiger Energy Investments; and *Circle Creek AquaCulture V, L.P,* (March 26, 1993).

[9] *Black Box Incorporated* (avail. June 26, 1990), as amplified by *Squadron, Ellenoff, Pleasant & Lehrer* (avail. Feb. 28, 1992).

[10] In order for the *Black Box* policy position permitting a private offering to take place concurrent with a registered offering to have meaning, it is generally understood that the presumptive general solicitation from filing the registration statement does not apply in this case.

[11] Before the recent amendment of Rule 477 described below, withdrawal required SEC approval, which could result in delay, and loss of the filing fee. A public company that was Form S-3 eligible for primary offerings might be able to convert the registration to a generic shelf and thereby terminate the presumptive general solicitation.

[12] For this purpose, "sale" can include the investors being contractually committed to buy subject only to conditions outside their control.

[13] The antifraud rules apply to the offering materials used in the private offering.

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[14] The Rule 155(c) safe harbor does not apply to a completed public offering.

[15] *See* the July 2000 article.

[16] The proposed 1998 Rule 152 amendments required this disclosure only to purchasers in the private offering.

[17] This is similar to the gloss on the *Black Box* letter that it represents solely an integration position and the offering, standing alone, must be a valid private offering.

[18] Some lawyers believe that the concept of general solicitation is inapt in relation to QIBs because of their nature and accessibility. The SEC has not endorsed this view.

[19] Rule 457 was also amended to codify certain staff interpretations regarding fees. Rule 429 was amended to move its fee provisions to Rule 457, leaving Rule 429 to deal with use of a combined prospectus for more than one registration statement.

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THE METAPHYSICS OF INTEGRATION OF PRIVATE AND PUBLIC OFFERINGS

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August 2001

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INTEGRATION OF PRIVATE AND PUBLIC OFFERINGS: ILLUSTRATIVE SITUATIONS ....

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THE METAPHYSICS OF INTEGRATION OF PRIVATE AND PUBLIC OFFERINGS*

I. Introduction

A. Outline Coverage

1. This outline will review the SEC's current interpretations that relate to the integration of private and public offerings and the difficulties they impose on the capital formation process. It will describe proposals that have been made to address these difficulties and the recent action of the SEC to provide some relief.

2. Included as Exhibit A are some illustrative situations that demonstrate the types of issues that have arisen.

B. Staff Positions

1. Over the past several years, the staff of the SEC's Division of Corporation Finance has revisited some of the basic concepts under the Securities Act of 1933 involving the relationship of private and public offerings. The results of this process typically have been reflected in comment letters to registration statements where they have the potential to disrupt transactions. Practitioners were often taken by surprise by some of the staff's positions and many viewed them as changes that sometimes appeared to be at variance with longstanding practice. The staff, on the other hand, has maintained that its positions have been consistent with past interpretations and arise because practitioners may have become too aggressive with respect to issues under §5 of the Securities Act. The staff's positions need to be understood by practitioners so that they can structure their transactions to avoid the pitfalls.

2. Dialog between the staff and the private bar and the SEC's adoption of Rule 155 described below have resolved some of the issues and clarified others, while some issues remain outstanding and new ones have arisen. This author's article *"Basic Securities Act Concepts Revisited,"* INSIGHTS, May 1995 at p. 5, discusses some of these issues and the policy implications of the staff's approach to them.

3. While the staff is continuing to apply these principles, they have from time to time shown greater flexibility in their application and have taken into account some of the policy considerations and practicalities. The extent to which they are prepared to do so seems to ebb and flow.

* This outline is based on prior outlines of the author and has been updated to reflect recent developments.

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C. Merging of the Public/Private Distinction

1. The staff's positions on the integration of public and private offerings are attributable in part to the strains placed upon basic Securities Act concepts by the blurring of distinctions between public and private offerings. Issuers have been seeking the flexibility of quick access to the public or private markets, both domestically and offshore, based on which will produce the most favorable terms. They file shelf registrations to cover public sales, which may be to one or a few investors, while also doing private placements, which might be to a large number of qualified investors. Investment bankers may act as underwriters or placement agents, often interchangeably. At the same time, there has been a trend toward combining the speed and certainty of a private placement with the pricing benefits that flow from the greater liquidity of having registered securities. This has been accomplished through techniques known as "PIPES," "A/B Exchange Offers" and more recently "private equity lines," as well as through the use of Rule 144A offerings.

2. One consequence of the focus on the public/private offering issues has been an expanded use by eligible issuers of shelf registrations, particularly a universal shelf.

D. The Influence of Roll-Ups

In addition to these developments, the staff had to confront the issue of roll-ups, as mandated by Congress, but subject to the constraint that the roll-up rules apply only to public offerings. Roll-up transactions frequently took place in the context of a reorganization or conversion of private partnerships coupled with an initial public offering of a real estate investment trust. In order to bring these "private" roll-ups under the roll-up rules, the staff sought to integrate the "private" roll-up with the REIT public offering. Having taken this position in the case of roll-ups, as a matter of consistency the staff carried over the same restrictive interpretations to more traditional transactions.

E. Commission Response

1. In 1996, the Commission issued a concept release on "Securities Act Concepts and Their Effects on Capital Formation," Release No. 33-7314 (July 25, 1996), in which it asked for comment on what changes should be made to reform the current regulation of the capital formation process, including addressing problems of integrating public and private offerings. In particular, it asked for comment on the specific proposals described in VIII below.

2. The American Bar Association's Committee on Federal Regulation of Securities responded by letter dated December 11, 1996 commenting on the various proposals, endorsing some of them and proposing a model for a long-term solution. The ABA Committee is currently working on an updated reform proposal that would include dealing with the integration problems.

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3. Then SEC Chairman Arthur Levitt, in a January 1997 speech entitled "Corporate Finance in the Information Age," recognized the problems created by these "metaphysics" and the need to begin to address them, including possibly removing some of the barriers between private and public offerings.

4. On November 3, 1998, the Commission issued a release that proposed far-reaching changes to the securities registration system and sought to address the problems created by the "metaphysics." Release No. 33-7606 (Nov. 3, 1998) (the "Comprehensive Revision Release"). See this author's article *"The SEC Integration Proposals,"* INSIGHTS, January, 1999 at p. 23. Because of the controversy over the proposed changes to the securities registration system, many of the proposals in the Comprehensive Revision Release were not pursued.

5. However, the integration proposals in the Comprehensive Revision Release were widely applauded. They were eventually adopted in scaled-back form as Rule 155 on January 26, 2001 in Release No. 33-7943 (the "2001 Release"). See this author's article, *"Understanding the New Integration Safe Harbors under Rule 155,"* INSIGHTS, April 2001 at p. 2.

II. Summary of Basic Concepts

The following is a brief review of some of the basic Securities Act concepts involved in the staff's analysis of public/private integration issues.

A. Offer and Sale

1. Under §2(a)(3), "offer" is defined broadly to encompass not only the common law concept of an offer sufficient to form a contract upon acceptance but any attempt to dispose of a security. The meaning of the term, which triggers §5(c) of the Securities Act, remains elusive. Some relief is provided by §2(a)(3) which excludes from the definition of "offer" a right to acquire a security which is not exercisable until some future date, as well as preliminary negotiations and agreements with underwriters in privity of contract with the issuer.

2. The SEC has adopted rules excluding certain communications and activities from the term "offer" and the related concept "prospectus." *See, e.g.,* Rules 134 through 139; *see also* Rule 254 under Regulation A.

3. The term "sale" presents less difficulty and includes every contract of sale or disposition of a security for value.

4. The terms are important because of the staff's strongly-held view that a transaction commenced as a private offering cannot be completed as a registered sale; rather both the offer and sale must be either private or registered.

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B. Underwriter

1. The term underwriter under §2(a)(11) means not only the traditional market professional but also others who purchase from the issuer or a controlling person with a view to, or assist in connection with, a distribution. Its purpose is to deny the §4(1) exemption and thus impose the registration requirements on not only the issuer but also on anyone acting as a conduit for the issuer or its affiliates. Over the years, the staff has sought to characterize various parties as underwriters so as to extend the protection of registration to investors who purchase from these parties.

2. Another consequence of characterizing a party as an underwriter is to convert that party's resale into a primary offering by the issuer. One of the results of conversion to a primary offering is to change the standard for availability of Form S-3 short-form registration. In addition, the exemption for the original offering may be called into question.

3. Prior to 1983, the staff treated the purchaser of a large block of a public offering (typically in excess of 10%) as a presumptive underwriter, restricting its ability to resell freely the purchased securities. In *American Council of Life Insurance* (avail. June 10, 1983), the staff put to rest the presumptive underwriter doctrine, at least in the case of an institutional investor purchasing in the ordinary course of its investment activities without arrangements for a redistribution. The staff has since confirmed that the presumptive underwriter doctrine will not be applied to the initial purchasers in a registered offering regardless of the percentage of the offering purchased or the nature of the purchaser (assuming it is not a market professional, *i.e.*, a broker-dealer).

4. A similar liberalization of the underwriter concept is reflected in the A/B exchange offer line of no-action letters beginning with *Exxon Capital Holding Corp.* (avail. May 13, 1988). These letters permit certain privately placed securities to be exchanged for similar registered securities without the holders being classified as underwriters. However, this does not apply to market professionals, which continue to be considered statutory underwriters. *See Shearman & Sterling* (avail. July 2, 1993).

C. Integration

1. The concept of integration of offerings was developed to prevent circumvention of the registration requirements through the separation of a single non-exempt offering into several exempt offerings. The several offerings, when integrated, are treated as a single offering to determine whether an exemption is available. Integration historically has been applied to test two or more otherwise exempt offerings. Today, the concept also is being applied to test exempt private offerings with registered offerings to determine whether there is gun-jumping or general solicitation, as well as to determine whether securities issuable on conversion or exercise may be registered.

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2. In 1962, in Release No. 33-4552, the SEC announced a five factor test to determine whether separate offerings should be integrated. The five factors are: (1) whether the offerings are part of a single plan of financing; (2) whether the offerings involve issuance of the same class of security; (3) whether the offerings are made at or about the same time; (4) whether the same type of consideration is to be received; and (5) whether the offerings are for the same general purpose. The five factor test has not brought certainty to the area because its application is subjective and the staff has not provided definitive guidance as to what weight to give to the various factors or indeed how many of them have to be met. *See Sonnenblick, Parker & Selvers* (avail. Jan. 1, 1986). An ABA Task Force proposed an integration safe harbor rule to provide increased certainty, but the suggested rule has not been adopted by the Commission. See ABA Task Force Report on *"Integration of Securities Offerings,"* 41 Bus. Law. 595 (1986).

3. In order to provide some certainty, the SEC has adopted integration safe harbors under certain of the specific exemptions. These include (i) Rule 502(a) under Regulation D excluding from integration offerings more than six months before or six months after the Regulation D offering; (ii) Rule 147(b)(2) establishing a similar six-month safe harbor for intrastate offerings; (iii) Rule 701(f) separating out employee benefit plans; (iv) Rule 251(c) under Regulation A providing a safe harbor for all prior offers and sales and for subsequent registered offerings and offerings more than six months after completion of the Regulation A offering; (v) Rule 144A(e) for resales to qualified institutional buyers; and (vi) the position reflected in Preliminary Note 7 to Regulation D and the note to Rule 502(a), as well as Release No. 33-6863 (Apr. 24, 1990), that offshore sales under Regulation S will generally not be integrated with domestic offerings.

4. Rule 152, adopted in 1935 in Release No. 33-305, is a safe harbor for issuers undertaking a registered public offering after conducting a private offering. As interpreted by the staff, a completed private offering will not be integrated with a subsequently commenced registered public offering. *See Verticom, Inc.* (avail. Feb. 12, 1986), which reversed *LaserFax, Inc.* (avail. Sept. 16, 1985); *see also Vulture Petroleum Corporation* (avail. Feb. 2, 1987) and *Quad City Holdings, Inc.* (avail. April 8, 1993). Note that Rule 152 provides protection for private offerings under §4(2) and the Rule 506 safe harbor under it but not for the §3(b) exemptions under Rules 504 or 505 or the North American Securities Administrators Model Accredited Investor Exemption, such as the one adopted in California and recognized by the SEC in Rule 1001 under Regulation CE (the "State Accredited Investor Exemption").

5. *Black Box Incorporated* (avail. June 26, 1990), as amplified by *Squadron, Ellenoff, Pleasant & Leher* (avail. Feb. 28, 1992), addresses the availability of Rule 152 and other integration issues in the context of related private and public offerings. In point 4 of the *Black Box* letter, the staff made clear that the private offering had to be completed before filing of the registration statement for Rule 152 to apply and that the offering would be considered completed if there are binding commitments subject only to conditions outside the investor's control. The SEC staff indicated that

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renegotiation of terms after the registration statement is filed could make Rule 152 inapplicable. Abandonment of a private offering could also constitute its completion. See also, *United States Enrichment Corporation* (avail. May 13, 1998). See V.C.4. for the staff's interpretation of "complete" for purposes of private equity lines.

6. The SEC adopted Rule 155 in the 2001 Release. Rule 155 provides two safe harbors from integration, one for undertaking a registered public offering after abandoning a private offering, and the other for undertaking a private offering after an abandoned registered public offering. See X below.

D. Gun-Jumping

1. Gun-jumping is a concept that applies to activities before or during the registration process that violate §5 of the Securities Act. Typically, gun-jumping has been applied to impermissible publicity during the pre-filing or waiting periods. However, it is also used to describe any offer prior to the filing of the registration statement that violates §5(c) of the Securities Act.

2. It is the staff's position that securities offered to investors based on the private offering exemption cannot subsequently be registered for sale to those investors since, viewed as a single transaction, the offer before filing of the registration statement would involve gun-jumping. Notwithstanding that the language of Rule 152 appears to permit converting a private offering into a registered offering, the staff's view is that Rule 152 does not apply to an offer and sale in the same transaction.

E. General Solicitation

1. A fundamental basis for the private offering exemption, in the view of the Commission, is the absence of general solicitation of investors. This principle took on increased importance with the adoption of Regulation D, which eliminated offeree qualification requirements. Rule 502(c) of Regulation D prohibits general solicitation in Rule 505 and Rule 506 offerings. The Commission requested comment in Release No. 33-7185 (June 27, 1995) and again in Release No. 33-7314 (July 25, 1996) as to whether this prohibition of general solicitation should be eliminated or modified.

2. A partial step in eliminating the general solicitation prohibition was taken with the adoption in 1996 of Rule 1001 exempting offerings that complied with California's State Accredited Investor Exemption, but only for offerings up to $5 million. The Commission indicated that it would extend the exemption to other states that adopted requirements similar to those of California but to date the exemption has not been extended. General solicitation can also occur in a Rule 504 offering, provided that certain state blue sky law requirements are met.

3. The Commission has taken the position that the mere filing of a registration statement for a specific offering, even without offering activity (*i.e.,* a quiet filing), constitutes general solicitation of the security that is registered. Letter dated

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March 23, 1984 from John J. Huber, Director of the Division of Corporation Finance, to Michael Bradfield, General Counsel of the Board of Governors of the Federal Reserve System. *See also* SEC Litigation Release No. 10241 (December 19, 1983) regarding Traiger Energy Investments and *Circle Creek AquaCulture V, L.P.* (Mar. 26, 1993). Consequently, the exemption for a private offering of the same or a similar security undertaken during the pendency of a filed registration would not be available as a result of general solicitation if the private offering were integrated with the registered offering. An SEC internal task force had recommended that the Commission abandon its presumptive "public offering" doctrine. See VIII.A. below. However, the Comprehensive Revision Release retained this doctrine and instead proposed a safe harbor for conducting a private offering after an abandoned public offering, which has now been adopted as part of Rule 155. See IX.D. and X below.

4. The *Black Box* letter (point 3) carved out on policy grounds a limited exception for a private offering during the pendency of a registration statement to "qualified institutional buyers" and a few other institutional accredited investors. In the *Squadron, Ellenoff* letter the staff indicated that this exception is to be narrowly construed, stating that it is limited to qualified institutional buyers and no more than two or three large institutional accredited investors. However, it remains an important exception to integration "metaphysics."

5. There have been questions regarding the scope of the *Black Box* exception. For example, does it apply to "underwritten" 144A offerings taking place contemporaneously with a registered offering? The SEC staff has indicated that it does apply, pointing to the non-fungibility requirement of Rule 144A. Will it apply to private offerings involving management along with QIBs? The prevailing view is that it will apply pursuant to the so-called "Macy's position." Another question, discussed below under V.B., is whether additional tranches of similar securities can be sold in Rule 144A offerings to QIBs while the first tranches are being registered either as part of an A/B Exchange Offer or for resale in a PIPE transaction?

III. Convertible Securities and Warrants

A. Registering Issuance of Underlying Securities

1. The staff's position is that privately placed convertible securities and warrants represent an ongoing private offering of the underlying securities, at least if they are then currently convertible or exercisable, and therefore the issuance of the underlying securities cannot be registered. Rather, an exemption would have to be found for the issuance of the underlying securities on conversion (*e.g.*, §3(a)(9), if available) or exercise and those securities could be registered for resale. The staff has indicated that a shelf resale registration of the underlying securities would not prevent those securities from being issued pursuant to a private offering exemption upon conversion or exercise.

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2. On the other hand, if the convertible securities or warrants are not convertible or exercisable until some future date, there would be no "offer" under §2(a)(3) and consequently a registration statement covering issuance of the underlying securities could be filed before the convertible securities or warrants become convertible or exercisable.

3. The question exists as to how long conversion or exercisability must be deferred for there not to be an "offer." The staff has not settled on the period but requires that there be a significant period prior to exercisability and points to its longstanding position taken in the registration process that a one-year non-exercisability period is necessary to avoid the need to register the underlying securities upon a public offering of convertible securities or warrants. Some counsel have been comfortable with a shorter period.

4. The staff has indicated that the convertible securities or warrants could themselves be registered for resale, in which case the issuance of the underlying securities upon conversion or exercise could also be registered, although not for issuance to the private purchaser of the convertible securities or warrants.

5. Although the logic of the staff's position would extend to employee stock options, the staff recognizes that the practice has been to include in the Form S-8 registration the shares underlying employee stock options that were granted and may have become exercisable prior to filing. This practice has been confirmed by the staff in the Division of Corporation Finance Manual of Publicly-Available Telephone Interpretations – July, 1997, Securities Act Forms Item 61 (available at *www.sec.gov/interp/telephone/1997manual.txt*). The staff has traditionally been more accommodating regarding employee benefit plans since they present fewer concerns than capital raising activity.

B. Integrating Convertible Securities with a Registered Offering

1. The question arose whether a separate public offering of the same class of securities as were issuable upon conversion or exercise of privately placed convertible securities or warrants would be integrated with, and therefore defeat the exemption for, that private placement since there was a continuing offering of the underlying security. For example, this question was raised by the staff in the context for an initial public offering of common stock following the private offering of convertible preferred stock, a typical form of investment in venture-capital backed companies. The staff has since indicated that the integration analysis should be based on the status at the time of the private placement of the convertible securities and warrants. If that placement was completed before the filing of the registration statement, Rule 152 could be applied to prevent integration with the public offering. This position was reflected in the Comprehensive Revision Release proposal.

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2. There have been recent examples where warrants were issued for nominal consideration in order to avoid later integration with a public offering. The staff's position is that warrants issued for nominal consideration are not treated as issued for this purpose and therefore are not entitled to the benefit of being tested at the time of their issue for purposes of the Rule 152 integration analysis. If the warrants are being issued as part of a larger transaction (e.g., convertible securities with warrants), it seems appropriate to take into account the entire transaction to see if more than just nominal consideration was paid. The issuance of warrants for nominal consideration, while not treated as issued for purpose of the Rule 152 analysis, could still raise gun-jumping issues. See V.E. below.

IV. Private Formation Transactions

1. The staff has confirmed that restructuring or formation transactions outside the roll-up context will not be integrated with the initial public offering which they were undertaken to facilitate. This position would have been partially codified by the Comprehensive Revision Release proposal. Examples of such transactions are the combination of several private companies to form the entity that goes public, the issuance of common stock to founders followed by an initial public offering, or the conversion of outstanding founder debt to common stock in connection with the initial public offering.

2. The staff has emphasized, however, that the restructuring or formation transactions in and of themselves have to comply with the Securities Act (*e.g.*, the combination of several entities with outside investors may have to be tested for an exemption on an integrated basis applying the five factor integration test).

V. Private to Public Offerings

A. A/B Exchange Offers

1. The *Exxon Capital* line of letters has created a procedure under which securities are privately placed and then promptly exchanged for similar securities which have been registered and therefore are freely resalable. *See Exxon Capital Holding Corp.* (avail. May 13, 1988), *Morgan Stanley & Co. Incorporated* (avail. June 5, 1991), *Mary Kay Cosmetics, Inc.* (avail. June 5, 1991), *Warnaco Inc.* (avail. Oct. 11, 1991), *Epic Properties, Inc.* (avail. Oct. 21, 1991), *Vitro, S.A.* (avail. Nov. 19, 1991), *Corimon C.A.S.A.C.A.* (avail. Mar. 22, 1993), *K-III Communications Corporation* (avail. May 14, 1993) and *Brown & Wood LLP* (avail. Feb. 7, 1997). However, this procedure is only available for nonconvertible debt securities, certain types of straight preferred stock and initial public offerings of common stock of foreign issuers, and the staff has indicated that it is not prepared to extend its use. The Comprehensive Revision Release proposed to eliminate the use of A/B exchange offers.

2. Typically, the issuer will place the securities privately to institutional investors or sell them pursuant to the private offering exemption to investment bankers

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who resell them to qualified institutional buyers under Rule 144A, to accredited investors under Regulation D and offshore pursuant to Regulation S. Upon the registered exchange offer the holders get freely tradable securities if they are not affiliated with the issuer, acquired the original securities in the ordinary course of business and do not have any arrangement for the distribution of the exchange securities.

3. In the *Shearman & Sterling* letter, the SEC placed special requirements on broker-dealers participating in the exchange offer.

B. PIPES

1. PIPE transactions (private investment, public equity) involve a procedure in which investors agree to purchase the securities in a private offering conditioned on a registration statement covering the resale of the securities being effective. PIPES can be viewed as an evolution of registration rights. These rights began as the grant of contractual demand and piggyback registration rights; then there was a contractual covenant to provide a shelf registration within a prescribed period, often coupled with a penalty for noncompliance in the form of an increased rate of interest or dividends, adjustment of conversion price or even redemption; this was followed by having as a condition of the closing that the registration statement be filed; and now in its ultimate form the closing condition requires that the shelf resale registration statement be effective.

2. The staff has confirmed that PIPE transactions are permissible if done correctly and the Comprehensive Revision Release reflected this position. See also, the Division of Corporation Finance Manual of Publicly Available Telephone Interpretations Supplement – March 1999 ("Telephone Interpretations Supplement"), #3S(b) (available at *www.sec.gov/interps/telephone/phonesupplement1.htm*). To be done correctly, the private offering must be completed before the resale registration statement is filed so that Rule 152 is available. The *Black Box* letter (points 1 and 2) makes it clear that the offering is completed if commitments are in place from all investors subject only to conditions outside their control so that there is no further investment decision. Examples of acceptable conditions are the filing or effectiveness of a resale registration statement or receipt of regulatory approvals. A no material adverse change condition should be an acceptable condition since there is an objective standard but a diligence out would not be acceptable. See V.C. below. In addition, the staff has indicated that a closing condition based on the market price of the issuer's securities would not be acceptable because the investors would not be at risk and therefore the private offering would not have been completed at the time of filing. On the other hand, the staff has indicated that convertible securities with the conversion price tied to the market price of the underlying common stock (*e.g.*, formula preferred) would not prevent the investor from being at risk. The staff has also confirmed that the use of a market price formula and collars in merger and acquisition transactions is permissible since these do not involve capital raising and therefore are not subject to the same abuse. The staff has been rethinking whether a variable price or market price condition will prevent having a completed private offering

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or whether it should just relate to the status of the investor as an underwriter, but they continue to take the position that market risk is a requirement for completion of the offering for purposes of Rule 152. The staff also requires that the closing take place promptly after the resale registration becomes effective so that it is a valid secondary offering and not a delayed primary offering. See V.C. below.

3. If not done correctly, you have a "burst PIPE." Renegotiation of terms, at least if they are material, after the registration statement is filed is not permissible. In addition, if the issuer obtains additional commitments from private investors after the filing, these post-filing offers would be considered part of the same offering, and Rule 152 would not be available. Since filing the registration statement is considered by the staff to be general solicitation, there would be no private offering exemption for the subsequent commitments which, in turn, would defeat the exemption for the prior commitments because of integration.

4. The question has come up regarding tack-on offerings in 144A transactions where an additional tranche of securities is sold. This occurs in two forms. One involves an A/B exchange offer and the other a PIPE transaction. In the A/B exchange offer, there should be no issue in doing the additional offering if it is completed before the filing of the exchange offer registration statement because Rule 152 would apply. There also should be no issue conducting the additional offering following completion of the exchange offer either in reliance on *Black Box*, by waiting 30 days and using the Rule 155 safe harbor or possibly under a five factor integration analysis based on the registered offering being an exchange offer while the 144A offering is capital raising for cash. An issue is whether the additional offering can be done contemporaneously with the registered exchange offer. Many lawyers believe it can be done contemporaneously based upon a *Black Box* or five factor analysis. In the case of a PIPE transaction, the issue is whether the 144A additional offering can be done after filing the resale registration statement for the first tranche or whether it is a "burst PIPE." Many lawyers have gotten comfortable with this offering when limited to QIBs and 2 or 3 large institutional investors based on a *Black Box* analysis, taking into consideration that the pending registration statement is for resale rather than a primary offering.

C. Private Equity Lines

1. A recent type of transaction that has raised concerns with the staff is a private equity line under which investors agree to buy equity from the company, with the company drawing down on the commitment on a periodic basis after the resale registration statement has been filed or become effective. These are structured as PIPE transactions with deferred takedowns.

2. It is the staff's view that private equity lines, because of their delayed nature and because when the takedown price is based on a formula tied to market price of the security the purchasers would not be at risk, are indirect primary offerings. Accordingly, as a general rule, Form S-3 may be used only if the issuer is eligible to use

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Form S-3 for primary offerings ($75 million market capitalization) and the purchasers under the line must be identified as underwriters and are subject to the restrictions applicable to underwriters in a primary offering (*e.g.*, Regulation M). See "Current Issues and Rulemaking Projects Quarterly Update" dated March 31, 2001 of the SEC's Division of Corporation Finance (available at *www.sec.gov/divisions/corpfin/cfcrq032001.htm*), at §VIII, "Equity Line Financings," which replaces Telephone Interpretations Supplement, #4S.

3. The staff will, however, permit a resale registration form to be used if the following conditions are met: (i) the private transaction must be "completed" before filing the registration statement; (ii) the registration statement must be on the form the company is eligible to use for a primary offering; and (iii) the investor must be identified in the prospectus as an underwriter, as well as a selling security holder.

4. For the transaction to be "complete," the investor must be irrevocably bound to purchase all the securities. This means that only the company may exercise the put subject only to conditions outside the investor's control. This would include "bring downs" of customary representations and warranties and customary material adverse change conditions. However, a "diligence out" will not qualify, nor may the investor have the right to transfer its obligation under the equity line or to acquire additional securities (such as through the exercise of warrants) at the same time or after the issuer exercises the put. Provisions allowing the investor to affect the timing or price or allowing termination of the put are also suspect. Also, the company may not put securities convertible into the common shares being registered because the investor would have a further investment decision whether to convert and purchase the underlying registered shares. The staff's interpretation of "complete" in this context may have relevance for purposes of Rule 152.

5. If these conditions are not met, the resale may not be registered unless the company is eligible to use Form S-3 (or Form F-3) for a primary offering, it complies with Rule 415(a)(4) (dealing with "at the market" offerings and limiting the amount that may be registered) and the prospectus addresses the potential violation of § 5 in connection with the private transaction.

6. The Quarterly Update referred to in C.2. above also addresses the treatment of the registration of the equity line if it is a primary offering as a Rule 415(a)(4) "at the market" offering and the need to comply with Regulation M and NASD pre-filing requirements.

D. Converting to a Public Offering

1. The staff will not permit a transaction commenced as a private offering to be converted to a registered offering covering the issuance of the securities. They view this as inconsistent with the registration provisions and a violation of §5(c) of the Securities Act. See "Current Issues and Rulemaking Projects" dated November 14, 2000

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of the SEC's Division of Corporation Finance (the "CorpFin Outline") (available at *www.sec.gov/worddocs/cfcr112k.doc.*) at §VIII.A.9 (second paragraph).

2. However, if the private offering is terminated, the staff will allow a subsequent registered offering. See point 4 of the *Black Box* letter. Prior to the Comprehensive Revision Release, the staff had not articulated what is necessary for termination of the private offering, but had indicated that private practitioners can make that determination. The traditional five factors of Release No. 33-4552 would be relevant. Although sales to different investors would be helpful, the staff indicated that investors contacted in the private offering are not necessarily foreclosed from participating in the registered offering.

3. Rule 155 establishes a safe harbor for doing a registered offering following an abandoned private offering, but does not address what is required for termination of the private offering for purposes of Rule 152 outside the safe harbor. See IX.C. below.

4. In *United States Enrichment Corporation* (avail. May 13, 1998) the question was posed whether a company could simultaneously pursue a private sale of the company and an initial public offering, with a decision which way to go being made before filing the registration statement. The facts were unique, involving the privatization of a U.S. government corporation, but the staff confirmed that the acquisition process could be terminated before filing the registration statement and would not be integrated with the initial public offering. This is a fairly obvious application of Rule 152 and *Black Box* point 4. A more interesting question would have been whether the efforts to privately sell the company could have continued during the pendency of the registration statement. The answer should be that it could have continued based on a traditional five factor analysis since the private sale efforts were not for capital raising purposes but rather were to dispose of the entire company. The analysis might be different if it were a disposition of only a partial interest in the company, particularly a minority interest.

E. Pre-IPO Options

1. A product of the recent era of rapidly appreciating dot.com offerings was the demand of venture capitalist and other pre-IPO investors to have the right to participate in a future initial public offering. This right might take the form of a firm option similar to a preemptive right or a best efforts undertaking by the issuer to make available to the investor shares offered in a future IPO (e.g., the right to participate in a directed share program). See Lubowitz and Weinberg, *"IPO Participation Rights,"* INSIGHTS, July 2000 at p. 7.

2. Initially, the staff treated these pre-IPO options as a violation of § 5 and required risk factor disclosure of rescission rights. This has ceased to be the staff's position if a *Black Box* or Rule 152 analysis applies.

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3. It has been the staff's position that if an IPO is commenced (i.e., filed) within one year of the grant of the pre-IPO option (whether a firm option or a best efforts undertaking), the private "offer" of the participation right before filing of the registration statement must be completed privately, either separately or as part of the IPO. If grant of the pre-IPO option is completed for purposes of Rule 152 (which may occur in this context even though the purchase price is the IPO price and the investor is therefore not at market risk) or if the investors satisfy the *Black Box* criteria of being qualified institutional buyers or two or three large institutional accredited investors, exercise of the option will not be integrated with the IPO. The securities purchased pursuant to the option would be "restricted" and eligible for resale pursuant to a resale registration statement or an exemption from registration.

4. The private bar has expressed the view that, in most cases, the prospects of an IPO are sufficiently inchoate and uncertain that an "offer" should not be considered as having made. The staff has not accepted this view yet if the IPO in fact commences within one year.

VI. Public to Private Offerings

A. Limited Public Offerings

The staff has confirmed that a registered offering to a limited number of investors is permissible and, based on the *American Council of Life Insurance* letter, the investors will not be presumptive underwriters and will receive freely tradable securities so long as they purchased in the ordinary course, were not market intermediaries and had no arrangements for redistribution. Although the *American Council of Life Insurance* letter focused on institutional investors, its principle should also apply to non-institutional investors.

B. Withdrawn Registrations

1. As stated above, the Commission's position is that the filing of a registration statement constitutes the commencement of a public offering and a general solicitation. Presumably, the pendency of the registration statement may constitute a continuing general solicitation. Accordingly, the registration statement would have to be withdrawn before a private offering that would otherwise be integrated with the registered offering could be undertaken. Withdrawal of the registration statement is an express condition of the Rule 155 safe harbor. See X below. An alternative for a public company eligible to use Form S-3 for a primary offering might be to convert the registration statement to a generic shelf registration. See VI.D. below.

2. The staff has expressed concerns over the availability of an exemption for a private offering that followed a withdrawn registration statement of the same class of securities. See the CorpFin Outline at §VIII.A.9 (first paragraph).

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3. In the absence of the Rule 155 safe harbor, in order to avoid integration and attribution of the registered offering's general solicitation, the private offering would have to be sufficiently separate under the five factor test. This could involve issuing a different security or waiting a suitable interval after withdrawal of the registration statement. The staff has cited the six-month integration safe harbor under Regulation D.

4. This situation could be particularly difficult for a company that files for an IPO only to have the IPO window close on it. Often, there would be a "quiet filing" with no marketing activity. While not determinative in the staff's view, the absence of marketing activity should be a helpful factor in negating the existence of general solicitation that is attributed to the subsequent private offering.

5. Alternatives for this company may include (i) use of a different security or the passage of time in order to avoid integration and permit a private offering, as well as carefully monitoring the private purchasers, (ii) use of Regulation S for sales offshore or (iii) proceeding under the registration statement for sales to the investors to whom the securities would have been sold privately.[1] Some companies have structured the security so that the underlying common stock cannot be acquired for at least a year in order to avoid integration with a failed registered common stock offering based on there not being a current offer of the common stock under § 2(a)(3).[2] Other companies have relied on *Black Box* and completed the private offering to *Black Box* eligible investors, either immediately if there had been no marketing activity or after waiting a suitable interval (sometimes as little as 30 days) to complete the private offering if there had been marketing activity, or they have otherwise satisfied themselves after a suitable interval that the nature of the investors was such and their relationship with the company existed independent of the marketing of the registered offering that a private offering exemption could be relied on. See this author's article. *"What Can We Do Now That Our Public*

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[1] As to Regulation S offerings, see Release No. 33-7392 (Feb. 20, 1997) in which the Commission proposed amendments to Regulation S to address abusive practices and Release No. 33-7190 (June 27, 1995), an interpretive release addressing certain abusive practices. The amendments were adopted in Release No. 33-7505 (Feb. 17, 1998).

[2] A question when convertible securities are being used is whether they can be made mandatorily convertible upon an IPO which may occur within the one year period. Some believe that this should not affect the no "offer" analysis for purposes of integration since the conversion would be outside the investor's control and would not involve an investment decision. Others are concerned that the analysis of mandatorily exchangeable securities in which the sale of the underlying security is deemed to occur when the primary security is sold might be applied and result in a current offer. Given the customary nature, for the benefit of issuers, of provisions requiring mandatory conversion of convertible securities upon an IPO and the uncertainty that an IPO will occur, the staff could conclude that it is not necessary to apply the mandatorily exchangeable securities analysis in this circumstance and therefore should recognize that such a provision would not adversely affect the integration analysis.

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Offering Has Aborted," INSIGHTS, July 2000 at p. 3, written before the adoption of Rule 155.

6. The staff has sometimes shown some sympathy toward the completion of a private offering following termination of the registered offering where the investors were not contacted as part of the registered offering. The staff is likely to be unsympathetic in the case of a private offering following withdrawal of a registration statement after receipt of troublesome comments from the staff. See the *Circle Creek* letter.

7. Following the Comprehensive Revision Release proposal to amend Rule 152 to establish a safe harbor for doing a private offering following an abandoned registered offering, Rule 155 was adopted providing such a safe harbor. See IX.D. and X below.

C. Completed Public Offering

The staff applies the same analysis to private offerings following a completed registered public offering. Accordingly, it is important to structure the subsequent private offering so that it is separate from the registered public offering under the five factor test of Release No. 33-4552 and the other factors relevant to negating the existence of general solicitation. The Rule 155 safe harbor does not apply to this situation.

D. Shelf Registrations

1. The staff has indicated that the pendency of a shelf registration, whether a traditional shelf of a specific security or a generic or universal shelf, would not prevent an exempt private offering from being done so long as the security being privately offered had not been taken off the shelf for offering under the registration statement. See the CorpFin Outline at § VIII.A.9 (first paragraph) and Release Nos. 33-7856, 34-42728, *"Use of Electronic Media"* (Apr. 28, 2000), at note 10.

2. The question comes up whether a resale shelf registration under which securities are actively being sold will constitute general solicitation preventing a private offering by the issuer of similar securities. For example, if the issuer files a resale S-3 covering common stock previously privately placed with investors, may the issuer engage in a private offering of its common stock? The answer should be that a registered secondary offering generally should not be integrated with a primary offering because they are for very different purposes and involve different sellers.

3. One situation where there may be a problem with the resale registration is a burst PIPE if the issuer's offering after filing the resale registration statement is deemed part of the same offering as the private placement, resulting in loss of the exemption. See V.B. above. Another situation that can present a problem is where a broker-dealer that participated in the private placement is included as a selling

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shareholder under the resale S-3. The staff may take the position that the broker-dealer is acting as an underwriter and its resale is really a primary offering. The mere existence of a broker-dealer as a selling shareholder, however, should not create a problem where that broker-dealer did not participate in the private placement.

VII. Acquisitions

A. Resale Registration

The Rule 152 analysis for PIPE transactions would apply in the case of acquisitions where the private offering exemption is relied upon for the offer of the acquirer's securities as the merger consideration and a registration statement covering resales of the securities is filed before the merger is completed. A condition that could prevent the private offering from being completed is the need for shareholder approval by the acquired company. As long as there are sufficient binding voting commitments in place for the merger before the registration statement is filed, Rule 152 would be satisfied. See VII.B.

B. Voting Commitments

1. The staff has raised questions about the status of the shares as to which voting commitments to vote in favor of the merger have been obtained in negotiated acquisitions prior to the filing of the Form S-4 registration statement. It has been traditional for acquirers to seek voting commitments from key shareholders in order to increase the likelihood that the transaction will be approved and the merger consummated. The staff's concern is that a private offering took place in connection with obtaining the commitments and therefore the committed shares cannot be included under the Form S-4 for issuance in the merger but rather are restricted securities eligible for resale registration.

2. The staff has recognized traditional practice and permits shares of major shareholders, directors and key employees subject to voting commitments to be included in the Form S-4, at least in the case of public companies or companies for which the acquisition could not be done as a private offering. See the CorpFin Outline at §VIII.A.9 (third paragraph). This position was proposed to be codified in the Comprehensive Revision Release by the adoption of Rule 159. That rule has not been adopted, and Rule 155 does not address this situation. Note that in most cases these holders are affiliates of the acquired company and therefore underwriters under Rule 145(c) and subject to the limitations of Rule 145(d) on resales.[3] So far, the staff has been

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[3] In Release No. 33-7390 (Feb. 20, 1997) the Commission reduced the holding period under Rule 145(d) to one year and in Release No. 33-7391 (Feb. 20, 1997) the Commission proposed eliminating the "presumptive underwriter" provisions of Rule 145(c) and (d).

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unwilling to apply this policy to closely-held companies and has even raised the question whether S-4 registration can be used at all, particularly when the committed shares are sufficient to effect the corporate action.

3. One approach for preserving the availability of S-4 registration of securities to be issued in an acquisition of a closely-held company is to structure the transaction as a merger or sale of assets requiring corporate action as opposed to a share exchange, and to refrain from obtaining voting commitments. Under Rule 145, the "offer" and "sale" occurs when the acquisition is submitted to shareholders for approval. The principal shareholders of the acquired company with whom the negotiations took place before the submission to shareholders can be considered to have been acting in their corporate capacities.

4. An alternative for dealing with these issues is use of an acquisition shelf registration statement. See *Service Corporation International* (avail. Dec. 2, 1985).

VIII. Proposals Prior to the Comprehensive Revision Release

A. Task Force Report

1. The SEC established an internal Task Force on Disclosure Simplification that issued its report in March 1996.

2. The Task Force Report focused on revisions to the existing shelf registration system to increase its flexibility and expand its availability. To the extent that the shelf registration system is used, the proposals would have addressed some of the current integration problems by expanding the offerings to which shelf registration would apply.[4]

3. The Task Force Report focused specifically on some of the strains resulting from the erosion of distinctions between private and public offerings and made several specific proposals:

i. Amend Rule 152 to permit a company to switch from a private offering to a registered public offering without an intervening termination of the private offering.

ii. Adopt a comparable safe harbor for limited offerings under §3(b).

[4] In Release No. 33-7393 (Feb. 20, 1997) the Commission proposed amendments to Rule 430A to permit delayed pricing in a registered offering by smaller public companies with at least a twelve-month reporting history which are not eligible to use Form S-3 for a primary offering.

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iii. Modify the Commission view that the filing of a registration statement (other than a shelf registration) constitutes commencement of a public offering and therefore general solicitation. The Task Force Report recommended consideration of a safe harbor when there is a "quiet filing" (i.e., where there is no marketing activity).

4. The Comprehensive Revision Release addressed these issues but not entirely as recommended in the Task Force Report. Rule 155 provides for a safe harbor.

B. Advisory Committee Report

1. In 1995, the Commission established the Advisory Committee on the Capital Formation and Regulatory Processes chaired by Commissioner Steven M.H. Wallman. The Advisory Committee delivered its report in July 1996.

2. The Advisory Committee recognized the problems in the current capital formation regulatory scheme, including those created by the erosion of the distinction between private and public offerings. Its primary recommendation was the adoption of a "company registration" system, initially through a voluntary opt-in pilot program.

3. For eligible issuers, company registration would eliminate the private/public offering problems by treating all offerings as registered and thereby eliminating the distinctions between them. Under the company registration system, registration of particular offerings would be streamlined through the initial registration of issuers and all their offerings with specific requirements at the time of actual offering.

C. Four-Part Approach

1. In a speech before the American Bar Association's Committee on Federal Regulation of Securities in November 1995, Linda C. Quinn, then Director of the SEC's Division of Corporation Finance, suggested rethinking some of the Securities Act underlying concepts. These include: (i) focusing more on the nature of purchasers, (ii) deregulating offers, (iii) allowing free-writing during the offering period and (iv) allowing constructive delivery of prospectuses.

2. Focusing on the nature of purchasers and exempting offers from registration would help overcome problems resulting from the private/public offering distinctions.

D. "Pink Herring" Concept

1. This proposal, suggested by then Commissioner Wallman, would not deregulate offers but would instead simplify the ability to make them without adverse consequence through a short-form registration filing.

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2. The short-form filing would, in essence, permit testing the waters for a public or private offering. The offering could be completed as either a public or private offering.

E. This Author's Suggested Approach

1. I have suggested an approach to revisiting the regulation of the capital formation process based on the following principles, most of which are reflected in one or more of the proposals identified above:

i. Limitations on offering activity, as opposed to sales, in the context of both private and public offerings, should be narrowly tailored.

ii. Regulation of sales activity should be based on the nature of the particular investors and their need for the protection of registration.

iii. The increased accessibility and broader dissemination of information should be recognized by permitting delivery of mandated disclosure through incorporation by reference.

iv. The improved quality of disclosure readily available through access should be substituted for other protective mechanisms such as prior SEC review and traditional gatekeeper involvement.

v. Impediments to resales of unregistered securities should be reduced in view of the improved quality of information in the marketplace.

vi. Interpretations of securities regulatory issues should not be based on doctrines but rather on the underlying reasons for which the doctrines were created.

2. Issuers should be free to make offers in any manner to "qualified investors,"[5] which can then be completed either privately or in a registered public offering. By definition, these investors do not need the protection of registration or to be shielded from gun-jumping.

3. Correspondingly, registered offers should not preclude private sales to qualified investors, either during the pendency of the registered offering (without regard to whether or not marketing activity has taken place) or anytime following completion of the registered offering. Since these investors do not need the protection of registration,

[5] I have left the concept of "qualified investors" undefined to avoid a debate over which investors need protection. Clearly, the category is broader than QIBs and may be broader, narrower or coextensive with the current concept of "accredited investors."

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they are not harmed by the public offering activity. Put another way, general solicitation should not preclude a private offering to qualified investors.

4. As is now the case, an issuer should be able to make sales privately to non-qualified investors within limits if it restricts its offering activity. Alternatively, an issuer should be able to broadly solicit potential investors by making a notice filing (either a "pink herring" short-form registration or solicitation of interest filing, as well as a traditional registration statement) and then complete the offering either as a registered sale (without regard to the nature of investors) or as a private sale to qualified investors. This recognizes the desirability of allowing test-the-waters activity but the need to protect non-qualified investors even at the offer stage.

5. A registration system reflecting the principles of the Advisory Committee company registration proposal (or, alternatively, a streamlined, pay as you go, universal shelf registration system) should be in place to permit eligible issuers to easily make registered offers and sales and thereby eliminate problems arising from the distinction between private and public offerings. Initially, this can be accomplished through a voluntary program, as proposed, and ultimately through a system that applies to all reporting issuers (with possible advance filing and prospectus delivery requirements for less seasoned issuers).

6. The initiatives under paragraphs 2 and 3 could be implemented through staff or Commission interpretation or, alternatively, through rule modification. The initiatives under paragraphs 4 and 5 would require Commission rulemaking.

7. The American Bar Association's Committee on Federal Regulation of Securities has made proposals with some similar elements.

IX. SEC Comprehensive Revision Release Proposals

In the Comprehensive Revision Release, the SEC proposed to deal with the metaphysics surrounding the integration of private and registered offerings. Although not adopted, the proposals may be relevant in understanding the staff's positions, particularly where the Release sought to clarify the existing staff positions on these issues. The proposals also help in understanding Rule 155. The Release did not provide explicit additional clarification on general integration concepts.[6] This was left to further interpretive guidance.

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[6] The 30-day safe harbor periods proposed in the Comprehensive Revision Release has influenced the time periods with which practitioners feel comfortable for purposes of treating offerings as separate. Rule 155's recognition of this period has added to the comfort.

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A. Completed Private Offerings

1. The Release sought to clarify the existing safe harbor under Rule 152 for the filing of a registration statement after a completed private offering by defining the meaning of "completed."

2. As proposed, for a private offering to be completed either (i) all purchasers must have paid the purchase price or (ii) they must be unconditionally obligated to do so except for conditions outside their control, the purchase price must be fixed and not contingent on market price and the transaction may not be renegotiated.

3. If the private offering is completed, Rule 152 would have provided that it will not be integrated with a subsequently filed registered offering of another transaction or with the registered resale of the securities issued in the private offering.

4. The proposal would have codified current SEC staff positions in recognizing the PIPE transaction by treating as "completed" contractual commitments, thereby allowing a resale registration statement to be filed and declared effective before closing of the transaction. However, the proposal would not have applied this safe harbor relief to resales by an affiliate or by a broker-dealer who purchased from the issuer or an affiliate because of the staff's concerns that these persons might be conduits for the issuer.

5. The proposal also reflected the staff's concern over private equity lines by requiring that the purchase price be fixed and not contingent on market price. Under private equity lines, investors provide an unconditional purchase commitment to the company which can be drawn down over time, usually at a discount to market price at the time of drawdown. See V.C. above. The staff's concern is that this amounts to a delayed offering by an issuer not eligible to use Form S-3 for a primary offering and, therefore, not eligible for a delayed offering under Rule 415.

B. Convertible Securities and Restructurings

1. The proposed changes to Rule 152 would have codified the staff's position that for purposes of the rule the time of the offering of a convertible security is when the offering of the underlying security is deemed completed even though there is a continuing offer of the underlying security.

2. The rule also would have made clear that a restructuring transaction outside the roll-up context to facilitate an initial public offering would not be integrated with the initial public offering so long as it did not involve capital raising. An example of such a transaction is the recapitalization of a company in connection with its initial public offering.

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C. Abandoned Private Offering

1. The Release proposed to amend Rule 152 to establish a safe harbor for engaging in a registered offering after abandoning a private offering. This has been a problem for companies that wish to switch to a registered public offering because of gun-jumping implications if the abandoned private offering is integrated with the public offering.

2. The proposed safe harbor for converting a bona fide private offering to a registered public offering would have been available if (i) all offerees in the private offering are notified of its abandonment; (ii) in case any offeree is non-accredited, there is a 30-day cooling off period after the offerees are notified of the abandonment before the registration statement is filed; (iii) no securities were sold in the offering; (iv) there was no general solicitation; and (v) either any selling material used in the private offering is filed with the registration statement or the offerees in the private offering are informed that the prospectus supercedes any selling material used in the private offering and any indications of interest are rescinded.

D. Abandoned Public Offering

1. The Release also proposed to amend Rule 152 to establish a safe harbor for doing a private offering following an abandoned registered offering. This has been a particularly troublesome problem for companies that commence a public offering only to find that the public market window has closed. The general solicitation involved in the public offering could prevent doing an integrated private offering within six months.

2. The safe harbor would have been available if (i) the registration statement is withdrawn or, if the public offering has commenced before filing of a registration statement as would be permitted in some circumstances under the new securities registration process proposed by the Release, all offerees are notified of abandonment of the public offering; (ii) no securities were sold; and (iii) either (x) the first offer is more than 30 days after abandonment or withdrawal of the public offering and each purchaser is notified that the offering is not registered, the securities are restricted and there is no §11 protection, or (y) if the first offer is within the 30-day period, the issuer and any underwriter agree that purchasers have the benefit of §11 protection if they purchased within the 30-day period and of §12(a)(2) protection if they purchase thereafter. The Commission also proposed to amend Rule 477 to permit registration statements to be withdrawn automatically upon filing a request rather than requiring approval. The safe harbor would not have been limited to quiet filings as proposed in the Task Force Report but would have applied regardless of marketing activities.

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3. This safe harbor would have applied only to private offerings following an abandoned public offering. It would not have applied to private offerings during a pending registered offering or following a completed public offering. Presumably, existing principles (such as the ability under certain circumstances to do a private offering to QIBs and a few other large institutional accredited investors during the pendency of a public offering as set forth in the *Black Box* interpretive letter) would have continued to apply to these situations.

E. Merger Voting Commitments

1. The Release proposed a new Rule 159 to codify the staff's position on the use of voting commitments or "lock-ups" in merger transactions. The proposed rule was generally consistent with the current understanding of practitioners described above under VII.B.

2. Proposed Rule 159 would have permitted registration if (i) the lock-up agreements are limited to executive officers, affiliates and directors of the target company, founders of the target company and their family members and holders of 5 percent or more of the target company's voting stock and (ii) less than 100 percent of the voting securities are covered by the lock-up agreements and votes will be solicited from shareholders who did not sign lock-up agreements and who are ineligible to purchase in a private offering.

3. In substance, the proposed rule would have permitted an identifiable group of shareholders of a public or non-private company to enter into lock-up agreements without affecting the ability to register the issuance of all the shares. This would have created a strange dynamic for counsel to seek to conclude that a private offering cannot be done (just the opposite of counsel's usual analysis), but it was consistent with the present approach. The permitted group was generally consistent with the current understanding although somewhat narrower. Under the current understanding, a few key employees and venture capital type investors, regardless of holdings, are permitted to sign lock-ups.

4. Another difference from the current understanding was the treatment of private companies, *i.e.*, those with which a private offering could be done. As currently understood, the transaction could be registered so long as the lock-ups were not sufficient to constitute the corporate action. Proposed Rule 159 would not have appeared to permit registration if there is any lock up and a private offering could take place.

5. By focusing on the holders of voting securities and the solicitation of votes, the proposal might unintentionally have affected the analysis of the treatment of acquisitions where there were non-voting securities or no vote was solicited. In Release No. 33-5463 (1974), Question C-1, the staff took the position that a short-form merger of a 90 percent owned subsidiary into the parent without a shareholder vote nevertheless involved a sale subject to Rule 145. By analogy, this position could apply to action by

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written consent by key shareholders holding the requisite percentage as permitted by the corporate law of Delaware and certain other states. It also could apply where there are unsophisticated non-accredited investors, such as regular employees, who hold non-voting stock. The staff will need to clarify this area.

X. The New Integration Safe Harbors Under Rule 155

A. General Provisions

1. Rule 155 adopted in the 2001 Release establishes two safe harbors, one for doing a registered public offering after terminating a private offering (Rule 155(b)) and the other for doing a private offering after terminating a registered public offering (Rule 155(c)). It is important to recognize that these are non-exclusive safe harbors and therefore their adoption adds to, rather diminishes, the alternatives that otherwise exist for avoiding integration in these situations.

2. Rule 155(a) limits the rule's relief to private offerings under § 4(2), including pursuant to Rule 506 of Regulation D, and § 4(6) of the Securities Act. A Rule 144A offering would qualify as a private offering. The rule does not apply to §3(b) limited offerings under Rules 504 or 505 of Regulation D because investors in those offerings may be neither accredited nor financially sophisticated. The rule also does not apply to the State Accredited Investor Exemption. The reason given in the 2001 Release is that this exemption permits general solicitation and is therefore not a private offering.

3. A preliminary note to the rule provides that the safe harbors are not available if they are used as part of a plan or scheme to evade registration. For example, Rule 155(b) may not be used for purposes of testing the waters to determine investor interest for a public offering. Rather, there must be a bona fide intention to conduct a private offering. Correspondingly, using a registered offering to generate publicity for the private offering would be such a plan or scheme.

4. Rule 155 does not deal with the general integration concept, the five factor test or the *Black Box* analysis. Nor does it deal with completed private offerings and PIPE transactions involving filing of a resale registration statement or with completed public offerings. These areas remain unaffected. In addition, the Commission's action on Rule 155 does not deal with voting commitments in merger transactions, which Rule 159 proposed in the Comprehensive Revision Release sought to address. This area may be dealt with separately by the Commission in the future.

B. Private to Public Safe Harbor

1. Rule 155(b) provides a safe harbor for an abandoned private offering followed by a registered offering if four conditions are met. The conditions are designed to insure that there is a separation in the two offerings and that investors understand this separation.

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2. The first condition is that no securities may be sold in the private offering. This sounds simple but it may not be. What if the private offering is being sold in tranches? If part of the same offering, the sale of some securities would make the safe harbor unavailable. However, even though the safe harbor of Rule 155(b) might be unavailable, Rule 152 could be available if the private offering is completed through a combination of the sale of securities in the first tranches and the termination of the remainder of the offering. Similarly, a traditional integration analysis might result in an earlier offering being treated as part of the current offering, causing a loss of the safe harbor. But again, Rule 152 might apply. Another issue involves how far you can go with the private offering before it is deemed "completed," making the safe harbor unavailable. For example, what if an investor orally commits to purchase in the private offering and another investor subsequently indicates it is prepared to invest only if the offering is registered Assuming that there was a bona fide intention to conduct a private offering and the first investor is not contractually bound, the company should be able to abandon the private offering and complete the transaction with these investors as a registered offering using the safe harbor. The 2001 Release indicates that providing this flexibility is one of the purposes of the safe harbor.

3. The second condition is that all offering activity in the private offering cease before the registration statement is filed. If the company is using agents to identify investors, it must make sure the activities of these agents cease. A question is whether a company can use the safe harbor to do a takedown from an existing shelf registration after terminating the private offering activity? The staff has indicated that the rule does not apply to shelf registrations. Nevertheless, Rule 152 might be available since a company is not treated as being "in registration" because of a generic shelf registration when there has not been a takedown.

4. The third condition is that the preliminary and final prospectus disclose the size and nature of the private offering, the date it was abandoned, that any offers to buy or indications of interest in the private offering were not accepted and that the prospectus supersedes any offering material used in the private offering. These disclosures need be made only to investors in the public offering entitled to receive a prospectus. They do not need to be furnished to the private offerees.

5. Finally, the registration statement may not be filed for 30 days after termination of all private offering activity unless all offerees were or were reasonably believed by the company to be accredited investors or financially sophisticated within the meaning of Rule 506. Although this would require keeping track of the status of offerees, the requirement applies only if the company wants to be able to file before waiting 30 days. In many controlled private offerings, it may not be difficult to identify who were offerees and their status as accredited or sophisticated.

6. The SEC will be monitoring the use of the Rule 155(b) safe harbor, and will likely be asking in comment letters on the registration statement for information

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about termination of private offering activity and, if the filing is within 30 days, about the private offerees.

C. Public to Private Safe Harbor

1. Rule 155(c) establishes a safe harbor for conducting a private offering after an abandoned registered offering. This safe harbor gives companies an important new alternative for doing an exempt private offering following an aborted public offering.

2. There are five conditions to be met for the safe harbor. These conditions are designed to assure that the private offering is separate and distinct from the registered offering and that offerees in the private offering are aware of the more limited legal protections they receive in the private offering. The first condition is that no securities be sold in the registered offering. The receipt of funds or placing funds in escrow will prevent this condition from being met.

3. Second, the registration statement must be withdrawn. As discussed below, withdrawal has been made easier. A question is whether this condition can be met in the case of a shelf registration without withdrawal, for example by terminating the public offering and putting the securities back on the shelf? The staff has indicated that the safe harbor would not be available in this situation. However, it might be possible to terminate the public offering from the shelf and conclude under a traditional integration analysis, including the five-factor test and the *Black Box* policy position, that an exempt private offering can be undertaken without reliance on the safe harbor.

4. Next, the private offering may not be commenced until 30 days after the withdrawal of the registration statement. This condition applies for purposes of the safe harbor regardless of the nature of the investors. However, if a company wants to undertake the private offering without waiting the 30 days, it may be able to do so using the existing alternatives, such as the *Black Box* analysis.

5. Fourth, each offeree in the private offering must be notified that the offering is not registered, that the securities are restricted, that purchasers do not have the protection of § 11 of the Securities Act and that a registration statement was filed and withdrawn, specifying the withdrawal date. Unfortunately, the Commission has reintroduced the concept of "offeree" that had been eliminated under Regulation D. Consequently, a determination of what constitutes an offer and the tracking of offering activity will be required. This condition adds unnecessary uncertainty to the availability of the safe harbor, and it would be helpful if the SEC interpreted it as applying to each purchaser and to each other investor furnished a private placement memorandum.

6. The final condition is that any private placement memorandum that is used disclose any material changes in the company's business or financial condition

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since the registration statement was filed. This condition does not, by its terms, seem to require a disclosure document, although one might be used to comply with antifraud rules.

7. The SEC staff has stated that the rule provides a safe harbor only from integration and that the private offering must meet the requirements for a valid exemption, including the absence of general solicitation. In a key paragraph of the 2001 Release, the Commission stated:

> We believe that ordinarily an issuer would not be inclined to incur the costs of preparing and filing a registration statement with the intention to withdraw it later and commence a private offering. Nevertheless, we wish to assure that issuers do not use this integration safe harbor merely as a mechanism to avoid the private offering prohibition on general solicitation and advertising. At the time the private offering is made, in order to establish the availability of a private offering exemption, the issuer or any person acting on its behalf must be able to demonstrate that the private offering does not involve a general solicitation or advertising. Use of the registered offering to generate publicity for the purpose of soliciting purchasers for the private offering would be considered a plan or scheme to evade the registration requirements of the Securities Act.

Absent a plan or scheme to evade registration, the question is the extent to which marketing activity in the public offering will affect the availability of the exemption for the subsequent private offering? It is clear that neither the presumptive general solicitation arising from the filing of the registration statement nor the fact that marketing activities, such as a roadshow, generally took place would defeat the exemption. Rather, the staff has indicated that a facts and circumstances analysis would apply. Relevant factors should include the nature of the investors, when the marketing activity occurred, whether the issuer or an underwriter had a pre-existing relationship with the investor at the time of the marketing in the public offering or whether such a relationship existed at the time of the private offering. For example, if the securities were marketed in the public offering to the customers of the underwriter or to well known institutional investors, the sale of the securities to these investors in the subsequent private offering should not raise general solicitation concerns. On the other hand, if a list was compiled of potential retail investors with which neither the underwriter nor the company had a relationship and no relationship was then established, the inclusion of those investors in the private offering might raise concerns about general solicitation. It is important that practitioners and the staff apply these factors in a way that fosters the Rule 155(c) safe harbor's purpose of enabling issuers to complete a private offering and reduce the financial risk of an abandoned public offering by permitting the two offerings to be separated.

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D. Withdrawal of Registration Statement

1. The Commission amended Rule 477 to permit an issuer to withdraw a registration statement before it becomes effective without SEC approval. The withdrawal is effective automatically upon filing unless the SEC objects within 15 days. This change will facilitate the ability of issuers to rely on Rule 155(c) without encountering administrative delays. If the registration became effective, SEC approval will be necessary, but the SEC has indicated that it will expedite its approval of the withdrawal. Withdrawal of the registration statement also withdraws any Form 8-A filed under the Exchange Act.

2. Rule 477 requires the issuer to state that no securities were sold in the offering and, if the issuer anticipates relying on Rule 155(c), that it may do so. However, the issuer may not discuss the terms of the anticipated private offering because that might result in a general solicitation. Importantly, stating an intention to rely on Rule 155(c) in the withdrawal application is not a condition to use of the safe harbor.

3. There is no refund of the filing fee on withdrawal. However, Rule 457 was amended to permit the issuer to apply the fee to any registration it, its majority-owned subsidiaries or its parent may file within five years. Rule 457 was also amended to codify certain staff interpretations regarding fees. Rule 429 was amended to move its fee provisions to Rule 457, leaving Rule 429 to deal solely with use of a combined prospectus for more than one registration statement.

XI. Conclusion

The Commission's adoption of Rule 155 is a helpful step forward in bringing added clarity and certainty to certain of the issues involved in the integration of private and public offerings. There are additional steps that need to be taken in the area. The Commission should continue to analyze the basic principles underlying the metaphysics, as well as the appropriate approach to integration generally, to determine if the area can be simplified in order to facilitate capital formation while preserving the appropriate level of investor protection. Ideally, this should be part of a comprehensive reform of the regulation of the securities offering process.

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EXHIBIT A

INTEGRATION OF PRIVATE AND PUBLIC OFFERINGS: ILLUSTRATIVE SITUATIONS

I. Registering the sale of common stock underlying warrants and convertible securities issued in a private offering.

1. Company A sells notes with warrants to purchase common stock in a private offering. Company A now wants to register the sale of the common stock upon exercise of the warrants. May it do so?

   a. The warrants are exercisable immediately.

   b. The warrants were exercisable after one year and (i) are not yet exercisable; or (ii) are now exercisable.

   c. The warrants become exercisable after 6 months; after 9 months; after one year.

2. Company A instead sells convertible preferred stock in a private offering and wants to now register the underlying common stock issuable upon conversion (perhaps because the 3(a)(9) exemption is unavailable). May it do so? Does it matter if the preferred stock is not convertible for one year; if it mandatorily converts upon an IPO?

3. Company A granted employee stock options when it was a private company. It now wants to include the shares underlying those options in its Form S-8 registration statement. May it do so?

4. Company A wants to register for resale the warrants issued under paragraph 1, as well as the sale of the underlying common stock upon exercise of the warrants. May it do so?

5. Company A has completed a venture capital round of financing and, as part of it, granted the venture capital investor a right to participate in a future IPO. What is the status of the shares purchased by the venture capital investor in the IPO? Does it matter if the IPO was before or after one year from the original venture capital round? Does it matter if instead of granting a right the issuer agreed to use its best efforts to permit the venture capitalist to participate in a directed share program? Do the answers change if, in addition to the venture capital investor, there were ten individual accredited investors who were granted the same right?

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II. Converting a transaction commenced as a private offering into a public offering.

1. Company B lines up several institutional investors for a private offering before hearing from a mutual fund that it would be interested in purchasing the security if it were registered so as to comply with investment restrictions. May Company B now file a registration statement to cover the offering? Does the answer change if Company B made offers to several non-accredited unsophisticated persons?

2. Company B comes to you as counsel to handle its private offering. After reviewing the contacts that have already occurred with potential investors you advise Company B that an exemption is unavailable. Can Company B now file a registration statement covering the offering?

3. Can Company B terminate its private offering and file a registration statement? What is required to terminate the offering? What if Company B had an initial closing on its private offering but while proceeding with the remainder of the private offering decides to file a registration statement?

III. Integrating an outstanding offering of common stock underlying convertible preferred stock or warrants with a separate public offering of common stock.

1. Company C has sold several rounds of convertible preferred stock and notes with warrants to venture capital investors, the most recent of which occurred within 60 days of filing a registration statement for its initial public offering. Is the continuing offering of the underlying common stock integrated with the public offering so as to defeat the private offering exemption and create rescission rights?

IV. Integrating transactions that form the venture with a capital raising public offering.

1. Company D sells common stock to the founders at a low price for cash and property and then promptly files a registration statement for an initial public offering. Is the sale to the founders integrated with the public offering?

2. A principal stockholder of Company D^2, which is an S corporation, agrees to exchange for common stock the notes delivered to him to reflect the taxes he paid on account of the company's income, effective upon completion of the company's initial public offering. Is the exchange of the notes for common stock integrated with the public offering?

3. Ten separate private businesses are acquired for cash and stock of new Company D^3 in connection with an initial public offering by Company D^3. Are the acquisition transactions to form Company D^3 integrated with the public offering?

4. Five syndicated real estate limited partnerships and several real estate properties owned by different investors are transferred to umbrella partnership P in exchange

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for limited partnership interests in P. The general partner of P is a real estate investment trust which raises capital for the venture through a public offering of REIT shares. Are the transactions forming partnership P integrated with the REIT public offering?

V. Private investment, public equity (PIPE) transactions.

1. Company E obtains commitments from private investors to purchase common stock at a set price reflecting a discount from their current market conditioned upon an S-3 registration statement being in effect covering resale of the shares. May this PIPE transaction be completed in compliance with section 5? Is the answer different if the purchase price is fixed at the time of closing based on a discount from the then market price? If the securities were convertible notes sold at a fixed price with the conversion price floating with the market price of the underlying common stock, is there a problem?

2. After filing the S-3 registration statement required under paragraph 1, Company E obtains additional commitments from private investors. May the PIPE transaction be completed in compliance with section 5? Is the result different if the additional investors are QIBs; if the first closing with the purchasers under paragraph 1 took place before the filing?

3. Company E's private offering was done as a 144A transaction solely to QIBs. After filing the S-3 resale registration statement, Company E wants to do another tranche of the Rule 144A offering. May it do so in compliance with §5? Does the analysis change if the transaction was an A/B exchange offer?

4. After filing the S-3 registration statement required under paragraph 1 but before closing the private placement, the investors agree to reset the purchase price. May the PIPE transaction be completed in compliance with §5? What if the change relates to covenants or board representation?

5. One of the investors in the transaction under paragraph 1 is the investment banking firm that served as placement agent. Does this create a problem regarding filing the resale S-3 registration statement or for the transaction?

VI. Private equity lines.

1. Company F obtains commitments from a small group of private investors to buy shares of common stock upon demand of Company F at any time within 90 days after a resale registration statement covering the shares becomes effective. Is there any issue regarding the ability of Company F to file a resale S-3 registration statement? Does it matter whether the purchase price of the common stock is fixed or floats? What if Company F can put the stock to the investors at periodic intervals over a one year period?

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2. The securities that Company F can put to the investors are convertible preferred shares. Does this affect the analysis? What if they are units consisting of common stock and warrants?

VII. Effecting a private offering during or subsequent to a public offering.

1. Company G does a quiet filing of a registration statement for a common stock initial public offering but the IPO market closes before it can proceed with the offering. Company G now wants to do a convertible preferred stock private financing with venture capital investors. Under what circumstance may it do so? May members of Company G management participate in the financing? May the financing be handled as an "underwritten" 144A transaction? Does it matter if Company G began marketing activity before abandoning the public offering; whether the investors were solicited in the IPO marketing; whether they had a preexisting relationship with Company G; with the placement agent who was one of the underwriters?

2. Company G is planning to obtain equity financing from X Corporation, a large multinational enterprise, with which it is negotiating a strategic alliance, while at the same time conducting a registered public offering of common stock. May Company G do any of the following:

   i. Obtain a commitment from X Corporation before filing the registration statement to buy common stock privately?

   ii. Obtain a commitment from X Corporation after filing the registration statement to buy common stock privately?

   iii. Obtain a commitment from X Corporation before filing the registration statement or during the waiting period to buy common stock in the registered offering?

   iv. Obtain an indication of interest from X Corporation before filing the registration statement or during the waiting period to buy common stock in the registered offering?

3. Company G files the registration statement but after getting staff comments requiring accounting changes it is not prepared to make withdraws the registration statement and seeks to do a private offering of the common stock. Is the result different than under paragraph 1?

4. May Company G amend the registration statement to do a directed offering to selected investors? May they be investors lined up before the amendment? Will the investors be treated as "underwriters"?

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5. Company G has completed a public offering of common stock and now wants to do a convertible preferred stock private offering to separate investors within six months. Is the subsequent private offering integrated with the public offering (i.e., is the public offering general solicitation attributable to the private offering)?

6. Company G has a shelf registration in effect and wants to do a private offering of the same securities covered by the shelf. May it do so? Does it matter whether it is a universal shelf or one just for common stock?

VIII. Acquisition Transactions.

1. Company H agrees to acquire Company P, a private company, for Company H stock in a private offering, with the closing conditioned on a resale registration statement being in effect. Is this permissible?

2. Company H agrees to acquire Company T in a merger for Company H stock to be registered on Form S-4. In order to ensure a successful transaction, Company H gets voting commitments from several Company T stockholders. May it register the acquisition transaction on Form S-4? May the committed shares be covered for exchange in the merger under the Form S-4? Does it matter whether Company T is a public company, a widely-held non-public company or a closely-held private company?

3. Company H plans to do a private offering of convertible securities to fund the cash portion of the acquisition consideration for Company T and its expansion plans for Company T at the same time that it is registering on Form S-4 the Company H stock to be exchanged in the merger. May it do so?

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SEC REGULATION FD – THE SELECTIVE DISCLOSURE RULES

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In August 2000, the Securities and Exchange Commission adopted Regulation FD (Fair Disclosure) dealing with selective disclosure of material nonpublic information.[*] The regulation became effective on October 23, 2000. In general terms, the new rules require public companies to disclose publicly any material nonpublic information they disclose to market participants, such as analysts, institutional investors and security holders, unless the recipient receives the information on a confidential basis. The public disclosure must be simultaneous if the selective disclosure is intentional and within 24 hours or the opening of next-day trading if the selective disclosure is inadvertent.

The Commission adopted this new disclosure regulatory regime because of its concern that market professionals and institutional investors were being given an informational advantage to the detriment of general investors. In the Commission's view, this leads to an erosion in investor confidence in the integrity of the securities markets. The Commission also expressed concern that corporate management uses the flow of material information to influence analysts to report favorably about a company or risk being cut off.

The Commission adopted the new rules notwithstanding the concerns voiced by a number of corporate and investment community groups that the new rules were unnecessary, were overly intrusive on corporate communication practices and would have a chilling effect on the flow of information to the marketplace.

Regulation FD does *not* impose new disclosure duties on companies in the absence of selective disclosure. However, it has had a significant impact on corporate communication practices, such as the conduct of analyst calls, meeting with analysts and institutional investors, participation in investor conferences, review of analyst reports and providing of guidance to analysts. It has also impacted ordinary course business communications with the enumerated information recipients.

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[*] The release adopting Regulation FD also included two new rules dealing with insider trading. Rule 10b5-1 makes being "aware" of material nonpublic information as opposed to "use" the basis for liability for insider trading. Rule 10b5-2 defines circumstances under which family and other non-business relationships create a duty of trust and confidence, the violation of which can be the basis of liability for insider trading. Rule 10b5-1 in particular is important because it provides helpful guidance by defining circumstances under which insiders, including the company under a stock repurchase program, can continue trading activities even though they become aware of material nonpublic information.

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Description of Regulation FD

The new regulation has the following key elements:

- *It applies to disclosures of material nonpublic information.*

  The concept of "nonpublic" is not defined but rather is left to existing case law interpretations. Information is nonpublic if it has not been disseminated in a manner making it available to investors generally. Although the concept is not expressly parallel with the public disclosure required under the regulation, meeting the disclosure standards of Regulation FD should satisfy its requirements.

  "Materiality" is not defined but is left to existing case law interpretations. Information is material if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision and would view the fact as significantly altering the total mix of information available. Making the "materiality" determination is probably the most difficult aspect of complying with Regulation FD. It is made more difficult by the SEC's August 1999 interpretation of materiality in Staff Accounting Bulletin No. 99, which requires both a quantitative and qualitative determination. The SEC's position in SAB No. 99 has been endorsed in *Ganino v. Citizens Utilities, Co.*, 228 F.3d 154 (2d Cir. 2000).

  To provide guidance, the Commission set forth a list of the types of information that might be material, while emphasizing that the list was neither exclusive nor the items on it per se material. The listed items include:

  - earnings information
  - mergers and acquisitions
  - new products or discoveries
  - acquisition or loss of major contracts
  - changes in control or management
  - changes in auditors or withdrawal of audit reports
  - defaults on senior securities
  - changes in dividends, stock splits, repurchases and recapitalizations
  - sales of additional securities

- *Regulation FD applies to disclosures by public companies or persons acting on their behalf.*

  For the regulation to apply, the issuer must be a reporting company under the Securities Exchange Act of 1934. Accordingly, it does not apply to communications in connection with an initial public offering. The regulation does not apply to investment companies other than closed-end funds. It also does not apply to foreign issuers.

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The persons whose disclosures can trigger the regulation are directors, executive officers, investor relations or public relations officers and any other officer, employee or agent (*e.g.*, public relations firm) who regularly communicates to securities market professionals or security holders. However, an issuer will not be responsible under the regulation for improper trading or tipping by these persons in breach of a duty to the issuer.

- *The disclosures covered are those made to enumerated securities market professionals and security holders.*

  The securities market professionals covered are (1) broker-dealers and their associated persons, which would include sell-side analysts, (2) investment advisers, institutional investment managers with portfolios of at least $100 million and their associated persons, which would include buy-side analysts, and (3) investment companies and hedge funds.

  Security holders are covered if it is reasonably foreseeable that they will trade on the basis of the information. No guidance is provided on the meaning of "reasonably foreseeable," and therefore it would be safe to assume that the communication will be covered unless there is a confidentiality undertaking.

  Communications to rating agencies are expressly excluded if the ratings are made public. Because of the limited scope of covered persons, ordinary business communications to non-enumerated persons and disclosures to the media and government agencies generally will not be covered.

  Communications to persons who owe the issuer a duty of trust and confidence, such as attorneys, accountants and investment bankers, and to persons who expressly agree to keep the information confidential are excluded. The confidentiality agreement may be oral or written and it may be obtained before or after the disclosure so long as the recipient has not disclosed the information or traded based on it.

- *If the disclosure is intentional, public disclosure must be made simultaneously.*

  Disclosure is "intentional" if the person knows or is reckless in not knowing prior to the disclosure that the information is both material and nonpublic. A person is reckless if no reasonable person under the circumstances would make the same determination. Note that an intention to disclose material nonpublic information or to convey an informational advantage on the recipients is not required; just that the information is material and nonpublic.

  Although there may be difficult materiality judgments, it will be easier to deal with the regulation's requirements in the case of premeditated disclosures (*e.g.*, pre-planned presentations), although last minute changes can make simultaneous public disclosure difficult. Dealing with the regulation's requirements is more problematic in the case of impromptu responses to unanticipated questions. If the person answering knows or is reckless in not knowing that the response is

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nonpublic and material, he or she must avoid providing the information on a selective basis to avoid violating the regulation because, in the absence of an adequately noticed open forum, it is doubtful that the information could be publicly disclosed simultaneously. Of course, greater deference will be afforded to materiality judgments made in an impromptu setting.

- *Non-intentional disclosures must be publicly disclosed promptly.*

  "Promptly" means as soon as reasonably practicable, but within 24 hours (or commencement of the next day's trading on the New York Stock Exchange, if later, *e.g.,* in the case of a Friday or weekend) after a senior official of the issuer learns there has been a non-intentional disclosure which he or she knows or is reckless in not knowing is both material and nonpublic.

- *"Public disclosure" is accomplished by furnishing to or filing with the SEC a Form 8-K unless the information is disclosed through another method (or combination of methods) that is reasonably designed to provide broad, non-exclusionary dissemination of the information to the public.*

  Issuers are afforded flexibility in determining the most appropriate means of disclosure under the particular circumstances. This generally includes press releases distributed through widely circulated services or announcements at press conferences or conference calls that members of the public may attend or listen to in person, by telephone or by other electronic means (such as the Internet), provided adequate notice is given.

  The release contains an example dealing with a regular earnings announcement: first, issue a press release; second, provide notice by a press release or website posting of a scheduled call and the means of accessing it; and third, hold an open conference call that can be accessed by telephone call-in or through simulcast webcast on the Internet.

  Posting information on the issuer's website, while encouraged, would not ordinarily by itself be sufficient for now.

  If Form 8-K is used to provide public disclosure, issuers can choose to "file" a report under Item 5 or to "furnish" a report under new Item 9 of Form 8-K that is not deemed "filed" unless the issuer so designates. The difference is that "filed" information is incorporated by reference into the issuer's registration statements but is subject to enhanced liability. In either case, inclusion of information in a Form 8-K is not an admission as to the materiality of the information.

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- *Disclosures in connection with registered securities offerings are not covered by Regulation FD.*

  This exclusion permits traditional roadshows to be conducted without triggering public disclosure that could cause a violation of the gunjumping prohibitions of the Securities Act. It does not apply though to registration of some continuing offerings, such as those for resales, DRIPS, options, convertible securities and warrants. The SEC is separately reviewing roadshow practices.

  Disclosures in unregistered private offerings by public companies are subject to the regulation. Since public disclosure required by the regulation could undermine the exemption, companies should avoid selective disclosure of material nonpublic information or disclose it only on a confidential basis when engaging in a private offering. Alternatively, a company may be able to publicly disclose the information, *e.g.*, through a Form 8-K, but it must avoid general solicitation.

- *Failure to file a Form 8-K required by Regulation FD will not impair an issuer's eligibility to use short-form registration under Forms S-2 and S-3 or to use Form S-8; nor will it affect the availability of Rule 144 for resales.*

- *Failure to make a public disclosure required by the regulation is not a violation of the 10b-5 antifraud rule and therefore cannot itself form the basis for a private cause of action.*

  However, the SEC retains the right to bring enforcement actions seeking administrative, injunctive or civil money remedies.

  The regulation does not eliminate existing bases for 10b-5 liability, such as tipping, insider trading, fraudulent disclosures or omissions when there is a duty to disclose.

Recommendations

For Companies

Some companies have responded to Regulation FD by stating that they are cutting back on their communications with analysts and others or terminating completely some of their communication activities, such as analyst or investor meetings. While each company must make its own decision based on its circumstances, this response is an unnecessary overreaction and may be counter-productive to a company's best interests in communicating and maintaining healthy relations with the investment community.

At one level, Regulation FD is consistent with the advice that has long been provided, *i.e., be careful to avoid providing material nonpublic information selectively and, if that should happen, promptly disseminate that information publicly.* What Regulation FD does do is raise

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the stakes on the need to follow this practice by making it a legal requirement, expand the information covered and put greater pressure on "materiality" determinations, and condense the time frame for making these difficult decisions. It also puts a premium on following the emerging trend of opening up earnings calls and makes more problematic "fencing with analysts while walking on a tightrope," as the process of dealing with analysts has previously been graphically characterized.

Regulation FD is still relatively new and best practices for compliance are evolving. However, it is possible to reach some preliminary conclusions. In considering the impact of Regulation FD on its communications activity, it is useful for a company to focus on several common methods of communication with the financial community.

- *Earnings calls and similar events.*

  The SEC release makes it clear that disclosure of material nonpublic information on an analyst call that is not open generally to the public, no matter how many participants are on the call, will trigger Regulation FD's public dissemination requirement. The release is equally clear that opening up the call, whether through a call-in number or, more efficiently, simultaneous webcast, will constitute sufficient public dissemination so long as adequate notice is given of the time and means of accessing the call (*e.g.*, by including reference to it in the earnings press release) and sometimes a general sense of the subject matter. If this practice is followed, a company will not have to be concerned that further public dissemination will be required for information disclosed in the call (*e.g.*, during the Q & A portion of the call) that is reasonably related to the purpose of the call.

  Many companies have adopted this practice. Typically, they arrange to have their earnings calls web-simulcast and then post them on their website for later access and replay. While posting the information on the company's website is not recognized by the SEC as sufficient public dissemination in itself, the SEC recommends such posting as an additional means of dissemination.

- *Analyst conferences.*

  The simulcast process also can be used for other structured presentations, such as analyst conferences, although it may be more difficult to implement, particularly if the company does not control the conference.

  If the simulcast or open call process is not used, the company should be more careful about what is said, particularly in impromptu settings. Company officials who will be presenting or who will be in the position of responding to questions, should be alerted to the new groundrules and prepared to respond to or deflect questions.

  The planned portion of any presentation should be reviewed in advance and consideration should be given to issuing a press release covering the substance of the presentation no later than the time it is given.

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It generally will be impractical to monitor impromptu or informal discussions by company officials. On the other hand, in addition to good preparation, it may be useful on appropriate occasions to hold debriefing sessions to determine whether any disclosures were made that might require public dissemination under Regulation FD or to establish a record that none were made. Such debriefing sessions may become necessary if, for example, there is unusual trading activity or price changes following informal discussions.

- *Fielding analyst calls and providing guidance.*

This has always been the most difficult area for dealing with selective disclosure concerns and it continues to be so. First, the company should limit the number of spokespersons and channel analyst calls to designated persons. The spokespersons should be familiar with the requirements of Regulation FD and the sensitivities surrounding selective disclosure of material nonpublic information. One technique sometimes used is maintenance of a log, including the general tenor of the conversation and whether or not material nonpublic information was disclosed.

The SEC has identified providing guidance to analysts on their earnings estimates as an area of particular concern and one involving a "high degree of risk [of violating] Regulation FD." On the other hand, the SEC encourages issuers to continue to provide information to analysts that is not material in itself but may be significant to that analyst to complete a "mosaic" of information. This obviously involves a very difficult balancing act with fine lines. If anything, Regulation FD has circumscribed providing guidance to analysts, such as by indicating "we are comfortable with the street's estimates" or by commenting on analyst estimates with such code words as "you are in the ballpark" or "we don't think you would be embarrassed." The SEC specifically noted that the use of code can violate Regulation FD. The regulation has also limited the practice of "talking down the street."

Most companies have followed the practice of reviewing analyst reports, at least to correct factual inaccuracies and possibly to question underlying assumptions. While this practice was recognized as having some risks of the company becoming "entangled" with analyst report, it has now become more perilous because of the concerns over selective disclosure. To the extent a company has decided to continue this practice, it should disclaim responsibility and state expressly that it is not commenting on the analyst's estimates or conclusions but rather is limiting its comments to correcting factual inaccuracies. It should also limit any guidance on underlying assumptions to those that are not themselves material or have been publicly disclosed.

To address the analyst guidance problem, some companies have expanded the guidance they give publicly in their earnings releases and Forms 10-Q and 10-K flings (with appropriate forward-looking information safe harbor statements). In this way, they may have more leeway in referring analysts to the company's guidance. However, providing even this guidance selectively to analysts must be evaluated on a case-by-case basis inasmuch as privately confirming the company's public guidance

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could be material, for example, if the street was skeptical about the guidance or if the confirmation comes late in the quarter and the company's results can be volatile. This risk can be reduced by limiting analyst communications to periods shortly after earnings releases, *e.g.,* by extending the black-out period most companies now follow in commenting to analysts on earnings results.

- *One-on-one meetings with institutional investors.*

  These meetings often involve the risk of disclosure of material nonpublic information, either as part of the presentation or in response to probing questions. To avoid the need to make public dissemination, either care should be taken not to disclose material nonpublic information or, if there is such disclosure, it should be done with an understanding of confidentiality.

  Confidentiality understandings may be used in other circumstances to avoid triggering Regulation FD public disclosure. For example, a company may want to give analysts advance notice of a significant acquisition so that they can analyze the transaction before the announcement. This could be done if the information is embargoed until it is publicly released.

For Institutional Investors

Although Regulation FD applies to public companies, it has had a significant impact on the ability of institutional investors to obtain information needed in connection with their investment activities (both debt and equity securities) and in maintaining their investment portfolios. As noted above, Regulation FD applies to communications in connection with a private placement. It could also apply to communications in connection with an acquisition transaction that does not involve a registered offering.

Together with Rules 10b5-1 and 10b5-2, Regulation FD can also increase exposure to insider trading liability because trading in securities at a time when the investor is aware of material nonpublic information it has agreed to maintain in confidence would be a breach of a duty of trust and confidence in violation of Rule 10b-5 unless adequate procedures were in place and the person making the trading decision was not aware of the information.

Accordingly, institutional investors should consider the following:

- *Policy on use of confidentiality agreements.*

  Although agreeing to keep information confidential can increase exposure to insider trading liability, it may be necessary in some circumstances in order to obtain needed information. Alternatively, the company can be required to publicly disclose the information. Risks of a confidentiality agreement can be minimized by narrowing the scope of information covered and circumscribing the time period it remains in place (*e.g.*, until the next Form 10-Q is filed). This shifts the burden of disclosure to the company. Also the agreement can be limited to maintaining the information in confidence and does not have to restrict the firm's ability to engage in trading

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activities if information barrier procedures are in place to comply with the Rule 10b5–1 defense.

- *Review information barrier procedures.*

  Effective procedures to separate investment and investment monitoring activities from trading activities can facilitate the ability to obtain information under confidentiality agreement.

- *Evaluate duties of trust and confidence.*

  Even in the absence of confidentiality agreements, the firm can take on a duty of trust or confidence for purposes of Rule 10b5-2 that can result in a violation of Rule 10b-5. An example might be service on a creditors committee. The firm should be aware of these circumstances and have procedures in place to avoid misuse of material nonpublic information received in such capacity.

General Observations

As general observations, and by way of recap:

- Companies should review their existing communications policies and practices in light of Regulation FD. This would include reviewing:

  The procedure for making earnings calls and other presentations generally available and announcing their availability.

  The policy on reviewing and commenting on analyst estimates.

  The extent of the guidance provided in earnings releases.

  The desirability of issuing press releases in anticipation of analyst and investor conferences and similar events.

- Companies should formalize the designation of authorized spokespersons. This may help to circumscribe the universe of persons for whose statements the company is responsible.
- The authorized spokespersons should be properly trained and educated on the requirements of Regulation FD.
- The company's written compliance procedures and disclosure policies should address complying with Regulation FD.
- Procedures should be put in place for advance review of presentation materials, for consultation with counsel prior to disclosures that might be material and for identifying when material nonpublic information might have been selectively disclosed.

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- The company should review its use of confidentiality arrangements and embargoing procedures.
- Correspondingly, institutional investors should review their policies regarding entering into confidentiality agreements.
- Institutional investors should review their procedures for keeping persons charged with trading responsibility from becoming aware of material nonpublic information that may be in the firm's possession.

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June 20, 2001

American Corporate Counsel Association
Corporate and Securities Law Committee

Regulation FD Survey Results

1. Since Regulation FD went into effect, is your company providing more (in terms of quantity), the same amount or less information to investors?

	Response Tallies	% of Answer
A. More information	36	35%
B. Same amount of information	56	55%
C. Less information	9	9%

1A. Since Regulation FD went into effect, is your company providing more (in terms of quantity), the same amount or less information to analysts?

	Response Tallies	% of Answer
A. More information	5	5%
B. Same amount of information	49	48%
C. Less information	47	46%

2. Is the quality of the information your company discloses better (more meaningful) than, the same as or worse than the quality of the information it disclosed prior to Regulation FD?

	Response Tallies	% of Answer
A. Better quality	20	19%
B. Same quality	70	69%
C. Worse quality	11	11%

3. Has your company disclosed more, less or the same amount of forward-looking information after the adoption of FD?

	Response Tallies	% of Answer
A. More	34	34%
B. Same	57	55%
C. Less	10	10%

3A. If more, is this principally due to FD or the weakened economy and markets, which have caused more earnings disappointments or is the increase due primarily to other reasons?

	Response Tallies	% of Answer
A. FD	22	58%
B. Weakened economy and markets	9	24%
C. Other reasons	7	18%

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3B. What actions, if any, should the SEC take that would make forecasting a better and/or more frequently used disclosure practice?

What is material?
What is not material?
And what all depends?
Such guidance, if clear, would result in more disclosure, i believe.

Treat a press release as adequate disclosure even absent an 8-K filing.

Not much they can do until effective deterrent is found so lawsuits don't result from simply missing forecast.

Make the forward-looking statement safe-harbor more objectives.

Allow analysts to disseminate and focus enforcement on building Chinese walls within banks

Clarify duty to update to minimize or eliminate risk of lawsuits based on forecasts.

Better definition of "materiality" and expand the safe harbor for forward-looking statements.

I'm not sure; the markets move on every piece of news and I'm not a fan of unnecessary volatility.

SEC needs to give more guidance. My Company is providing less forward looking information, because of Reg. FD & the lack of guidance provided by the SEC.

We would need stronger legislation that would prevent shareholder lawsuits if a company makes a forecast that does not occur and as a result causes its stock price to drop

None. The SEC should let this Reg. settle in before considering more regulation.

Provide guidelines/framework in regards to forecasting. IR Departments are currently struggling with this issue.

Reinforce in safe harbor language.

Preempt state law, which still permits private strike bar suits despite Reform Act at federal level

Prohibit companies from forecasting-leave it to analysts, it is their job.

Eliminate the requirement that issuers identify statements as forward looking.

This is particularly difficult to do when making oral statements to analysts and the press.

reduce or eliminate exposure in the event the forecast later turns out to be wrong

It isn't an SEC issue, it is a private securities litigation issue. The SEC can help by advocating legislation and providing regulatory guidance to assure that courts will uphold the safe harbor for forecasts.

We are not convinced that changes made by the SEC would improve forecast disclosures. We are discouraged more by the over-reaction of the financial community to slight variations in performance from forecast.

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The problem is not so much SEC positions; the problem is the exposure to precipitous stock price drops on any failure to make announced goals and the ensuing litigation, the PSLRA notwithstanding.

Establish a specific safe harbor for one quarter and full year forecasts provided in good faith.

Clarify the use of the safe harbor with respect to - and any duty to update - forecasts.

More clarity as to what is covered by FD and what is not.

Minimize the Company's liability if forecasts do not meet performance targets.

Provide better clarity and narrow the obligation to update.

Reverse FD. (I gave more detailed response but was allowed only a limited # of characters.)

Define what is material.

Continue to give companies flexibility as to how to present information

4. Has Regulation FD affected the manner in which your company communicates with its employees?

Yes	74	73%
No	27	27%

If yes, how?

A bit more cautious about what we're saying--don't want to run afoul of FD in employee communication.

Providing less detailed information

Less information flow to employees to avoid inadvertent disclosure and need to release publicly to all.

Reduces communication to employees due to concerns about release of material information into analysts and other investment community members.

More careful in controlling access to material non-public information.

Less information is being provided.

Indirectly, Regulation FD gave us the impetus to bolster our internal measures to ensure that our employees understand that they are not to respond to questions from financial analysts without Investor Relations involvement.

Much less likely to discuss company with analysts on matters for fear of inadvertent disclosure issues.

Less communication to staff and lower level officers. However, due to FD and other factors, there has been better communication with senior officers.

If we widely distribute any information, we ensure that it either is already or simultaneously distributed to public media or our website.

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We have had several employees ask that we move to an open book management practice, but with FD in effect we believe there is too much risk.

We communicate less to employees to avoid inadvertent public disclosure.

We increased the reminders about the need for confidentiality before we share non-public future plans with employees.

We added internal review of communications that are sent to all employees

By adopting a formal communications policy keyed to the authority of senior officials to make disclosures of company information.

Don't tell employees material info until it is public info.

We are more guarded about employee communication.

Insemination internally tends to mimic what is provided to the market. Management feels less free to discuss the financial and business conditions of the business.

Established tighter public disclosure policy and restricted further access to non-public information

We used to feel freer to disclose information to entire employee group, we've stopped that practice

You cannot guarantee that employees will not disseminate confidential, non-public information. As a result, you have to be sure that information that you tell employees could be told to the public.

Because many employees are investors who also talk to their investment advisors, we no longer provide any projections or prognostications of future business until after public release of quarterly financial statements.

The Law Department reviews for Reg FD compliance most news articles about the company, which are communicated to employees over our secure Intranet, by hard copy newsletters, in speeches at company forums and other internal media.

Somewhat greater care in disclosing material nonpublic info.

4A. Has your company informed all employees, or a more limited group of employees (such as only those affected by the rule) about FD and their compliance obligations thereunder?

A. All employees	10	10%
B. A more limited group (briefly describe the group)	91	90%

Senior and middle management
Exec/management team
Those individuals who routinely have discussions with "trade groups" or analysts
Senior officers, subsidiary heads, associates in Investor Relations, in Public Relations and all Law Department attorneys.
key spokespersons

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Management

Senior officers, those in charge of a business unit, those likely to run into analysts at trade shows.

Senior management (board, CEO, COO, CFO, Exec. VPs)

Group of senior managers and executive officers, board members and PR/IR staff.

Chairman & CEO and portfolio managers who might be called upon to comment on our funds' performance

Board members, executive committee members, finance.

Investor relations and financial reporting personnel

Senior Management, investor relations, communications, legal department

All of our Company's management has been notified.

key managers and investor relations manager

Executives and people who talk to the financial community regularly

Officers and managers for whom it may conceivably be an issue.

Management, IR personnel and senior level employees.

Management, IR personnel and senior level employees.

Persons who talk with the press, executives, and financial managers

Our group comprises those senior officers who are authorized to communicate with investment professionals, etc. Our Investor Relations Director is responsible for coordinating those who speak with investment professionals.

All senior management and all personnel who have communications responsibilities.
Managers

Have issued a general statement but spent time counseling affected group of insiders.

Only a limited group is permitted to provide information covered by Reg. FD & those in the group are well aware of Reg. FD.

All vice presidents have been informed (we have approx. 10, only 5 of whom are Section 16 officers).

Execs, directors, finance and investor relations
Those affected by the rule

Executive Officers

Those senior officers and others most likely to encounter the information or persons seeking the information affected by FD.

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Those senior officers and others most likely to encounter the information or persons seeking the information affected by FD.

Executive and senior managers.

Those likely to come in contact with investors/analysts.

Senior management received a memo, which I wrote, that was sent from the general counsel and the IR VP

education of shareholder relations and PR staff

executives and those involved in communications and marketing

CEO, CFO and some senior management personnel who interact with investors.

Management employees

Officers of the Company

Senior executives and investor relations personnel. We have also posted a Reg FD policy on our

Website for both investors' and employees' viewing.

All directors, executive officers, IR staff and PR staff.
executive officers and corporate communications department
Those employees who have some likelihood of possessing material non-public information and those who are likely to be approached to speak on behalf of the company on matters that should be subject to controlled disclosure.

Executives and managers, certainly those who participate in conference calls and meetings with analysts, but also those who engage in product marketing activities where disclosure of future plans could occur.

Senior and middle management

All officers and business managers

Executive, finance and IR personnel.

Upper management only

CEO, COO, CFO and VP of Investor Relations

Executive officers, directors, finance/accounting management

Management and spokespersons

All management employees

upper management

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Executives and middle managers

directors, executive officers, IR personnel, PR personnel

Senior management and heads of individual business units

Those affected by the rule.

We have shared an explanation of FD obligations with key employees who may possess or disclose information that requires disclosure. We have also informed our non-employee directors concerning FD and their responsibilities.

Officers, Directors, Managers

Executives and employees that communicate with the press and the investor/financial community.

In terms of information, we have communicated to all employees. In terms of who can communicate with analysts, we have three Designated Spokespersons (the CEO, CFO and head of Investor Relations)..

Senior officials, Investor Rel. and Corp. Communications staff and those employees who routinely deal with market professionals and shareholders.

Headquarter employees and Senior management

Senior management

Senior Management who may have contact with the investing community.

All "covered persons" and others involved in communications.
management group

executive management team

All management and supervisory employees

All officers, all media/investor relations people, and legal.

The Defense segment of our business because that is the most watched by the media and outside attorneys interested in litigation

Somewhat greater care in disclosing material non-public information.

5. **Has Regulation FD affected your company's ordinary business course communications (e.g., with its bank, suppliers, customers or others)?**

Yes	22	22%
No	76	78%

If yes, how?

Less information provided across the board.

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More strict about having non-disclosure agreements in place

Anything that is not specific to the inquirer's request must be posted on the website.

Senior officer's say that they are more guarded in what they will say about the company's plans and results.

Limited bank communications

Created a chilling effect.

It has made us a bit more reluctant to share information with them.

Depending on the type of information that must be disclosed, we have found it prudent to make sure the recipient understands the sensitivity of the information.

More cautious about what is said and to whom.

We cannot reveal material undisclosed information without a signed confidentiality agreement.

Information is more limited and is in the context of most recent press releases or no comment is a lengthy period of time has passed since the last press release.

We are documenting more closely the communications we make with all groups. We have also limited somewhat those who provide public disclosure.

Greater insistence on non-disclosure agreements

Not a great deal, but we are more careful about what we give them and we use confidentiality agreements more often.

To a certain extent. While we required NDA's is all commercial transactions, we are using such contracts on an even more widespread basis.

More confidentiality agreements to avoid FD problems with "market professionals".

Has limited the information and communications

You cannot guarantee that bankers, suppliers and customers will refrain from disseminating information that is confidential. As a result, you must be cautious when providing information to any group, even if not subject to Reg FD.

Key spokespersons

Senior exec. Also, we've adopted a new company-wide disclosure policy.

Business units have become more aware of issues which might be deemed material and non public. They now contact the Law Department prior to sharing this information.

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5A. Reg FD covers communications by two categories of personnel (1) Senior Officials and (2) officers, employees or agents who regularly communicate with market professionals or security holders. Do you need more guidance from the SEC on who should be included in the second category?

Yes	19	19%
No	83	81%

5B. If yes, does this uncertainty leave you unclear on how deep in your company you must go for FD compliance, (e.g., proper groups to train, who must get confidentiality agreements, etc.)

Yes	17	45%
No	21	55%

6. Has Regulation FD affected your company's private placement financings or private acquisitions?

Yes	12	12%
No	89	88%

If yes, how?

Affects timing of everything; anything in the disclosure book must be on the web.

Reduced disclosure because without CA no way to be comfortable with disclosure of anything not public

We do very little in the way of private placements. But the rule needs to be changed to fix the private placement bug.

tremendous concern over what we can or should be saying to private placement investors

We had to change our form of NDA agreement to cover disclosures.

Not really an applicable question.

We are more careful to obtain confidentiality agreements when material nonpublic information will be discussed.

We don't do private placements.

More careful in protecting info.

timing of due diligence if they won't sign confidentiality agreement

You must be much more diligent in your confidentiality procedures and refuse to provide any information that could be considered material until you have a signed confidentiality agreement in place.

There is enhanced monitoring to ensure that the information provided is either public or, if material, subject to a confidentiality agreement.

6A. Does your company have a written disclosure policy on Reg FD?

Yes	61	60%
No	40	40%

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7. Prior to Regulation FD, did your company conduct one-on-one meetings with analysts?

Yes	97	96%
No	4	4%

7A. . If you answered yes to question 7, after Regulation FD, have such one-on-one meetings with analysts increased, decreased or stayed the same?

A. Increased	4	4%
B. Same	50	52%
C. Decreased	43	44%

7B. Does your company require that at least two representatives attend one-on-one meetings with analysts?

Yes	41	41%
No	60	59%

7C. Are analysts putting less pressure on your company to provide potentially material non-public information as a result of FD?

Yes	38	38%
No	63	62%

8. Does your company have a black-out period prior to earnings releases during which they will not speak to analysts about financial results?

Yes	79	78%
No	22	22%

If yes, how?

Begins on 11th day of third month of each quarter and continues until 3rd trading day after results for that quarter are released.

It is the same as our insider window, which closes 45 days after public release of earnings. However, we don't get into the "how's the quarter look?" stuff at any time. We stick to the earnings release data.

Approximately 3 to 4 weeks before earnings are released

From end of quarter to earnings release

From the beginning of the 3rd month in our quarter

30 days

2 weeks

30 days

30 days prior to end of quarter

About three weeks prior to the announcement.

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From the end of the 3rd week of the third month of the quarter until the announcement of quarterly results.

Begins the middle of the third month of the quarter

From 2 weeks before the end of a qtr. until the investors conference call following the earnings release for that qtr.

two weeks prior to end of quarter, through the date of the release

six weeks

It starts the first day of the last month of the quarter and ends when earnings are announced

Normally 3-4 weeks prior to the release of earnings.

From the second week of the last month of the quarter until financial results are released

Depends on facts and circumstances. Generally 2-4 weeks.

ten business days

close of the quarter until the earnings release

9A. Prior to Regulation FD, how often were you personally asked for advice as to the materiality of information that your company disclosed to analysts or other persons now covered under Regulation FD?

A. All the time	6	6%
B. Sometimes	65	64%
C. Seldom	25	25%
D. Never	5	5%

9B. After Regulation FD, how often are you asked for advice as to the materiality of information that the company is considering disclosing to analysts or other covered persons under Regulation FD?

A. Much more often	33	33%
B. Somewhat more often	41	41%
C. About the same	26	25%
D. Less Often	1	1%

10A. How much time does your company typically give as advance public notice of an analyst call or press conference in which material, non-public information will be disclosed?

	Routine Earnings Releases	%	Planned Conference Presentations	%	Transaction Developments	%
A. Less than 12 hours	7	7%	5	5%	14	14%
B. 12 hours	0	0%	0	0%	1	1%
C. 24 hours	5	5%	6	6%	10	10%
D. 48 hours	12	12%	8	8%	3	3%
E. 72 hours	8	8%	12	12%	4	4%
F. More than 72 hours	64	63%	52	51%	5	5%
G. Depends on facts and	5	5%	18	17%	64	63%

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circumstances

10B. Do your public notices indicate that material, non-public information will be disclosed in the analyst call or press conference?

Yes	15	15%
No	86	85%

10C. In most instances, do your public notices indicate the subject matter of the information to be disclosed in the analyst call or press conference?

Yes	83	82%
No	18	18%

10D. Does your company issue a press release containing the material, non-public information in advance of the analyst call or press conference; or does it only issue the public notice of the analyst call or press conference?

A. Issue a press release in addition to public note	77	76%
B. Issue public notice only	24	24%

11. Since Regulation FD went into effect, what has been your experience with respect to the willingness of analysts and institutional investors to enter into confidentiality agreements to allow your company to protect disclosures that are material and non-public for some period of time?

A. Very willing	5	5%
B. Moderately willing	11	11%
C. Will not enter not confidentiality agreements	28	28%
D. Depends on facts and circumstances	57	56%

12. When your company uses confidentiality agreements, how often do these agreements take the form of a signed, written contract?

A. Always	46	46%
B. Sometimes	27	27%
C. Seldom	10	10%
D. Never	18	17%

12A. Are you comfortable that your material non-public information will be deemed public if you post it on your website, <u>and</u> also give public notice by 8-K or press release a week or so in advance that such information will be located on your website (but omitting the actual disclosures on the web from the 8-K?)

Yes	40	40%
No	61	60%

12B. Are you more comfortable making public disclosures through a webcast with the same notice of the webcast a week or so in advance by press release or 8-K?

Yes	67	66%
No	34	34%

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13. Do you believe that the SEC's position on the Internet and websites should be changed to permit an issuer to use its website as a method of public dissemination of information under Regulation FD?

Yes	69	68%
No	32	32%

13A. For your company, which method of public dissemination of material information under Reg FD would probably result in the greatest number of people actually becoming aware of the information within 24 hours of disclosure *(check only one)*?

A. File a Form 8-K	3	3%
B. Issue a press release	85	84%
C. Conduct a press conference	2	2%
D. Conduct a webcast	1	1%
E. Post the information on the company's website	8	8%
F. Email/push technology	2	2%

14. How does your company comply with the public dissemination requirement of Regulation FD? *(check all that apply)*

A. File a Form 8-K	61	17%
B. Issue a press release	99	28%
C. Conduct a press conference	38	11%
D. Conduct a webcast	72	21%
E. Post the information on the company's website	68	19%
F. Email/push technology	13	4%

14A. If you file 8-K's, does your company typically use Item #5 (filing), Item #9 (furnishing) or a combination?

A. Items 5	**25**	**39**%
B. Item 9	**16**	**25**%
C. Combination	**23**	**36**%

14B. Do you ever use Item #5 and Item #9 in the same 8-K? If yes, for what reason?

Yes	**6**	**10**%
No	**59**	**90**%

Reason

Assure legal compliance

Thought about it, but on reflection I think Item 9 should be used only by issuers for whom releasing a press release to the wires might not result in broad dissemination.

Differentiate between forward looking info and interim earnings report numbers

No particular reason - simply hasn't come up

14C. If you use a press release, do you think your company needs to check to see if the release was actually picked up by a major newswire before you can be comfortable the press release constitutes broad dissemination.

Yes	39	39%

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No	60	60%

15. Does your company review drafts of analysts' reports and earnings models?

Yes	60	60%
No	41	40%

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15A. If yes, does your company:

A. Only review them for factual accuracy of historical information in the public domain	59	64%
B. Limit their review to some other aspect of the content (**describe the other limitation below**)	33	36%

Factual accuracy of historical information; forecasts within range of analyst's forecasts.

Factual accuracy of historical information in the public domain and also consistency with company issued guidance for forecasted periods.

review only historical info and strategic philosophy as outlined in public settings, such as areas of acquisition interest

We have been asked to review them, but I try to discourage any review. If there is a review, it is only for factual accuracy of public historical info.

16. Does your company inform analysts whose forecasts are at variance with the company's forecasts of that fact?

Yes	23	23%
No	78	77%

17. Does your company confirm on a non-public basis their previously announced forecasts to analysts?

Yes	24	24%
No	77	76%

If yes, for how long after the announcement of the forecasts?

Refer back to conference call or public presentations

Depends on facts and circumstances. After Motorola's problems, we like to keep this short (72 hours). But theoretically, we could do it weeks out.

not sure

Until the black-out period

7-10 days after the public announcement

three to four weeks

analyst meetings generally within the first 30 days after the webcast

Until another announcement updates the forecast.

depends on circumstance, but generally for approx. 6 weeks

4-6 weeks

1 week.

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About one month into quarter guidance applies to.

On #16, we would do so only to remind them of existing public guidance.

On #17, under FD, we cannot confirm (never mind update) analysts' forecasts on a non-public basis regardless of when forecasts were made. This is another major flaw of FD.

Weeks.

Less than half-way through period with respect to which the forecast was made.

Varies but generally approximately half-way through a quarter.

Up to two to four weeks after the public announcement of the forecast or "guidance".

until the forecast changes

We announce at the beginning of the conference call that forecasts can be relied upon until the end of the quarter.

they reach materiality threshold more easily; also, their press releases are less likely to be picked up by the media

18. Do you believe that Regulation FD impacts small and mid-cap companies differently from large-cap companies?

Yes	56	55%
No	45	45%

If yes, how?

Not as confident of Press coverage and pick-up of releases

Much greater impact for smaller and midcap companies to the extent of compliance and even what is deemed material.

Burden much larger b/c internal resources much smaller. Much more difficult to monitor/stay up to speed on what current forecasts are.

Good FD compliance requires manpower, and small companies have limited IR capabilities.

Need to hire consultants or attorneys to advise on the area, at extra expense to the smaller companies compared to the large companies who have those resources in-house

Reduction in coverage by analysts who are not willing to put additional work in for smaller companies

Does it have any practical applicability to the way we operate?

What is the definition of "material"?
What constitutes "full disclosure"?

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What can I say?

By encouraging public forecasting which is more difficult for small companies.

Hinders smaller companies in fostering analyst relationships.

More events can be considered material, have fewer resources to meet such requirements, fewer analysts cover them, etc.

In large companies the analysts probably have enough sources of information to do a decent job of analysis. However, in smaller companies, the loss of access to and information from management clearly makes it more difficult to do quality analysis.

A large cap company has more flexibility in ensuring dissemination.

I personally believe that small & mid-cap companies loose the following of some analysts by refusing to give forward looking information, which can have a disproportionate adverse effect, as compared to large cap companies.

Small cap companies have to fight to get the attention of analysts who routinely cover large-cap companies. Therefore, large-cap companies can afford to take a harder line with analysts

FD (and the questions in this survey)speak to issues affecting larger companies, such as whether there are advance notices and investor conference calls.

More desperate to curry favorable relations with analysts so will continue to supply with non-public data

The cost of compliance is felt disproportionately

More pressure on large cap companies with many analysts to give forecasting data to ensure a tight range of numbers.

Impacts greatly on small and mid caps trying to generate coverage.

Reg FD is extremely burdensome for smaller legal departments.
Reg FD makes investors more jittery about small and mid-cap companies' stock.

Large cap company's have more research and factual information, which becomes available to analysts generated by third parties. A larger proportion of information about smaller and mid cap company's comes from and is attributable to the issuer

Less analyst interest and inter-analyst competition, therefore less pressure for disclosure

It increases their disclosure requirements to ensure adequate dissemination. For large companies who receive extensive media coverage, it does not impose the same disclosure practices (i.e. Filing 8-Ks to ensure public dissemination).

More difficult for small and mid-cap companies to attract and retain analyst followings.

Difficulty in maintaining or increasing analyst coverage while refusing to risk violating the inadequately defined "mosaic" exception to the rule.

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Most definitely. Smaller org need to have the attention of the investment community for a number of reasons. This necessitates a more open and cooperative dialogue.

Small caps generally have a shorter history and less Street visibility. As such, they are more vulnerable to the communications limitations inherent in FD.

The less visibility of smaller companies puts an affirmative burden on them to broaden the public disclosure that is automatic with communications of larger companies with more analyst coverage.

Small cap comps. Had further to go to meet compliance and usu. Have less leverage to influence analyst behavior.

It places a larger, more expensive burden for companies not followed by analysts

Vastly different level of materiality means smaller companies must be much more alert to FD implications while at the same time facing much more pressure to assure coverage by analysts

Increased costs for Ir. function and webcasts

Yes, because they are not as widely followed and analyst coverage is very important.

Small and mid-cap companies are less likely to have media or analyst coverage of their press releases.

They reach materiality threshold more easily; also, their press releases are less likely to be picked up by the media

19. Does your company invite members of the media to conference calls or analyst meetings?

A. Encourage	**20**	**20%**
B. Discourage	**4**	**4%**
C. Neutral	**74**	**76%**

20. What are the two or three questions that your company most frequently ask you about Regulation FD?

Who reads 8-ks

Seldom asked about it at all

Should we have a written policy?
Do we need to file 8-K's for so many things?

Is this information "material".

There has been an overreaction to its impact by a number of companies.

Sellside analysts don't (or choose not to)understand Reg FD. They often publish statements implying that a Co. was giving them material non-disclosed info. (even when not the case). Is unfortunate that analysts have no incentive to comply with Reg FD.

Good rule. Need to fix the MA and private placement glitches, and we need a comprehensive communcations/33 Act release.

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Does this need to be disclosed?
When should we disclose this?
Why can't I tell the analyst more?

1. Where's the line between material info and detailed info that would be helpful to an analyst/institution. The material vs. Mosaic issue.
2. We've done a press release. Do we also have to file the release on an 8-K?

Can we say this?

None. Questions vary widely as we attempt to respond to the requirements.

Who is covered by the communication restrictions?
What information is "material"?

What is material?
Why isn't posting on our website sufficient disclosure?

Who does it apply to?
How do we comply with it?

What information is covered.
How much info can we give to our banks.

Whether a certain item of information is likely material.

Do we need to update current earnings guidance?
Is a particular item material?

Analysts still look for earnings confirmation

Why do I have to do this?
Can the press release wait until morning?
1. What is material non-public information?
2. Why isn't posting presentations on our Website sufficient disclosure?

1. Is Fact X material?
2. Do we need to file an 8-K?

Materiality, liability, timing of disclosure

What, where, when & how can I say what I want to say?

Can we say XYZ now that we did a press release that says something slightly different?

What can and can't be said in Q&A

Procedures to use;
Whether information is material.

Is market share information material?

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1. Whether or not information is material
2. What method of disclosure satisfies FD

Particular questions about exactly what we can say to analysts.
Questions about individual stock buy/sell plans.

1. How often do we need to update our forecasts/guidance?
2. How is forecasts/guidance defined?
3. Is a presentation at an investor conference considered a public forum if it is webcast?

What are the criteria for disclosure?
How much or little do we have to disclose?
When do we have to disclose?

What means of disclosure is adequate. What can be said to analysts in private meetings.
Whether they should talk with a particular analyst.

1. What to do about bank private placements?
2. What to do about tax exempt "public" offerings that are exempt transactions?
3. Whether a new presentation is materially different form a prior one by virtue of immaterial updates?

1. How can we respond to questions from analysts regarding forecasts or projections? (or some bad piece of news is published about the industry)?
2. What can we tell analysts about environmental issues facing the industry (and us)?

Can we talk to the party?
Can we make projections?
Can we confirm or deny we are or are not comfortable with previous financials and/or projections?

Whether items are material
Can they confirm information the company previously disclosed

Does it have any practical applicability to the way we operate?

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21. Any other comments on Regulation FD?

I am not opposed to it, so long as the sec continues to not rigorously enforce it and materiality standards are more clearly delineated

Need some guidance on materiality from SEC

Believe it has caused increased market volatility. Believe it is unclear and chills disclosure.

Lack of SEC guidance to large financial websites reporting company information. Companies are working hard to comply with Reg FD and these large financial websites don't pass along information on a timely basis.

The more rules, the better employment is for lawyers.

The decrease in qualitative disclosure to analysts clearly has resulted in a decrease in the amount and quality of information available to the market. Good analysis is being replaced by chatroom gossip. Is this really what the SEC intended?

Much guidance needed from the SEC.

As a Canadian issuer who is also traded in the U.S., Regulation FD has made us more careful about disclosure but Canadian rules already required similar considerations so that our practices have not changed dramatically.

Works better than I thought it would although analyst community is unhappy and that large holders continue to twist arms of issuers who can't say no (e.g., Fidelity)- suggesting that penalties should fall on requestor as well as disclosure

I am concerned that the SEC is asking companies filing registration statements to incorporate Item 9 8-K filings.

The SEC has used a bazooka to kill a mosquito. We are all awaiting the first enforcement action to get some sensible guidelines.

Reg FD was well intentioned however, the chilling effect it has had seems like overkill.

It's an ill-conceived regulation that should be eliminated.
It has created more work for lawyers but hasn't improved communication to the public.
The standard of "intentional" disclosure is unfair when persons are merely reckless.

In a competitive industry, our non-public competitors or those that are part of a public company (and don't have to separately report), have an unfair advantage in that they can participate in the webcast. We cannot do the same as to them.

We chose to invite the public to our analyst conference call, and it has not signicantly affected the call. There are a few more questions, but they are relevant for the most part, and sometimes they probe issues the analysts missed.

As a large company that is carefully scrutinized by the media and analysts, Regulation FD has not resulted in material changes to our disclosure policies or practices.

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This questionnaire is poorly designed. It requires you to answer questions that don''t apply to you with answers that don't apply. Why can't you leave some answers blank if they don't apply?

I had a fairly well thought out comment, but your computer program will not let me give it without more editing for length than I am prepared to spend time on.

What, if any, did FD really change?

SEC needs to coordinate the apparent flexibility of alternative means of providing public disclosure (including the prospect of web site posting) against the NYSE's "requirement" of using press release as mechanism, which results in NO flexibility

Things filed on Form 8-K are incorporated into a Form S-3 except information furnished pursuant to Item 9 (which is furnished but not "filed"). Can Item 9 have exhibits (typically Item 7 exhibits are deemed filed) and still not be deemed a filing?

No significant change in how we communicate with investors has been necessary

There should be good faith safe harbor to protect disclosures made w/o intent to selectively disclose - only intentional, not reckless, behavior should be violation.

It did not add value to the SEC rules and prior practice.

I have sat in analyst meetings where the analysts ask numerous questions that they know the company cannot respond to. Analysts still seem to try to get any information they can, regardless of whether it is proper under Reg FD.

There has been an overreaction to its impact by a number of companies

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The results are in from the survey of members of the Corporate and Securities Law Committee on their experiences with new Regulation FD. The responses from over 100 members yield some key early insights into some of the effects of Regulation FD on corporate disclosure practices. For example, for many companies (36%), there has been an increase in the quantity of information disclosed but fewer respondents (20%) believe that the quality of disclosures has improved. Most respondents (73%) believe Regulation FD has affected the manner their company communicates with employees. Many respondents noted that less information is being provided to employees out of fear that material information may be released to analysts or market professionals. Many companies (44%) also appear to be reducing the number of one-on-one meetings with analysts.

Most respondents (74%) indicated that since adoption of Regulation FD, they are more often asked to provide advice on the materiality of information to be disclosed. Among various methods of public dissemination, 84% of respondents believe that issuing a press release is the one most likely to result in the greatest number of people actually becoming aware of the information within 24 hours. Nevertheless, 68% of respondents believe the SEC should change its position and permit public dissemination to be made using corporate websites. The committee thanks everyone who participated in the survey. During the Committee's meeting with the SEC staff on June 20,2001, there was much staff interest in and discussion of the survey results.

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http://www.niri.org/publications/alerts/ea070201.cfm

Publications

Executive Alerts

National Investor Relations Institute Releases Survey Results on the Impact of SEC Regulation Fair Disclosure

In the most comprehensive survey yet on the impact of the Securities and Exchange Commission's Regulation Fair Disclosure on corporate disclosure practices, the National Investor Relations Institute found that 27 percent of 577 NIRI member companies surveyed by Rivel Research say they are providing more information to investors than before the new rule went into effect last October and 48 percent are issuing about the same amount.

"We are concerned that 24 percent say they are providing less information, a phenomenon that NIRI and other organizations predicted would happen once a regulatory structure was placed around the voluntary disclosure process between companies and the investment community," said NIRI President & CEO Louis M. Thompson. He added that, "further study is needed to determine the reasons that a fourth of the companies are more reticent in providing information of a voluntary nature to investors and what can done about it."

"Our survey suggests, however, that Regulation FD is largely working as the SEC envisioned to provide more equal access to information. Prior to the adoption of the disclosure rule, 60 percent of our companies were providing full public access to their conference calls to discuss quarterly earnings results and guidance. Today, 89 percent are doing so - mostly through web casts, only one percent are conducting calls restricted to analysts and major investors, and 10 percent don't hold conference calls since there is no requirement to do so," said Thompson.

Eighty-four percent of companies are notifying investors and the media of their upcoming conference calls in a news release, 75 percent post a notice on their companies Web site and 55 percent are using "push technology" whereby interested investors who want an e-mail alert are notified directly, said Thompson.

Of those companies that provide quarterly earnings guidance, 67 percent are putting it in a news release and 33 percent are filing it with SEC. In most instances, the news release, Thompson added, is also being posted on the company's Web site once it is confirmed that the release has been broadly distributed to the public. Investors may access the company's filings with the SEC through its EDGAR online system.

Seventy-nine percent of companies are providing some form of earnings guidance and 56 percent are updating their guidance in a news release, should material facts or circumstances change during the quarter. Thirty-five percent are not updating guidance once it is issued. "Reg. FD, however, does not require that companies update their guidance, although a majority does," said Thompson.

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Thompson said that there was concern that companies might severely cut back their one-on-one meetings in light of the SEC's warning that issuing companies risked violating the rule if they talked to analysts, one-on-one, about earnings guidance. Yet, NIRI advised its members that there is important information, much of which is non-financial, that companies can and should discuss with analysts and investors.

"We were pleased to see that companies heeded our advice and that 74 percent say they are still conducting the same number of one-on-ones and five percent are conducting even more, thereby providing important non-earnings related information that analysts can use in valuing the company," he said.

"In terms of the impact of Regulation FD on analyst coverage and institutional investor ownership, we found that only one percent attributed a loss of sell-side analyst coverage or the sale of the company's securities by institutional investors to their company's changes in disclosure policies due to Regulation FD," Thompson added.

"We also found that 47 percent say fewer analysts are asking the company to review their earnings models and 43 percent will still review them, primarily for factual accuracy of information that is already in the public domain. This is down from 79 percent who reviewed earnings models prior to Reg. FD," he said. Fifty-seven percent are still reviewing analysts' draft reports when requested to do so, down from 79 percent, prior to Reg. FD.

A PDF file of the complete survey report (including charts, tables and the questionnaire) is available free to NIRI members
on the 'members only' web site (http://www.niri.org/members/surveys/index.cfm).
Non-members may buy the PDF file for $50 through NIRI's Bookstore online:

http://www.niri.org/publications/bookstore/GetCategories.cfm?Type=Surveys

A copy of the PDF file will be emailed to you once you purchase the survey online. Black and white printed copies can be order through this link as well: $10 members/$75 non-members.

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CORPORATE DISCLOSURE PRACTICES SURVEY 2001

MARCH, 2001

A study conducted for:

National Investor Relations Institute

Among:

Senior Investor Relations Executives at NIRI Companies

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I. Preface

Background and Study Purpose

This study represents the third survey conducted on behalf of the National Investor Relations Institute by Rivel Research Group that focuses on key trends affecting corporate disclosure. (The previous measurements were completed in 1998 and 1995.) The overall purpose of this ongoing research effort is to develop a comprehensive informational database that will assist members in dealing more effectively with the constantly evolving dynamics of investor communications.

The current study is the first completed since the implementation of Regulation Fair Disclosure (Reg FD), and focuses on the impact this statute is having on corporate investor relations practices. Given the far-reaching implications of Reg FD, the study methodology has been enhanced to ensure that the data generated are both valuable and actionable for the NIRI membership. These changes include inviting senior IR officers to complete the survey online so that as comprehensive a database as possible is developed on each of the questions explored. NIRI will continue to monitor change on Reg FD through a follow-up tracking study and a second report on this subject at yearend.

Methodology

To ensure the most accurate representation of current disclosure policies, this study has been conducted among senior investor relations practitioners at NIRI member companies. While the sample group is similar to that targeted for the research conducted in 1995 and 1998, the line of inquiry has been revised so that it focuses exclusively on questions that can be used to measure the impact of Reg FD. In addition, this year's methodology utilized e-mail and an online questionnaire. The 1995 and 1998 surveys employed a combined telephone and mail procedure.

At the outset of the interviewing on January 25, 2001, all NIRI corporate members (a total of 2,736 firms) were e-mailed a NIRI Executive Alert which announced the survey, requested the participation of the most senior IR practitioner in their firm and directed them via hyperlink to the survey Web site. Once at the site, participants were able to answer questions and submit their responses via an automatically generated e-mail to the research team which was then imported into a data file. A second e-mail was disseminated to NIRI corporate members on February 6 to remind those who had not yet filled out the survey to please respond. Using this technique, 600 survey responses were received by the cutoff date of February 16, which translates into a response rate of 21%. After data cleaning and removal of duplicate results (only one response was allowed per company), a total of 577 records remained in the data pool from which

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I. Preface

the survey results were extracted and analyzed. The data collected are representative of the NIRI corporate membership as a whole in terms of market capitalization and spanned a wide variety of industry groups.

Profile of Companies Included in Study

		Total Companies Interviewed	
	(Base/Percentage)	(577)	100
		#	%
Market Capitalization:	Large-cap ($1.5 billion or more)	224	39%
	Mid-cap ($500 million to $1.49 billion)	140	24%
	Small-cap (Under $500 million)	211	36%
	Not reported	2	.5%
Title:	CFO	37	6%
	Vice President, Investor Relations	187	32%
	Director/Executive Director of IR	198	34%
	Manager of Investor Relations	105	18%
	IR Associate/Specialist	29	5%
	Other	21	4%
Stock Market:	New York Stock Exchange	277	48%
	NASDAQ	267	46%
	American Stock Exchange	24	4%
	Other Market	9	2%
Industry:*	Technology (net)	148	26%
	Internet	53	9%
	Software	50	9%
	Hardware	45	8%
	Telecommunications	54	9%
	Diversified financial services	42	7%
	Drug & research, drug distribution	41	7%
	Medical devices and products	34	6%
	Utilities & power	33	6%
	Banks	31	5%
	Fuel – coal, oil and gas, petroleum	29	5%
	Consumer products	29	5%
	Electronic products	29	5%
	Manufacturing – capital goods	29	5%
	Insurance	22	4%
	Retailing	21	4%
	Real estate	21	4%
	Chemicals	20	3%
	Service industries	19	3%
	Health care services	19	3%
	Entertainment	17	3%
	Metals and mining	16	3%
	Food/beverage	15	3%
	Other industries	79	14%

* Multiple responses.

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I. PREFACE

Report Organization

The Research Highlights section of this report (which follows this Preface) gives an overview of the key findings from this research. This is followed by the Summary of Findings, which presents detailed results for the total group of senior NIRI practitioners participating in this study. The findings are referenced to a set of summary tables which provides more complete documentation of the issues covered. As a service to NIRI members, a series of industry tables also has been prepared for sectors in which sufficient numbers of interviews were completed to yield reliable results. The final section includes a text version of the online questionnaire.

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II. Research Highlights

- ❒ Investor relations officers in most NIRI companies report that they have not made major changes to key aspects of their IR programs as a result of Reg FD.
  - Three out of four IROs (75%) say their companies provide the same, or even more, information to analysts and investors as they did before Reg FD.
  - Nearly four out of five (79%) continue to hold one-on-one meetings with investment professionals to the same or greater extent than previously.
  - Four in five (79%) still offer some form of earnings guidance to the investment community (most often including factors driving earnings or a range of estimated EPS).
- ❒ Regulation FD also is seen by IROs as having minimal impact on the composition of their company's sell-side coverage or institutional shareholder base.
  - Of the 577 IROs surveyed, only one directly attributes a loss of sell-side coverage to Reg FD restrictions.
  - Similarly, only five IROs (still less than 1%) say that portfolio managers have sold stock in their company because of Reg FD.
- ❒ However, a distinct minority of IROs has cut back their investor communications since Reg FD went into effect.
  - One in four is disseminating less information about their firms.
  - One in ten has reduced the number of one-on-ones conducted.
  - And, of those providing earnings guidance, one-third do not update this insight during the quarter.

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II. Research Highlights

❒ IROs are making a concerted effort to avoid selective disclosure.

- Fewer IROs review analysts' earnings models and draft reports than was the case before Reg FD was implemented:
  - Since Reg FD went into effect, 43% report that they go over analysts' earnings models (compared to 81% previously).
  - Just over half (57%) review draft reports (down from 79% pre-Reg FD).
- Seven in ten IROs (70%) say they *always* accompany top corporate officers during one-on-one meetings with investment professionals.
- And, just under two-thirds (63%) report that their firms currently have written disclosure policies, with an additional 25% saying they plan to establish one.

❒ At the same time, most NIRI companies have taken steps to facilitate access to corporate information through conference calls, webcasts and corporate Web sites.

- Fully 89% of companies that provide earnings guidance do so by allowing full public access to their quarterly conference calls and webcasts.
- Two out of three of these firms (67%) include earnings guidance in their news releases.
- Over half of all companies (55%) are using e-mail push technology to notify investors of upcoming webcasts or telephone conference calls.

❒ While IROs appear to be adjusting to the post-Reg FD era, they would like to see some changes in the regulation. The most commonly expressed suggestions include:

- Greater clarity on the statute's rules and definitions (especially in terms of what constitutes materiality).
- More flexibility in meeting the information needs of analysts and investors. One of the most frequently mentioned rules that IROs would like to change is the stipulation which they believe requires companies to issue news releases simply to confirm existing guidance.

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III. Summary of Findings

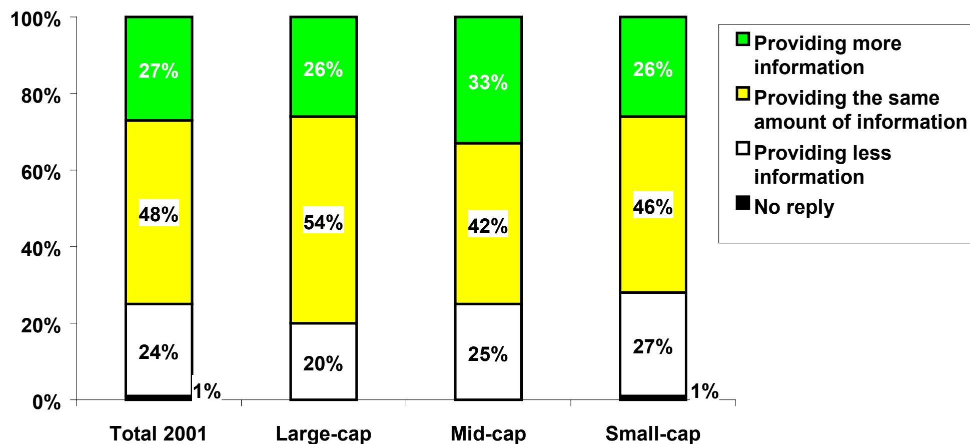
Assessing the Impact of Regulation Fair Disclosure on IR

❒ According to most investor relations officers, Reg FD has not reduced the amount of information they disseminate to analysts and investors.

- Nearly half the senior IROs surveyed (48%) say they are providing the same quantity of data as they did before Reg FD went into effect.
- In addition, better than one in four (27%) report sharing an even greater amount of information.
- However, a similar number (24%) does indicate that they have cut back on the information they regularly send out to the investment community.

The following chart illustrates these findings and also presents results by the market capitalization of the companies represented in the study. [1] [ALSO REFER TO SUMMARY TABLE 1 AT THE END OF THIS REPORT]

Change in Level of Information Provided Since Reg FD Passed



[1] Throughout this report, the following definitions are used: Large-cap – companies with a market capitalization of $1.5 billion or more; Mid-cap – $500 million to $1.49 billion; Small-cap – under $500 million.

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III. Summary of Findings

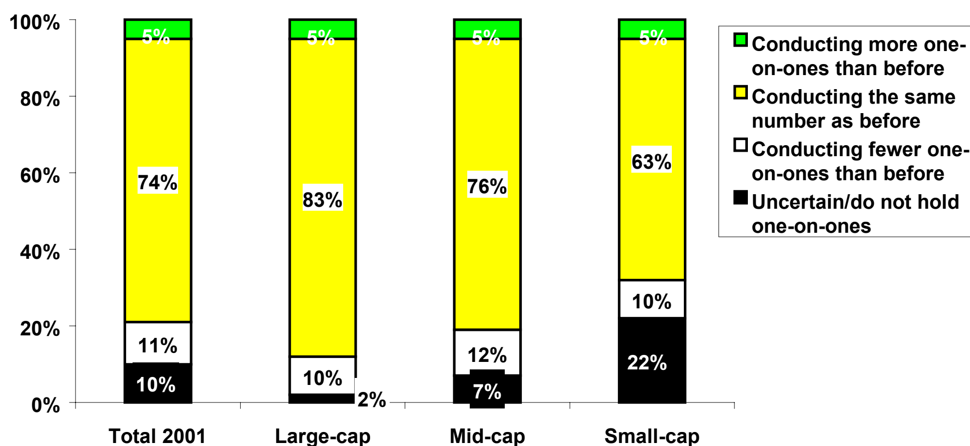
❒ Correspondingly, the number of one-on-one meetings being held between senior corporate management and investment professionals has been little affected. [REFER TO SUMMARY TABLE 2]

- Three out of four IROs (74%) say their companies are conducting the same number of one-on-one sessions as they did before Reg FD. Five percent actually report an increase.

- Relatively few firms (about one in ten) have cut back on the number of one-on-ones they hold.

- As might be anticipated, one-on-ones are part of a large company's IR program (83%) to a greater extent than that of a smaller company (63%).

Change in Level of One-on-Ones Conducted Since Reg FD Passed



❒ IROs say they typically accompany senior corporate officers during one-on-one sessions with analysts and investors (reported by 94% of the IROs interviewed). Seventy percent report they *always* go with senior executives. [REFER TO SUMMARY TABLE 3]

- Investor relations officers also try to bring along another company executive when they themselves are the primary spokesperson at such meetings (62%).

- Earnings topics are covered at about half the one-on-one meetings held between corporate executives and investment professionals (54%).

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III. Summary of Findings

- ❒ Most investor relations executives (73%) do not think that investment professionals have turned to gathering insight from corporate employees not covered by Reg FD.
  - In fact, only 6% have detected such inquiries, while 20% are uncertain whether there have been any. [REFER TO SUMMARY TABLE 4]

- ❒ A loss in analyst coverage or institutional ownership is rarely attributed to the implementation of Reg FD. [REFER TO SUMMARY TABLES 5 AND 6]
  - Of the 577 IROs surveyed, only one (.2%) blames Reg FD specifically for a decline in sell-side coverage.
    - Nearly two in three (63%) say there has been no change, and 20% actually indicate an increase (although not necessarily due to Reg FD).
    - Average sell-side coverage reported in this study ranges from 16 analysts for large-cap companies to 7 for mid-caps and 3 for small-caps. [REFER TO SUMMARY TABLE 7]
  - Similarly, only five of the 577 respondents (1%) hold Reg FD directly responsible for a falloff in institutional holdings. [REFER TO SUMMARY TABLE 8]

- ❒ However, while very few IROs report an actual (or even threatened) decrease from these constituencies, several IR executives do say that they are receiving fewer requests to review analysts' earnings models or draft reports. [REFER TO SUMMARY TABLE 9]
  - Nearly half (47%, and 56% in large-cap companies) are being asked to review earnings models less frequently than was the case before Reg FD.
  - Better than one-third (36%) say they receive a smaller number of requests to look over draft reports.

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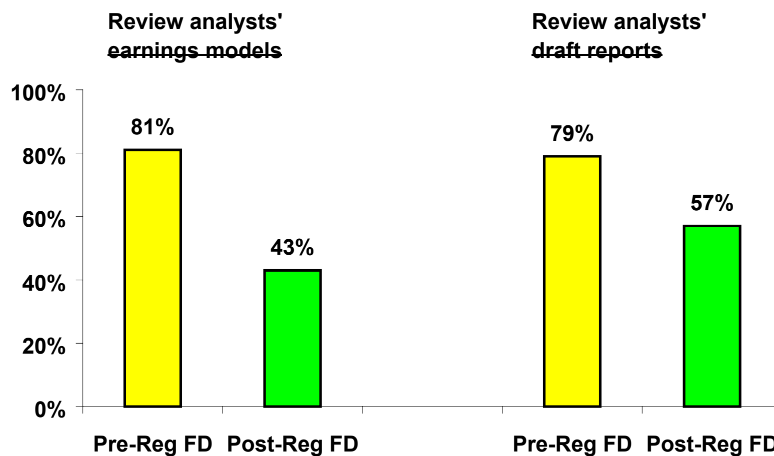
III. Summary of Findings

❒ The reduced number of analysts' requests also is reflected in the less extensive earnings guidance being supplied by IROs. [REFER TO SUMMARY TABLES 10 AND 11]

- While 81% of the IROs surveyed say they reviewed analysts' earnings models prior to the adoption of Reg FD, only 43% report that they continue this practice today.

- Similarly, 79% used to look over analysts' draft reports, compared to 57% currently. [REFER TO SUMMARY TABLES 12 AND 13]

Extent to which IROs Review Analysts' Earnings Models/Draft Reports



❒ Most IR executives providing such reviews (over 90%) report that they do so in order to check the factual accuracy of historical information in the public domain. [REFER TO SUMMARY TABLES 14 AND 15]

- Half (50%) also indicate that they are reviewing assumptions that they believe are non-material.

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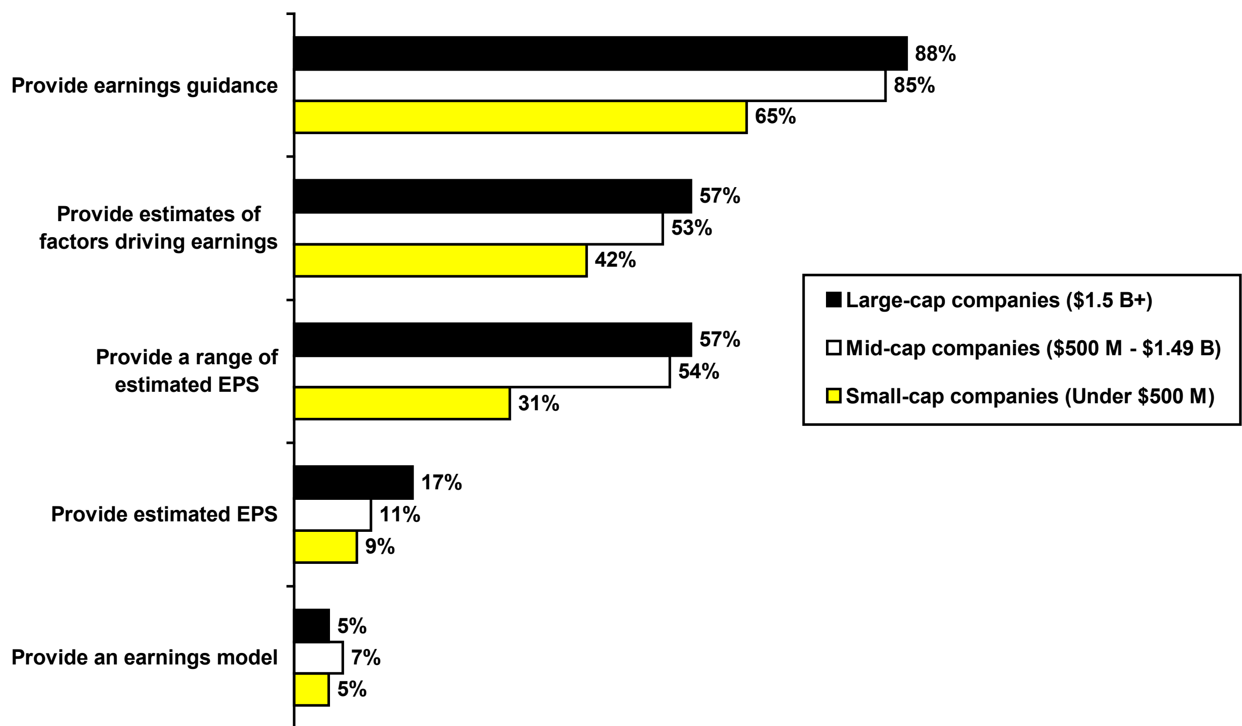
III. Summary of Findings

Focus on Earnings Guidance

- ❒ The large majority of NIRI companies (79% of total interviewed, and 88% of large-cap companies) continues to provide some form of earnings guidance. [REFER TO SUMMARY TABLE 16]
    - This usually takes the form of discussions of factors that drive earnings, but not a comprehensive review of all elements in these equations (51%).
    - Nearly as many IROs (47%) report sharing a range of estimated earnings per share.
    - Only one in ten (12%) provides a specific earnings target, with even fewer (6%) divulging an earnings model.
- ❒ As the following graph indicates, larger companies are the most likely to disclose various types of earnings guidance.

Types of Earnings Information Currently Disclosed



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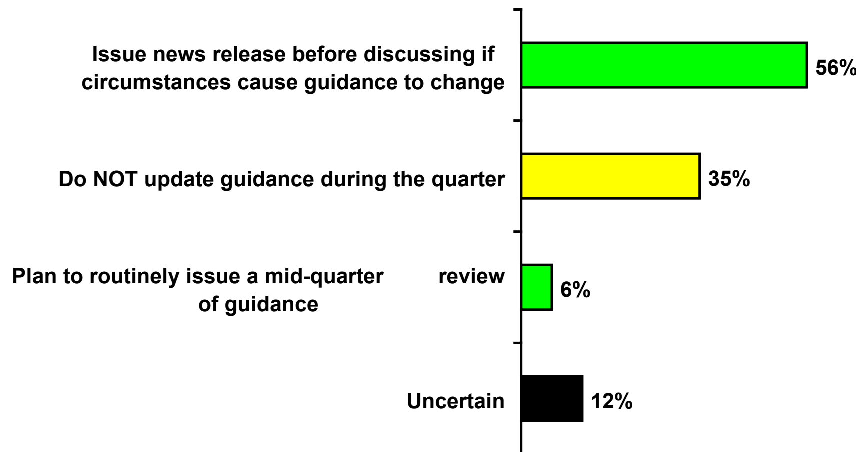
III. Summary of Findings

❒ IROs in NIRI companies who currently give earnings guidance generally update this information during the fiscal quarter. [REFER TO SUMMARY TABLE 17]

- Well over half either disseminate news releases to announce material events that will cause the guidance to change (56%), or plan to routinely issue a mid-quarter review of guidance (6%).
  - In fact, one out of four (28%) says their companies have made a public commitment to updating earnings guidance if it changes materially. [REFER TO SUMMARY TABLE 18]
- A substantial minority (35%), however, reports that their firms do not update guidance during the quarter.
- Another 12% have not yet decided how to resolve this question.

How Earnings Guidance Is Updated *



* Among companies that provide earnings guidance. Multiple responses.

- Note: These percentages do not differ markedly by the size of a company's market capitalization.

❒ Importantly, quiet periods are employed extensively by NIRI companies that discuss earnings with the Street (86%) – typically ranging from one to five weeks prior to their quarterly earnings releases. [REFER TO SUMMARY TABLES 19 AND 20]

- The average length of these quiet periods is 25 days.

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III. Summary of Findings

Current Methods of Communicating

❒ Individual investors and the media are usually alerted to upcoming conference calls or webcasts through news releases and notices posted to a firm's Web site. [Refer to Summary Table 21]

- Each of these means of advance notification is employed by two out of three or more NIRI firms, regardless of company size.
- Just over half are using push technology whereby interested investors who want an e-mail alert are notified directly.

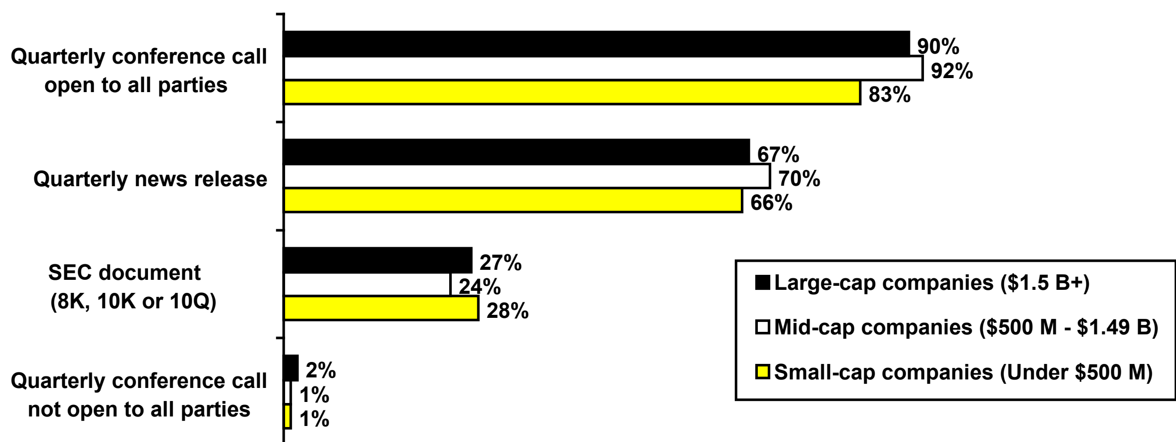
❒ Announcements of upcoming conference calls and webcasts typically do not include insight as to whether new material information will be discussed. This kind of advance notice is supplied by 38%. [Refer to Summary Table 22]

❒ The vast majority of quarterly conference calls in which earnings guidance is given is open to all interested parties and the media. [Refer to Summary Table 23]

- Fully nine in ten IROs (89%) in these companies say they provide full public access to their quarterly conference calls.
- Two out of three also disseminate guidance in the quarterly news release.
- The restricted access call is rare, reported by only 1% of survey participants.

❒ As the following chart illustrates, these results do not differ significantly by company size.

*Methods by Which Earnings Guidance Is Currently Provided**



* Among companies that provide earnings guidance. Multiple responses.

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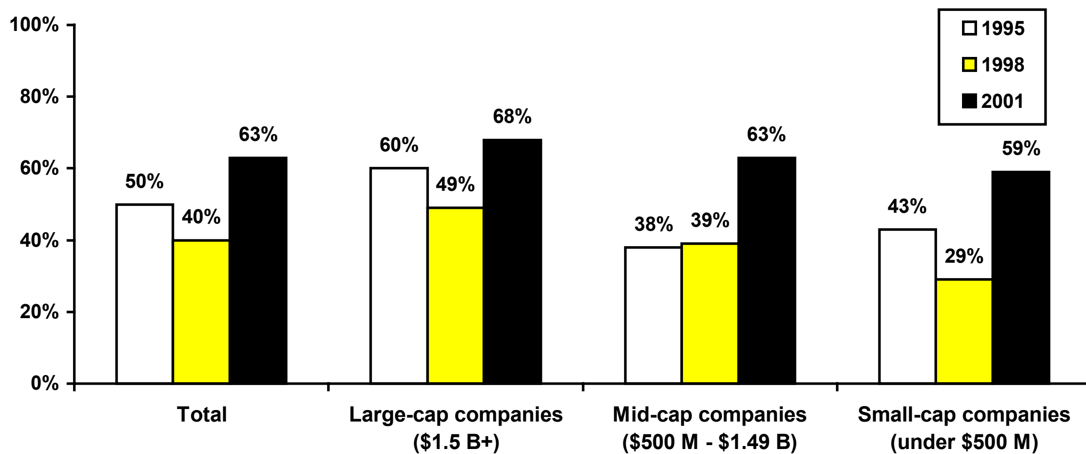
III. Summary of Findings

Internal Company Policies

❒ Written disclosure policies are becoming the norm for NIRI companies.

- Nearly two out of three IROs (63%) now say that these directives are in place (up from 50% and 40% in NIRI research completed in 1995 and 1998, respectively). [REFER TO SUMMARY TABLE 24]

Company Has a Written Disclosure Policy



- In addition, 25% in the current study indicate that their firms have plans to formalize their disclosure policy in writing.

❒ Three-quarters of NIRI companies (73%) also have policies to prevent employees from participating in chat rooms or unauthorized discussions about the firm. [REFER TO SUMMARY TABLE 25]

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III. Summary of Findings

Suggestions for Changing Regulation Fair Disclosure

❒ When asked to specify aspects of Reg FD they would like to change, IROs most often call for the following:

- Greater clarity on Reg FD's rules and definitions (cited by 16%) – particularly, a better definition of material information, as well as insight from the SEC on how best to comply with the statute's mandates.

- More latitude in meeting the information needs of analysts, investors and the media (15%). These respondents would like more freedom to respond to questions or to confirm existing guidance without having to issue news releases.

- In addition to these two leading issues, some IROs (6%) would like to see a broader application of Reg FD so that it also applies to some of the questions asked by such key interest groups as analysts, investors and, particularly, the media.

- Others (5%) want a more liberal interpretation as to how information can be disseminated, frequently suggesting that a company's Web site should suffice as the source for public disclosure, obviating the need for myriad news releases.

The following verbatim comments lend further insight into the views expressed:
[Refer also to Summary Table 26]

> *"They should clarify exactly what we can or should say about future earnings expectations. No one wants to be the first test case, so we won't say anything about future expectations. That result certainly seems contrary to the intent of the rule."*

> *"I would change the restriction throughout the quarter that we cannot say that we remain comfortable with earnings consensus without having to announce it via a press release."*

> *"The definition of materiality needs to be changed. At present, everything is 'material' however small or truly insignificant it is. Not every bit of information needs full disclosure."*

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III. Summary of Findings

"It should directly involve other players, such as sell-side firms and buy-side analysts, in the process of improving disclosure. Today, the onus and policing lies solely with the issuer, and better cooperation by investors, rather than trying to keep one foot in the 'old days,' would be helpful. Overall, we do not have problems with the purpose of Reg FD, and the process is getting institutionalized fairly quickly."

"Having accurate information available for the investing public, including reasonable earnings estimates, is a valuable contribution provided by the analysts' community. It would be helpful if there were a means in the regulation, a safe harbor, that would allow management to review analysts' earnings models, and minimize the variations in earnings estimates that will otherwise likely occur."

"We need a solid definition about what exactly constitutes materiality in today's world. The 'average' investor rule is not good enough."

"While the intent of Regulation FD is noble and has resulted in a more level playing field with respect to investors' access to company conference calls (which is a positive), the 'noise' created by the significantly increased number of corporate press releases announcing earnings dates and conference call access information is cluttering up the newswires. I would advocate that corporate Web sites should publish that information, then provide for push technology which can alert investors and the media – the ones who have requested and want the information – to the news. Automatic issuance of press releases to announce every corporate earnings release date and every investor conference appearance is overkill. The very noise this activity creates may ultimately dampen the spirit of the Regulation by jading everyone with so much news traffic that they eventually tune it out."

"If I gave guidance for the future in an earnings release, I would like to be able to refer to that release throughout the quarter assuming the guidance was still true. I don't think it should be necessary to issue a new release when guidance has not changed."

"It should include sell-side analysts. They can report rumors and write anything they want without SEC oversight. Companies have little power to respond or correct information without the burden of putting out more press releases or holding more conference calls."

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III. Summary of Findings

"They should define webcasting of conference calls and financial conferences over the Internet which are available from company Web sites as adequate disclosure for Reg FD purposes. Allow push technology, where interested persons register an e-mail address to receive adequate notification and allow the corporate Web site to be a satisfactory source of dissemination of material information for Reg FD purposes."

"Revise FD so that the media is not given special exemption. We do not give any material, non-public information to the media, but several media folks believe that they have a right to receive it and we can not, as a company, invoke Reg FD in not providing them the data they are seeking."

"Remove the subjectivity whereby the SEC can, after the fact, accuse the company of making a material non-public disclosure. Our evaluation as to whether an item is material is done in advance. The SEC can, looking back, argue that an item was material simply based on movement in the company's stock price that day."

"I would make it standard policy that if the company does not issue an update to the guidance issued in an earlier release then the public must assume there has been no material change to the guidance. It seems silly to me to issue an update mid-quarter that says nothing has changed."

"Regarding materiality – at what specific point does the company have an obligation to disclose, for example, new products, mergers and management changes? This appears to be a very gray area."

"It is extremely difficult for young, growing companies with evolving corporate models to not give more guidance to the analyst initiating coverage of the company."

"They need to be more cognizant of the perception created by the rule, rather than the rule itself. Companies can still talk about many things – history, industry, trends, factors driving the industry – but many companies now seem petrified to discuss anything because of a fear of Regulation FD."

"We need clearer definitions of what is considered material and clearer guidance on what can and cannot be disclosed. And, we need more guidance on one-on-ones. The SEC should conduct training in major cities and be able to explain their own policies."

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IV. Summary Tables

Table 1. Change in Level of Information Provided Since Reg FD Passed

	Total	Market Capitalization		
		$1.5B or more	*$500M - $1.49B*	*Under $500M*
(Base)	(577) %	(224) %	(140) %	(211) %
Providing more information	27	26	33	26
Providing the same amount of information	48	54	42	46
Providing less information	24	20	25	27
No reply	1	-	-	1

Table 2. Change in Level of One-on-ones Conducted Since Reg FD Passed

	Total	Market Capitalization		
		$1.5B or more	*$500M - $1.49B*	*Under $500M*
(Base)	(577) %	(224) %	(140) %	(211) %
Conducting a greater number of one-on-ones than before	5	5	5	5
Conducting the same number of one-on-ones as before	74	83	76	63
Cutting back on the number of one-on-ones conducted	11	10	12	10
Have not been holding one-on-ones and do not plan to begin	4	1	1	11
Uncertain	6	1	6	11

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IV. Summary Tables

Table 2.1. How Companies are Cutting Back on One-on-ones

	Total	Market Capitalization $1.5B or more	$500M - $1.49B	Under $500M
(Base)	(577) %	(224) %	(140) %	(211) %
Sell-side				
Conducting fewer one-on-ones with sell-side analysts	9	9	11	8
Eliminating one-on-ones with sell-side analysts	1	-	1	2
Not cutting back sell-side one-on-ones	89	90	88	90
No reply	1	1	-	-
Buy-side				
Conducting fewer one-on-ones with the buy-side	9	9	11	7
Eliminating one-on-ones with the buy-side	1	-	1	2
Not cutting back buy-side one-on-ones	89	90	88	90
No reply	1	1	-	1

Table 3. Current Practices for One-on-ones

	Total	Market Capitalization $1.5B or more	$500M - $1.49B	Under $500M
(Base: among companies that hold such meetings)	(552) %	(222) %	(139) %	(189) %
IR accompanies top corporate officers during one-on-ones				
Yes (net)	94	98	94	91
Yes, always	70	86	67	53
Yes, sometimes	24	12	27	38
No	5	2	6	8
No reply	1	-	-	1
Senior IR officer brings other person during one-on-ones				
Yes (net)	62	60	56	69
Yes, always	17	14	13	22
Yes, sometimes	45	46	43	47
No	34	37	38	26
No reply	4	3	6	5
Earnings topics are covered in one-on-ones				
Yes	54	56	57	50
No	44	43	42	45
No reply	2	1	1	5

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IV. Summary Tables

Table 4. Believe Employees Not Covered by Reg FD are Now Getting More Calls From Analysts/Investors

		Market Capitalization		
	Total	*$1.5B or more*	*$500M - $1.49B*	*Under $500M*
(Base)	(577) %	(224) %	(140) %	(211) %
Yes	6	5	7	5
No	73	72	76	73
Uncertain	20	23	16	21
No reply	1	-	1	1

Table 5. Perceived Impact of Reg FD on Analyst Coverage

		Market Capitalization		
	Total	*$1.5B or more*	*$500M - $1.49B*	*Under $500M*
(Base)	(577) %	(224) %	(140) %	(211) %
Sell-side coverage increased since passage of Reg FD	20	29	21	9
Sell-side coverage stayed the same	63	62	63	63
Sell-side coverage decreased	12	7	12	18
Uncertain	4	1	4	9
No reply	1	1	-	1

Table 6. Decline in Sell-side Coverage Believed to be a Result of Reg FD

		Market Capitalization		
	Total	*$1.5B or more*	*$500M - $1.49B*	*Under $500M*
(Base)	(577) %	(224) %	(140) %	(211) %
Yes, believe decline of sell-side coverage result of Reg FD	♦	♦	-	-
No, do not believe decline of sell-side coverage result of Reg FD	10	6	10	16
Sell-side coverage has not decreased	88	93	88	81
Uncertain	2	1	2	3

♦ Between zero and .5.

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IV. Summary Tables

Table 7. Number of Sell-side Analysts Covering Firm

	Total	Market Capitalization $1.5B or more	Market Capitalization $500M - $1.49B	Market Capitalization Under $500M
(Base)	(577) %	(224) %	(140) %	(211) %
1 to 4 analysts	28	3	26	57
5 to 9 analysts	27	20	53	18
10 to 14 analysts	14	22	16	3
15 to 19 analysts	10	22	1	1
20 to 29 analysts	9	23	-	-
30 or more analysts	3	9	1	-
No analyst coverage	8	-	2	20
No reply	1	1	1	1
(Average – number of analysts)	*(9)*	*(16)*	*(7)*	*(3)*

Table 8. Believe Institutional Investors Sold Stock Due to a Change in Disclosure Policy Since Reg FD

	Total	Market Capitalization $1.5B or more	Market Capitalization $500M - $1.49B	Market Capitalization Under $500M
(Base)	(577) %	(224) %	(140) %	(211) %
Yes	1	1	2	-
No	86	90	86	82
Uncertain	11	8	11	16
No reply	2	1	1	2

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IV. Summary Tables

Table 9. Perceived Impact of Reg FD on Analysts

	Total	Market Capitalization		
		$1.5B or more	*$500M - $1.49B*	*Under $500M*
(Base)	(577) %	(224) %	(140) %	(211) %
Believe fewer analysts are requesting a review of their earnings models since Reg FD				
Yes	47	56	49	35
No	38	32	39	44
Uncertain	15	12	12	21
Believe fewer analysts are requesting a review of their draft reports since Reg FD				
Yes	36	39	39	30
No	48	50	47	46
Uncertain	16	11	14	23
No reply	♦	-	-	1
Threatened with dropped coverage/selling stock due to change in disclosure policies since Reg FD				
Yes	3	3	2	2
No	96	96	97	96
No reply	1	1	1	2

♦ Between zero and .5.

Table 10. Pre-Reg FD: Reviewed Analysts' Draft Earnings Models

	Total	Market Capitalization		
		$1.5B or more	*$500M - $1.49B*	*Under $500M*
(Base)	(577) %	(224) %	(140) %	(211) %
Reviewed analysts' earnings models before Reg FD	81	91	89	65
Did not review analysts' earnings models before Reg FD	14	9	10	23
No sell-side coverage	5	-	1	12

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IV. Summary Tables

Table 11. Post-Reg FD: Still Review Analysts' Draft Earnings Models

	Total	Market Capitalization		
		$1.5B or more	*$500M - $1.49B*	*Under $500M*
(Base)	(577) %	(224) %	(140) %	(211) %
Still review analysts' earnings models	43	51	49	30
Do not review analysts' earnings models	37	39	39	35
Did not review prior to Reg FD/no sell-side coverage	19	9	11	35
No reply	1	1	1	-

Table 12. Pre-Reg FD: Reviewed Analysts' Draft Reports

	Total	Market Capitalization		
		$1.5B or more	*$500M - $1.49B*	*Under $500M*
(Base)	(577) %	(224) %	(140) %	(211) %
Reviewed analysts' draft reports before Reg FD	79	89	84	65
Did not review analysts' draft reports before Reg FD	16	11	14	23
No analyst coverage	5	-	2	12

Table 13. Post-Reg FD: Still Review Analysts' Draft Reports

	Total	Market Capitalization		
		$1.5B or more	*$500M - $1.49B*	*Under $500M*
(Base)	(577) %	(224) %	(140) %	(211) %
Currently review analysts' draft reports	57	67	62	42
Do not currently review analysts' draft reports	21	21	22	22
Did not review before Reg FD/no sell-side coverage	21	11	16	35
No reply	1	1	-	1

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IV. Summary Tables

Table 14. Post-Reg FD: How Analysts' Draft Earnings Models are Reviewed

	Total	Market Capitalization *$1.5B or more*	 *$500M - $1.49B*	 *Under $500M*
(Base: among those still reviewing draft earnings models)	(248) %*	(115) %*	(68) %*	(64) %*
Reviewing draft earnings models only for factual accuracy of historical information in the public domain	95	95	97	92
Reviewing assumptions that are believed to be non-material	50	46	59	48

* Multiple responses.

Table 15. Post-Reg FD: How Analysts' Draft Reports are Reviewed

	Total	Market Capitalization *$1.5B or more*	 *$500M - $1.49B*	 *Under $500M*
(Base: among those still reviewing draft reports)	(329) %*	(151) %*	(87) %*	(89) %*
Reviewing draft reports only for factual accuracy of historical information in the public domain	97	97	99	97
Reviewing assumptions that are believed to be non-material	50	46	62	44

* Multiple responses.

Table 16. Post-Reg FD: Types of Earnings Information Currently Disclosed

	Total	Market Capitalization *$1.5B or more*	 *$500M - $1.49B*	 *Under $500M*
(Base)	(577) %*	(224) %*	(140) %*	(211) %*
Provide some form of earnings guidance	**79**	**88**	**85**	**65**
Estimates or forecasts of specific factors that drive earnings, but not all factors that might be in internal financial forecasts	51	57	53	42
A range of estimated earnings per share	47	57	54	31
Estimated earnings per share	12	17	11	9
An earnings model	6	5	7	5

* Multiple responses.

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IV. Summary Tables

Table 17. How Company Handles Questions as to Whether Previously Given Guidance is on Track

	Total	Market Capitalization		
		$1.5B or more	*$500M - $1.49B*	*Under $500M*
(Base: among those who currently provide earnings guidance)	(457) %*	(199) %*	(119) %*	(138) %*
If facts or circumstances cause the guidance to change, we issue a news release before responding to such questions	56	55	61	51
We do not update guidance during the quarter	35	33	36	38
We plan to routinely issue a mid-quarter review of guidance	6	9	4	2
Uncertain	12	12	8	15

* Multiple responses.

Table 18. Company has made Public Commitment to Updating Earnings Guidance If It Changes Materially

	Total	Market Capitalization		
		$1.5B or more	*$500M - $1.49B*	*Under $500M*
(Base: among those who currently provide earnings guidance)	(457) %	(199) %	(119) %	(138) %
Yes	28	29	30	25
No	69	69	68	69
No reply	3	2	2	6

Table 18.1. How the Mid-Quarter Review of Guidance is Disseminated

	Total	Market Capitalization		
		$1.5B or more	*$500M - $1.49B*	*Under $500M*
(Base: among those who issue a mid-quarter review of guidance)	(26) %*	(18) %*	(5) %*	(3) %*
News release	69	72	80	33
Fully accessible, non-exclusionary conference call	27	28	20	33
Furnishing any revised guidance in the appropriate section of an 8K	27	17	40	67

* Multiple responses.
Note: Caution – extremely small base sizes.

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IV. Summary Tables

Table 19. Company has Quiet Period Prior to Earnings Releases

		Market Capitalization		
	Total	*$1.5B or more*	*$500M - $1.49B*	*Under $500M*
(Base: among those who currently provide earnings guidance)	(382) %	(158) %	(103) %	(121) %
Yes	86	87	86	84
No	13	12	12	15
No reply	1	1	2	1

Note: Question added to survey after some interviews were already completed.

Table 20. Number of Days Quiet Period Begins Prior to Earnings Releases

		Market Capitalization		
	Total	*$1.5B or more*	*$500M - $1.49B*	*Under $500M*
(Base: among those who have quiet period)	(329) %	(138) %	(89) %	(102) %
Up to one week	9	8	9	9
Two weeks	29	25	27	38
Three weeks	16	28	9	6
Four weeks	25	19	35	24
Five weeks	5	8	6	2
Six or more weeks	11	8	11	14
No reply	5	4	3	7
(Average – number of days)	*(25)*	*(24)*	*(27)*	*(25)*

Table 21. Post-Reg FD: Method Used to Notify Individual Investors and the Media of Webcasts/Conference Calls

		Market Capitalization		
	Total	*$1.5B or more*	*$500M - $1.49B*	*Under $500M*
(Base)	(577) %*	(224) %*	(140) %*	(211) %*
Press release	84	87	89	78
Notice on company Web site	75	80	79	67
E-mail (using push technology)	55	57	57	51

* Multiple responses.

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IV. Summary Tables

Table 22. Post-Reg FD: Notification of Upcoming Meeting Includes Company's Intent to Discuss New Material Information

		Market Capitalization		
	Total	$1.5B or more	$500M - $1.49B	Under $500M
(Base)	(577) %	(224) %	(140) %	(211) %
Yes	38	38	41	36
No	42	43	44	41
No reply	20	19	15	23

Table 23. Methods by Which Earnings Guidance is Currently Provided

		Market Capitalization		
	Total	$1.5B or more	$500M - $1.49B	Under $500M
(Base: among those who currently provide earnings guidance)	(457) %*	(199) %*	(119) %*	(138) %*
In a quarterly conference call that is conducted by telephone and/or webcast open to all parties	89	90	92	83
In the quarterly news release	67	67	70	66
In an SEC document (the 8K , 10K or 10Q) (net)	26	27	24	28
In a 10K or 10Q	19	17	18	23
In an 8K	14	17	12	11
In a quarterly conference call that is not fully accessible to all parties and the media	1	2	1	1

* Multiple responses.

Table 24. Company Has a Written Disclosure Policy

		Market Capitalization		
	Total	$1.5B or more	$500M - $1.49B	Under $500M
(Base)	(577) %	(224) %	(140) %	(211) %
Yes, company has a written disclosure policy	63	68	63	59
No, not aware of any plans to establish policy	11	10	8	13
No, but plan to establish one	25	21	28	27
No reply	1	1	1	1

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IV. Summary Tables

Table 24.1. Reason Company Doesn't Have a Written Disclosure Policy

	Total	Market Capitalization		
		$1.5B or more	*$500M - $1.49B*	*Under $500M*
(Base: no plans to establish written disclosure policy)	(62) %*	(23) %*	(11) %*	(28) %*
Company has a disclosure policy but it is not in writing	74	78	55	79
Company counsel specifically recommends against a written disclosure policy	6	4	18	4
Other reason for not having a written disclosure policy	19	13	27	21
No reply	2	4	-	-

* Multiple responses.

Table 25. Company has Policy Against Employee Participation in Chat Rooms or Unauthorized Discussions

	Total	Market Capitalization		
		$1.5B or more	*$500M - $1.49B*	*Under $500M*
(Base)	(577) %	(224) %	(140) %	(211) %
Yes, company has policy	73	75	71	70
No, not aware of any plans to establish policy	15	18	12	14
No, but plan to establish one	11	6	16	15
No reply	1	1	1	1

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IV. Summary Tables

Table 26. One Thing Respondents Would Change about Reg FD

	Total	Market Capitalization		
		$1.5B or more	$500M - $1.49B	Under $500M
(Base)	(577) %	(224) %	(140) %	(211) %
Greater clarification of rules, definitions (net)	16	17	16	14
Better definition of material information	9	11	10	7
Clarify uncertainties/gray areas/more guidance from SEC on how to comply	7	7	6	8
More freedom in providing information (net)	15	20	16	9
Ability to confirm existing guidance without having to issue a press release	7	10	7	2
More room to comment on information, estimates without having to issue a press release	7	8	7	4
Remove restriction on reviewing models/need ability to comment on analysts' earnings models	4	4	4	3
Allow forecasting of material information with disclaimers as before	1	1	-	-
Extend rules to corporate audiences – analysts/investors/media (net)	6	8	2	5
More rules for analysts, investors on what information they can ask for/some onus on audiences	3	5	1	3
No exemption for the media as an okay-to-selectively-disclose-to audience	3	4	1	2
Reg FD should apply to foreign private issuers as well	1	1	-	-
Change in means of making information public (net)	5	7	7	1
Allow Web site to suffice as public disclosure, without having to issue press release or file with SEC	2	3	2	1
Remove focus on webcasting as means of fair disclosure/ don't require live conference broadcasts	1	1	2	-
Allow push e-mail to suffice instead	1	-	1	-

Note: No other issue cited by 5% or more.

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IV. Summary Tables

Table 27. Market Capitalization

	Total	Market Capitalization		
		$1.5B or more	*$500M - $1.49B*	*Under $500M*
(Base)	(577) %	(224) %	(140) %	(211) %
Less than $100 million	15	-	-	41
$100 - $499.9 million	22	-	-	59
$500 - $999.9 million	17	-	69	-
$1 - $1.49 billion	8	-	31	-
$1.5 - $4.9 billion	16	41	-	-
$5 - $9.9 billion	9	23	-	-
$10 - $19.9 billion	6	16	-	-
$20 - $29.9 billion	2	6	-	-
$30 billion or more	5	14	-	-

Table 28. Stock Market Listings

	Total	Market Capitalization		
		$1.5B or more	*$500M - $1.49B*	*Under $500M*
(Base)	(577) %	(224) %	(140) %	(211) %
NYSE	48	74	52	18
NASDAQ	46	24	46	70
AMEX	4	1	-	10
Other	1	1	2	1
No reply	1	-	-	1

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IV. Summary Tables

Table 29. Title of Respondent

	Total	Market Capitalization		
		$1.5B or more	*$500M - $1.49B*	*Under $500M*
(Base)	(577)	(224)	(140)	(211)
	%	%	%	%
Director/Executive Director of IR	34	32	41	32
Vice President, IR	32	46	28	20
Manager of IR	18	13	19	23
CFO	7	1	5	14
IR Associate/Assistant/Specialist	5	5	4	6
Other	4	3	3	5

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IV. Summary Tables

Table 30. Industry

	Total	Market Capitalization: $1.5B or more	Market Capitalization: $500M - $1.49B	Market Capitalization: Under $500M
(Base)	(577) %*	(224) %*	(140) %*	(211) %*
Telecommunications – equipment, long distance, services, telephone companies, wireless, etc.	9	8	9	11
Technology – software	9	6	7	12
Technology – Internet	9	4	5	18
Technology – hardware, semiconductors, peripherals	8	7	11	6
Financial – diversified financial services	7	13	4	4
Drugs & research/drug distribution	7	5	9	9
Utilities & power – electric, gas, water, transmission, etc.	6	10	4	2
Medical devices and products	6	3	5	9
Banks	5	7	4	4
Fuel – coal, oil and gas, petroleum	5	7	4	4
Consumer products – apparel, appliances, household products, personal care, tobacco	5	6	5	4
Electronic products & electronics	5	6	4	4
Manufacturing – capital goods, machinery, etc.	5	4	4	6
Insurance	4	6	4	1
Retailing – discount, fashion, business, etc.	4	4	4	3
Real estate	4	1	9	3
Food/beverage – processing, retailing	3	4	1	2
Chemicals	3	3	4	3
Metals and mining – aluminum, steel, etc.	3	3	4	2
Service industries – advertising, consulting, engineering, environmental, printing, etc.	3	3	3	4
Health care services – HMOs, hospitals, etc.	3	2	3	5
Entertainment – hotel, gaming, media, publishing, restaurants	3	1	5	3

* Multiple responses.
Note: No other industry cited by more than 3%.

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V. Industry Tables

Table A. Summary of Key Disclosure Measures by Industry: Banks, Chemicals and Consumer Products

	Banks	Chemicals	Consumer Products
(Base: Total)	(31) %	(20) %	(29) %
Change in level of information provided since Reg FD passed			
Providing more information	23	20	21
Providing same amount of information	58	50	58
Providing less information	19	30	21
Change in level of one-on-ones conducted since Reg FD passed			
Conducting a greater number of one-on-ones than before	3	5	-
Conducting same number of one-on-ones as before	65	80	83
Cutting back on the number of one-on-ones conducted	16	15	10
Review draft earnings models			
Pre-Reg FD	71	75	86
Post-Reg FD	26	40	48
Review draft reports			
Pre-Reg FD	74	75	79
Post-Reg FD	48	70	62
Types of earnings information currently disclosed*			
Provide earnings guidance	68	60	90
Provide estimates of factors driving earnings	48	40	45
Provide a range of estimated EPS	32	50	72
Provide estimated EPS	13	5	10
Provide an earnings model	-	-	-
Number of days quiet period begins prior to earnings releases			
(Base: currently provide earnings guidance)	(13)	(8)	(21)
Average number of days	24	24	28
Median	25	30	30
Methods by which earnings guidance is currently provided*			
(Base: currently provide earnings guidance)	(21)	(13)	(26)
Quarterly conference calls and/or webcast open to all parties	86	62	100
Quarterly news releases	43	77	85
In SEC documents (8K, 10K or 10Q)	33	38	27
Quarterly conference calls not fully accessible to all parties and media	-	-	-
Company has a written disclosure policy			
(Base: Total)	(31)	(20)	(29)
Yes	42	70	76
No, but plan to establish one	36	20	21
No, not aware of any plans to establish one	19	10	3

* Multiple responses.

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V. Industry Tables

Table B. Summary of Key Disclosure Measures by Industry: Drugs, Electronics and Diversified Financial Services

	Drugs	*Electronics*	*Diversified Financials*
(Base: Total)	(41) %	(29) %	(42) %
Change in level of information provided since Reg FD passed			
Providing more information	24	10	31
Providing same amount of information	34	76	50
Providing less information	39	14	19
Change in level of one-on-ones conducted since Reg FD passed			
Conducting a greater number of one-on-ones than before	10	3	2
Conducting same number of one-on-ones as before	73	90	71
Cutting back on the number of one-on-ones conducted	10	-	14
Review draft earnings models			
Pre-Reg FD	85	79	83
Post-Reg FD	44	48	36
Review draft reports			
Pre-Reg FD	90	76	86
Post-Reg FD	54	59	55
Types of earnings information currently disclosed*			
Provide earnings guidance	68	90	74
Provide estimates of factors driving earnings	44	59	50
Provide a range of estimated EPS	22	41	50
Provide estimated EPS	20	10	10
Provide an earnings model	2	14	2
Number of days quiet period begins prior to earnings releases			
(Base: currently provide earnings guidance)	(25)	(18)	(23)
Average number of days	26	28	20
Median	21	30	20
Methods by which earnings guidance is currently provided*			
(Base: currently provide earnings guidance)	(28)	(26)	(32)
Quarterly conference calls and/or webcast open to all parties	82	85	88
Quarterly news releases	68	69	63
In SEC documents (8K, 10K or 10Q)	21	23	31
Quarterly conference calls not fully accessible to all parties and media	-	-	3
Company has a written disclosure policy			
(Base: Total)	(41)	(29)	(42)
Yes	56	72	59
No, but plan to establish one	37	14	24
No, not aware of any plans to establish one	5	14	12

* Multiple responses.

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V. Industry Tables

Table C. Summary of Key Disclosure Measures by Industry: Healthcare Services, Insurance and Manufacturing

	Healthcare Services	*Insurance*	*Manufacturing*
(Base: Total)	(19) %	(22) %	(29) %
Change in level of information provided since Reg FD passed			
Providing more information	32	36	35
Providing same amount of information	47	55	48
Providing less information	21	9	17
Change in level of one-on-ones conducted since Reg FD passed			
Conducting a greater number of one-on-ones than before	-	9	10
Conducting same number of one-on-ones as before	63	64	52
Cutting back on the number of one-on-ones conducted	21	18	17
Review draft earnings models			
Pre-Reg FD	74	91	76
Post-Reg FD	53	45	41
Review draft reports			
Pre-Reg FD	74	86	76
Post-Reg FD	58	73	48
Types of earnings information currently disclosed*			
Provide earnings guidance	79	77	76
Provide estimates of factors driving earnings	53	45	48
Provide a range of estimated EPS	42	64	59
Provide estimated EPS	16	-	7
Provide an earnings model	5	5	3
Number of days quiet period begins prior to earnings releases			
(Base: currently provide earnings guidance)	(14)	(14)	(17)
Average number of days	28	28	20
Median	29	28	21
Methods by which earnings guidance is currently provided*			
(Base: currently provide earnings guidance)	(15)	(17)	(22)
Quarterly conference calls and/or webcast open to all parties	93	88	86
Quarterly news releases	53	53	86
In SEC documents (8K, 10K or 10Q)	20	29	32
Quarterly conference calls not fully accessible to all parties and the media	-	-	-
Company has a written disclosure policy			
(Base: Total)	(19)	(22)	(29)
Yes	69	82	59
No, but plan to establish one	21	9	34
No, not aware of any plans to establish one	5	5	7

* Multiple responses.

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V. Industry Tables

Table D. Summary of Key Disclosure Measures by Industry: Retail, Medical Devices and Real Estate

	Retail	*Medical Devices*	*Real Estate*
(Base: Total)	(21) %	(34) %	(21) %
Change in level of information provided since Reg FD passed			
Providing more information	10	27	43
Providing same amount of information	71	47	28
Providing less information	19	26	24
Change in level of one-on-ones conducted since Reg FD passed			
Conducting a greater number of one-on-ones than before	-	-	5
Conducting same number of one-on-ones as before	62	68	71
Cutting back on the number of one-on-ones conducted	19	18	10
Review draft earnings models			
Pre-Reg FD	86	74	90
Post-Reg FD	43	47	38
Review draft reports			
Pre-Reg FD	90	62	86
Post-Reg FD	62	53	62
Types of earnings information currently disclosed*			
Provide earnings guidance	81	71	76
Provide estimates of factors driving earnings	57	35	52
Provide a range of estimated EPS	52	32	48
Provide estimated EPS	10	18	19
Provide an earnings model	10	9	-
Number of days quiet period begins prior to earnings releases			
(Base: currently provide earnings guidance)	(14)	(22)	(14)
Average number of days	20	28	26
Median	17	30	14
Methods by which earnings guidance is currently provided*			
(Base: currently provide earnings guidance)	(17)	(24)	(16)
Quarterly conference calls and/or webcast open to all parties	88	96	88
Quarterly news releases	76	71	56
In SEC documents (8K, 10K or 10Q)	35	38	25
Quarterly conference calls not fully accessible to all parties and media	-	-	6
Company has a written disclosure policy			
(Base: Total)	(21)	(34)	(21)
Yes	76	65	48
No, but plan to establish one	24	26	38
No, not aware of any plans to establish one	-	9	14

* Multiple responses.

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V. INDUSTRY TABLES

Table E. Summary of Key Disclosure Measures by Industry: Technology, Telecom and Utilities & Power

	Technology	*Telecom*	*Utilities & Power*
(Base: Total)	(121) %	(54) %	(33) %
Change in level of information provided since Reg FD passed			
Providing more information	31	18	33
Providing same amount of information	49	54	49
Providing less information	20	26	18
Change in level of one-on-ones conducted since Reg FD passed			
Conducting a greater number of one-on-ones than before	5	6	12
Conducting same number of one-on-ones as before	74	70	79
Cutting back on the number of one-on-ones conducted	9	15	9
Review draft earnings models			
Pre-Reg FD	76	85	82
Post-Reg FD	45	41	52
Review draft reports			
Pre-Reg FD	69	80	85
Post-Reg FD	52	59	61
Types of earnings information currently disclosed*			
Provide earnings guidance	83	85	88
Provide estimates of factors driving earnings	60	61	45
Provide a range of estimated EPS	44	37	61
Provide estimated EPS	10	20	21
Provide an earnings model	10	9	-
Number of days quiet period begins prior to earnings releases			
(Base: currently provide earnings guidance)	(90)	(44)	(26)
Average number of days	26	29	19
Median	30	30	15
Methods by which earnings guidance is currently provided*			
(Base: currently provide earnings guidance)	(100)	(46)	(29)
Quarterly conference calls and/or webcast open to all parties	94	91	76
Quarterly news releases	55	61	79
In SEC documents (8K, 10K or 10Q)	19	22	48
Quarterly conference calls not fully accessible to all parties and media	-	4	-
Company has a written disclosure policy			
(Base: Total)	(121)	(54)	(33)
Yes	70	67	52
No, but plan to establish one	20	24	33
No, not aware of any plans to establish one	9	9	15

* Multiple responses

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Corporate Disclosure Practices Survey

The following survey questions relate to your company's disclosure practices, particularly those related to the SEC Regulation Fair Disclosure. We ask that only a senior member of your firm's investor relations staff fill out this questionnaire and that only one version is completed per company.

To begin, please enter your company's ticker symbol

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Please select which of the following best approximates your actual title:

- ❑ CFO
- ❑ Vice President, IR
- ❑ Director/Executive Director of IR
- ❑ Manager of IR
- ❑ IR Associate/Assistant/Specialist
- ❑ Other

Section 1: Trends in Corporate Disclosure Practices

Q1 Since Regulation FD went into effect, has your company been providing more, the same amount or less information to analysts and investors?

- ❑ Providing more information
- ❑ Providing the same amount of information
- ❑ Providing less information

Q2 Prior to the adoption of Regulation FD, did you or someone in your company review analysts' draft earnings models?

- ❑ Yes **(Go on to Q3)**
- ❑ No **(Skip to Q5)**
- ❑ No sell-side coverage **(Skip to Q8)**

Q3 Are you still reviewing analysts' draft earnings models?

- ❑ Yes **(Go on to Q4)**
- ❑ No **(Skip to Q5)**

Q4 Are you: *(Select both if applicable)*

- ❑ Reviewing draft earnings models only for factual accuracy of historical information in the public domain
- ❑ Reviewing assumptions that you believe are non-material

Q5 Prior to the adoption of Regulation FD, did you or someone in your company review analysts' draft reports?

- ❑ Yes **(Go on to Q6)**
- ❑ No **(Skip to Q8)**

Q6 Are you still reviewing analysts' draft reports?

- ❑ Yes **(Go on to Q7)**
- ❑ No **(Skip to Q8)**

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Q7 Are you: *(Select both if applicable)*

- ❑ Reviewing draft reports only for factual accuracy of historical information in the public domain
- ❑ Reviewing assumptions that you believe are non-material

Q8 Prior to Regulation FD, did your company publicly disclose earnings projections?

- ❑ Yes **(Go on to Q9)**
- ❑ No **(Skip to Q10)**

Q9 Which of the following types of earnings information did you disclose prior to Regulation FD? *(Select all that apply)*

- ❑ Estimated earnings per share
- ❑ A range of estimated earnings per share
- ❑ An earnings model
- ❑ Estimates or forecasts of specific factors that drive your earnings, but not all factors that might be in your internal financial forecasts

Q10 Since Regulation FD was adopted, which of the following types of earnings information do you disclose? *(Select all that apply, or the last option only)*

- ❑ Estimated earnings per share
- ❑ A range of estimated earnings per share
- ❑ An earnings model
- ❑ Estimates or forecasts of specific factors that drive your earnings, but not all factors that might be in your internal financial forecasts
- ❑ OR, we do not provide earnings guidance

Q10b In which of the following ways are individual investors and the media usually notified of an upcoming webcast, telephone conference call or other webcast presentation? *(Select all that apply)*

- ❑ Press release
- ❑ Notice on company Web site
- ❑ E-mail (using push technology)

Q10c If you are planning to discuss new material information on your upcoming webcast, telephone conference call or other webcast presentation, do you indicate this in your notification to individual investors and the media?

- ❑ Yes
- ❑ No

(If you do not provide earnings guidance, Skip to Q15. Otherwise, proceed with Q11.)

Q11 In which of the following ways do you currently provide earnings guidance? *(Select all that apply)*

- ❑ In the quarterly news release
- ❑ In a quarterly conference call that is conducted by telephone and/or webcast and is open to all interested parties and the media
- ❑ In a quarterly conference call that is not fully accessible to interested investors and the media
- ❑ In an 8K
- ❑ In a 10Q or 10K

Q12 Do you make any public commitment to update earnings guidance should it change materially?

- ❑ Yes
- ❑ No

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Q13 If you provide earnings guidance early in the quarter, how do you respond to analysts' questions later in the quarter related to whether the guidance is still on track? *(Choose one)*

- ❑ We do not update guidance during the quarter **(Skip to Q14b)**
- ❑ If facts or circumstances cause the guidance to change, we issue a news release before responding to such questions **(Skip to Q14b)**
- ❑ We plan to routinely issue a mid-quarter review of guidance **(Go on to Q14a)**
- ❑ Uncertain **(Skip to Q14b)**

Q14a In which of the following ways do you plan to disseminate the mid-quarter review of guidance? *(Select all that apply)*

- ❑ News release
- ❑ Fully accessible, non-exclusionary conference call
- ❑ Furnishing any revised guidance in the appropriate section of an 8K

Q14b Does your company impose a quiet period prior to normal earnings announcements during which time you do not provide analysts with any earnings guidance?

- ❑ Yes **(Go on to Q14c)**
- ❑ No **(Skip to Q15)**

Q14c How many days prior to the earnings release does the quiet period begin? *(Please fill in the blank)*

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Section 2: Focus on Personal Meetings

Q15 Now that Regulation FD is in effect, how many "one-on-ones" is your company conducting with the investment community? *(Choose one)*

- ❑ We are conducting a greater number of one-on-ones than before **(Skip to Q17)**
- ❑ We are conducting the same number of one-on-ones as before **(Skip to Q17)**
- ❑ We are cutting back on the number of one-on-ones we conduct **(Go on to Q16a)**
- ❑ We have not been holding one-on-ones and do not plan to begin **(Skip to Q20)**
- ❑ Uncertain **(Skip to Q17)**

Q16a How are you cutting back with sell-side analysts? *(Choose one)*

- ❑ We are conducting fewer one-on-ones with sell-side analysts
- ❑ We are eliminating one-on-ones with sell-side analysts

Q16b How are you cutting back with the buy-side? *(Choose one)*

- ❑ We are conducting fewer one-on-ones with the buy-side
- ❑ We are eliminating one-on-ones with the buy-side

Q17 Do you cover earnings-related topics in your one-on-ones?

- ❑ Yes
- ❑ No

Q18 Do you or someone else from the IR department accompany top corporate officers when they conduct one-on-ones?

- ❑ Yes, always
- ❑ Yes, sometimes
- ❑ No

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Q19 As a senior IR officer, do you have someone else accompany you or listen in when you conduct one-on-one discussions with members of the investment community?

- ❑ Yes, always
- ❑ Yes, sometimes
- ❑ No

Section 3: Internal Company Policies

Q20 Does your company have a policy designed to prevent employee participation in Internet chat rooms or any unauthorized discussions with analysts and reporters?

- ❑ Yes
- ❑ No, but we plan to establish one
- ❑ No, not aware of any plans to establish one

Q21 Does your company have a written disclosure policy?

- ❑ Yes **(Skip to Q23)**
- ❑ No, but we plan to establish one **(Skip to Q23)**
- ❑ No, not aware of any plans to establish one **(Go on to Q22)**

Q22 Why doesn't your company have a written disclosure policy?

- ❑ Company counsel specifically recommends against a written disclosure policy
- ❑ Company has a disclosure policy but it is not in writing
- ❑ Other reasons for not having a written disclosure policy *(please specify)*

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Section 4: Regulation FD's Impact on Analyst Coverage/Institutional Ownership

Q23 Since Regulation FD was implemented on October 23, 2000, has sell-side coverage of your company:

- ❑ Increased **(Skip to Q25)**
- ❑ Stayed the same **(Skip to Q25)**
- ❑ Decreased **(Go on to Q24)**
- ❑ Uncertain **(Skip to Q25)**

Q24 Do you believe the decline was because of your company's changes to its disclosure policies due to Regulation FD?

- ❑ Yes
- ❑ No
- ❑ Uncertain

Q25 Approximately how many sell-side analysts currently cover your company? *(Please do not include a range. Record your best estimate. If there is no analyst coverage of your firm, write in "0".)*

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Q26 Since the adoption of Regulation FD, are fewer analysts (either buy- or sell-side) requesting a review of their earnings models?

- ❑ Yes
- ❑ No
- ❑ Uncertain

Q27 Since the adoption of Regulation FD, are fewer analysts (either buy- or sell-side) requesting a review of their draft reports?

- ❑ Yes
- ❑ No
- ❑ Uncertain

Q28 Has anyone on either the buy- or sell-side threatened to drop coverage or sell your stock because of a change in your disclosure policies due to Regulation FD?

- ❑ Yes
- ❑ No

Q29 To your knowledge, have any institutional investors actually sold your company's stock because of a change in your disclosure policies due to Regulation FD?

- ❑ Yes
- ❑ No
- ❑ Uncertain

Q30 To your knowledge, are your company's employees who are not covered by Regulation FD getting more calls from analysts or investors than they did before the rule was adopted?

- ❑ Yes
- ❑ No
- ❑ Uncertain

Section 5: Summation

Q31 If you could change one thing about Regulation FD, what would it be?

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Q32 Which of the following best reflects your company's current market capitalization?

- ❑ Less than $100 million
- ❑ $100 million - $499.9 million
- ❑ $500 million - $999.9 million
- ❑ $1 billion - $1.49 billion
- ❑ $1.5 billion - $4.9 billion
- ❑ $5 billion - $9.9 billion
- ❑ $10 billion - $19.9 billion
- ❑ $20 billion - $29.9 billion
- ❑ $30 billion or more

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Q33 Which of the following are the one or two most important industries in which your company operates?

- ❑ Aerospace/defense
- ❑ Automotive - cars, trucks, equipment, tires, parts
- ❑ Banks
- ❑ Building materials/construction
- ❑ Chemicals
- ❑ Conglomerates/multi-industry
- ❑ Consumer products - apparel, appliances, household products, personal care, tobacco
- ❑ Containers - glass, metal, paper, plastic
- ❑ Drugs & research/drug distribution
- ❑ Electrical instruments
- ❑ Electronic products & electronics
- ❑ Entertainment - hotel, gaming, media, publishing, restaurants
- ❑ Financial - diversified financial services
- ❑ Food/beverage - processing, retailing
- ❑ Fuel - coal, oil and gas, petroleum
- ❑ Health care services - HMOs, hospitals, etc.
- ❑ Insurance
- ❑ Manufacturing - capital goods, machinery, etc.
- ❑ Retailing - discount, fashion, business, etc
- ❑ Medical devices and products
- ❑ Metals and mining - aluminum, steel, other metals
- ❑ Paper and forest products
- ❑ Publishing & broadcasting
- ❑ Real estate
- ❑ Savings & loans
- ❑ Service industries - advertising, consulting, engineering, environmental, printing, etc.
- ❑ Technology - hardware, semiconductors, peripherals
- ❑ Technology – Internet
- ❑ Technology – software
- ❑ Telecommunications - equipment, long distance, services, telephone companies, wireless, etc.
- ❑ Transportation - airlines, railroads, trucking, etc.
- ❑ Utilities & power - electric, gas, water, transmission, etc.

Q34 On which market does your company's stock trade?

- ❑ NYSE
- ❑ NASDAQ
- ❑ AMEX
- ❑ Other

Thank you very much for your time and cooperation

Please fax this questionnaire to (203) 226-5644 or mail it to Rivel Research Group, 830 Post Road East, Westport, CT 06880

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From the Chair

by
Stanley Keller
skeller@palmerdodge.com

There are two important initiatives of the Committee that I want to discuss – one involving Regulation FD and the other reform of the regulation of the securities offering process. We have task forces at work on both subjects. With a new Chairman of the SEC being nominated, this is a good time to focus on these subjects because both should be on the new Chairman's agenda.

Regulation FD

Regulation FD, which became effective in October 2000, is designed to address what the Commission saw as improper selective disclosure by public companies to market professionals and the need to place all investors on a more level playing field in terms of access to material information. As a result, public companies are required to publicly disseminate material non-public information if they are to provide it to market professionals. Regulation FD has had a pervasive impact on company public information practices, but not without controversy. Views range from those of investor groups and the media who see Regulation FD as the most important development for the protection of the rights of investors since adoption of the federal securities laws to those of market professionals who attribute the recent sharp decline in the securities market to adoption of Regulation FD. The truth is obviously somewhere in between.

My view is that Regulation FD has produced some significant benefits by accelerating the trend toward broader dissemination of information and increased disclosure of forward-looking information. However, it has come at the cost of a reduction in the quality of the information that is available to the market generally because, although more people are getting the information companies want to provide, investors, particularly market professionals, are not getting the answers to their questions. In addition, because of its broad reach, the regulation interferes with legitimate ordinary course business activities that are not designed to provide a market advantage. The consequence has been higher compliance costs.

This does not mean that Regulation FD is a failure and should be repealed. I think it is unrealistic to think that we can go back to a pre-Regulation FD world. On the other hand, the problems under Regulation FD can and should be addressed through interpretation of the regulation and, if necessary, rule change. This can be accomplished without undermining the regulation's basic purpose of preventing improper selective disclosure and affording investors broader access to information. What is needed is a recalibration of the regulation's application. If we think of the policy objectives of the regulation as ranging from preventing improper selective disclosure on one end to assuring equal access to all material information to each investor on the other, the Commission has set the pendulum on the scale far (though admittedly not completely) in the direction of the latter. I believe the pendulum needs to be brought back more to the scale's center to what I would characterize as achieving broad dissemination of clearly significant information.

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Here are a few specific suggestions:

- There should be an exclusion for ordinary course business communications that are not designed to convey a market advantage.

- The bar needs to be raised on the type of information that triggers the public dissemination requirement in order to eliminate the impediment to legitimate dialogue that produces the type of information flow and analysis that benefits the entire market. This might be accomplished by the SEC's revisiting its interpretive approach to materiality in the FD context or it may be necessary to recognize that materiality is too imprecise and overreaching a concept for use in a regulation with the broad application of FD (just as it is for required Form 8-K filings and continuous municipal securities disclosure under Rule 15c2-12). If a new approach is needed, it could be based on a concept such as information likely to have a significant impact on the market price for the company's securities (thereby leaving room for the mosaic to operate).

- The realities of spontaneous responses by executives in the heat of battle should be recognized by defining intentional disclosure to mean premeditated. That, after all, was the basis for the examples that triggered the cry for the regulation.

- The Commission should embrace web posting as an effective method of providing broad public dissemination. Its reluctance to do so because not enough investors have access to the Internet illustrates the distinction between a policy that is driven by equal access and one based on broad dissemination, each of which serves as an antidote for selective disclosure (although at a different point on the scale).

- The differences in communication practices globally should be recognized by excluding bona fide communications made offshore in compliance with local standards.

This recalibration might allow some situations in which market professionals gain an informational advantage to occur. However, I believe it would be an appropriate price to pay to achieve the right regulatory balance that proscribes improper selective disclosure, permits the freer information flow that benefits the market as a whole, encourages continued broad dissemination of information, particularly of a forward-looking nature, and reduces the intrusiveness and cost of Regulation FD.

Regulation of the Securities Offering Process

The present system for regulating the securities offering process was designed in the 1930s for a world premised on paper delivery of documents to individual investors. It has remained relatively the same since except for changes in the offering process in 1954 and the development of the shelf registration system based on integrated disclosure in the early 1970s and expanded in the early 1980s. The nature of communications and the securities markets have changed dramatically since then, and it is time that the regulatory system kept pace. The extensive regulation of communications in an electronic world with virtually instantaneous dissemination of information without regard to national borders is both unrealistic and

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unnecessary. Additionally, the imposition of regulatory speed bumps in markets with today's volatility and velocity is both costly and often not needed.

The Commission began to recognize the need for regulatory reform of the securities offering process in the 1990's through the work of the Wallman Advisory Commission, followed by issuance of the so-called Aircraft Carrier proposal. However, this proposal failed to recognize market realities and was, on balance, regulatorily regressive. As a consequence, it met opposition and was not pursued. Nevertheless, the Commission was correct in seeing the need for regulatory reform, and some aspects of the proposal were on the right track. The regulatory reform effort needs to be completed, and it needs to be completed in a way that recognizes current market and regulatory realities.

Our Task Force on the Future of Securities Regulation has put forth the outline of a reform proposal with the following fundamental elements:

- The securities registration process for public offerings should be modernized.
    - For seasoned issuers, this would mean a streamlined universal shelf registration system covering an unlimited amount of securities of any kind without distinction for primary and secondary offerings. The registration statement would become effective automatically after a brief waiting period and fees would be on a pay-as-you-go basis at the time of takedown.
    - Communications (whether oral or written) would be freely permitted, with liability for "offering material" under § 12(a)(2) for the preparer b and user of the material, except that for first-time registrants communications amounting to "offers" would be restricted during the 30 day period before filing. Ordinary course research for public companies would be permitted subject to liability under Rule 10b-5.
    - Except for first-time registrants, confirmations could be sent without prospectus delivery. Instead, access to filed information would substitute for physical delivery.
- The efficiency of the market for private offerings and other transactions not requiring registration should be enhanced.
    - Eliminate restrictions on "offers," "general solicitation" and "directed selling efforts." Eligibility for an exemption would turn on the status of purchasers, not the number or status of offerees or the method of reaching eligible purchasers.
    - Define a class of "exempt purchasers" to which securities may be sold, and among which they may be resold for a period, without registration before becoming freely resaleable.
    - Retain Regulation D, without limitation on "general solicitation" or limitation to use by issuers.

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We welcome your reactions to this proposal.

These are two important issues for the next Commission. Our Committee has an important role to play in assisting the Commission deal with them. We will be discussing these issues at our Committee's meetings at the ABA Annual Meeting in Chicago on Monday, August 6 and Tuesday, August 7 at the Chicago Marriott. The current schedule of our Committee's activities is included at the end of this newsletter. I look forward to seeing many of you there.

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From the Chair

by
Stanley Keller
skeller@palmerdodge.com

There are two important initiatives of the Committee that I want to discuss – one involving Regulation FD and the other reform of the regulation of the securities offering process. We have task forces at work on both subjects. With a new Chairman of the SEC being nominated, this is a good time to focus on these subjects because both should be on the new Chairman's agenda.

Regulation FD

Regulation FD, which became effective in October 2000, is designed to address what the Commission saw as improper selective disclosure by public companies to market professionals and the need to place all investors on a more level playing field in terms of access to material information. As a result, public companies are required to publicly disseminate material non-public information if they are to provide it to market professionals. Regulation FD has had a pervasive impact on company public information practices, but not without controversy. Views range from those of investor groups and the media who see Regulation FD as the most important development for the protection of the rights of investors since adoption of the federal securities laws to those of market professionals who attribute the recent sharp decline in the securities market to adoption of Regulation FD. The truth is obviously somewhere in between.

My view is that Regulation FD has produced some significant benefits by accelerating the trend toward broader dissemination of information and increased disclosure of forward-looking information. However, it has come at the cost of a reduction in the quality of the information that is available to the market generally because, although more people are getting the information companies want to provide, investors, particularly market professionals, are not getting the answers to their questions. In addition, because of its broad reach, the regulation interferes with legitimate ordinary course business activities that are not designed to provide a market advantage. The consequence has been higher compliance costs.

This does not mean that Regulation FD is a failure and should be repealed. I think it is unrealistic to think that we can go back to a pre-Regulation FD world. On the other hand, the problems under Regulation FD can and should be addressed through interpretation of the regulation and, if necessary, rule change. This can be accomplished without undermining the regulation's basic purpose of preventing improper selective disclosure and affording investors broader access to information. What is needed is a recalibration of the regulation's application. If we think of the policy objectives of the regulation as ranging from preventing improper selective disclosure on one end to assuring equal access to all material information to each investor on the other, the Commission has set the pendulum on the scale far (though admittedly not completely) in the direction of the latter. I believe the pendulum needs to be brought back more to the scale's center to what I would characterize as achieving broad dissemination of clearly significant information.

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Here are a few specific suggestions:

- There should be an exclusion for ordinary course business communications that are not designed to convey a market advantage.

- The bar needs to be raised on the type of information that triggers the public dissemination requirement in order to eliminate the impediment to legitimate dialogue that produces the type of information flow and analysis that benefits the entire market. This might be accomplished by the SEC's revisiting its interpretive approach to materiality in the FD context or it may be necessary to recognize that materiality is too imprecise and overreaching a concept for use in a regulation with the broad application of FD (just as it is for required Form 8-K filings and continuous municipal securities disclosure under Rule 15c2-12). If a new approach is needed, it could be based on a concept such as information likely to have a significant impact on the market price for the company's securities (thereby leaving room for the mosaic to operate).

- The realities of spontaneous responses by executives in the heat of battle should be recognized by defining intentional disclosure to mean premeditated. That, after all, was the basis for the examples that triggered the cry for the regulation.

- The Commission should embrace web posting as an effective method of providing broad public dissemination. Its reluctance to do so because not enough investors have access to the Internet illustrates the distinction between a policy that is driven by equal access and one based on broad dissemination, each of which serves as an antidote for selective disclosure (although at a different point on the scale).

- The differences in communication practices globally should be recognized by excluding bona fide communications made offshore in compliance with local standards.

This recalibration might allow some situations in which market professionals gain an informational advantage to occur. However, I believe it would be an appropriate price to pay to achieve the right regulatory balance that proscribes improper selective disclosure, permits the freer information flow that benefits the market as a whole, encourages continued broad dissemination of information, particularly of a forward-looking nature, and reduces the intrusiveness and cost of Regulation FD.

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Speech by SEC Acting Chairman:
This Year's Proxy Season: Sunlight Shines on Auditor Independence and Executive Compensation

Remarks by

Acting Chairman Laura S. Unger

U.S. Securities & Exchange Commission

Center for Professional Education, Inc.
Washington, D.C.

June 25, 2001

Good morning. For those in the crowd who are securities lawyers, you've no doubt heard the phrase "sunlight is the best disinfectant." In other words, full disclosure makes our securities markets fairer and more efficient. I'd like to use my time this morning to prove that this old adage continues to ring true today - not just as it relates to the purchase or sale of securities, but to corporate governance matters as well. If there was ever any doubt that sunlight is the best disinfectant, the results from this year's recently-ended proxy season prove it. Our eyes were opened wide in two particular areas: auditor independence and executive compensation.

For the first time, as a result of our new auditor independence rules, public companies were required to disclose in their proxy statements their expenditures for both audit and non-audit consulting services. The numbers disclosed leave no doubt that the Commission's concern about the potential for auditors' conflicts of interest to affect the integrity of financial statements was justified. In fact, the numbers appear to demonstrate that the problem may be larger than we originally thought, but I'll get to that in a minute.

Some disclosures about executive compensation were also startling. Along with many investors, we were taken aback at some of the compensation packages awarded to executives. Executive compensation disclosure is not new. What is new is looking at this information against the backdrop of current economic conditions. It's no secret that the pay of top executives has skyrocketed in the last decade. But you have to scratch your head at seeing these salaries continue to go sky-high during the recent leaner times in the market, when companies don't appear to be doing as well and shareholders are suffering losses. Obviously it's not the Commission's role to judge these packages. Rather, it is our role to ensure that the packages are put on full display for shareholders. A related area benefiting from more sunlight that I'll touch upon is options repricing - what companies are doing about "underwater" stock options.

Let's Start with the Auditor Independence Rules.

As you are all well aware, the Commission adopted new auditor independence rules last year after months of heated debate. The rules were designed to limit the scope of consulting services offered by audit firms to SEC audit clients, and to direct sunlight on

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the types and magnitude of other services being provided by audit firms to SEC audit clients.

At the time of the rulemaking and during the public hearings, the Commission was very interested in learning the extent to which accounting firms were providing non-audit services to SEC audit clients, but no one offered any concrete data. Many in the accounting industry argued that the Commission should not go forward with the rulemaking because of a lack of evidence demonstrating that providing non-audit services to an audit client could impair the integrity of the financial statements.

The Commission had good reason, however, for forging ahead. As early as 1988, large public accounting firms were looking to enter into joint ventures, limited partnership agreements, and other similar arrangements with audit clients. According to the Commission's estimates, consulting was contributing to half of the Big Five's revenue - and was growing three times as fast as their basic auditing business. Public companies such as Waste Management, Cendant, Sunbeam and Microstrategy were announcing accounting irregularities all too often, and raising concerns at the Commission about the integrity of financial statements.

The Commission was also seeing many companies restate their financial statements: 104 in 1997, 116 in 1998, and 142 in 1999. The growing trend in the number of restatements did not abate in 2000. According to a recent study, there were 156 restatements last year. The study further reports that the restatements resulted in total market losses of $31.2 billion in 2000, $24.2 billion in 1999 and $17.7 billion in 1998.

The final auditor independence rules meet to a large degree the Commission's original goals. We could have engaged in substantive regulation and banned non-audit services. We didn't. Rather, we put faith in the fact again that sunlight would serve as the best disinfectant and adopted a disclosure-based approach. The new rules charge public companies with disclosing in their annual proxy statements the fees for audit, IT consulting and all other services provided by their auditors during the last fiscal year. In addition, they require the audit committee to state that it has considered whether providing non-audit services is compatible with maintaining the auditor's independence.

The Commission's Office of Chief Accountant recently released data based on the latest proxy filings from more than half of the Fortune 1000 companies regarding fees paid for audit and non-audit services. The data is illuminating.

It shows that, on average, for every dollar of audit fee audit clients paid to their independent accountants, they paid $2.69 for non-audit services. On average, non-audit fees comprised 73% of total fees companies paid to their accounting firms. The ten companies that paid the most in IT fees paid their independent accountants between $3.57 and $32.33 for non-audit services for each dollar of the audit fee paid.

What is the significance of this information? Although the numbers we're seeing as a result of the new disclosure obviously don't prove that the audits for these companies have been impaired, I think we were all quite surprised by the disparity between the auditing and consulting fees.

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Disclosure in this context serves a number of purposes. First, and most apparent, investors will now receive information on the amount of non-audit services provided by their companies' auditors. This will enable investors to decide for themselves whether the auditor of the company they've invested in - who, after all, is supposed to be their watchdog - is really in a situation to bark should the company attempt to steal some biscuits. I think that if we've learned anything from this first proxy season under the new rules, it is that these disclosures will receive plenty of attention.

Second, disclosure requirements have the capacity to shape the behavior of the company required to make the disclosure. Companies may perceive disclosing the ratio of fees for non-audit to audit services will decrease investor confidence in the validity of their financial statements. In that case, we can expect companies to take steps to improve that ratio - if doing so costs less than finding another service provider to perform those non-audit services. Disclosure will create market discipline regarding the size of the fees for non-audit services in a flexible and efficient way.

Third, the disclosures required by the final rules promote effective corporate governance. As I mentioned before, under the Commission's final rules, audit committees must state that they have considered whether the provision of non-audit services is compatible with maintaining the auditor's independence.

The financial reporting process is often analogized to a three-legged stool - with the public company's management, outside auditors and audit committee comprising the three legs. In the last few years, a number of steps have been taken to make sure that audit committees are holding up their end of the stool; including the recommendations of Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, new SRO audit committees rules, new Commission rules, Standard No.1 of the Independence Standards Board, and the recommendations of the O'Malley Panel. The audit committee disclosure required by the Commission's final rules complements these other initiatives. It encourages audit committees to focus particular attention on the effect of non-audit services on the auditor's independence.

Fourth, and finally, the new disclosures lay the groundwork for future study of the effect of non-audit services on auditor independence. Even casual observers of the Commission's recent rulemaking probably know that certain accounting firms argued that there was no empirical evidence to show that providing non-audit services affect audit quality. What accounting firms didn't talk about was that such "evidence" would be hard to come by. Among other things, accounting firms and their audit clients did not have to disclose the audit and non-audit fees charged to individual clients. Indeed, some of the most useful recent studies of the relationship of non-audit services to audit failures are based on U.K. companies, where disclosures similar to those in the Commission's final rules have been required for the last several years. I hope that the Commission's new disclosure rules will enable improved study and better empirical information on the effect of various non-audit services in the future.

One last word on auditor independence. During our rulemaking, many argued the problem was only in our minds, as we couldn't cite examples of audit failures where the auditors had also provided significant consulting or other non-audit services. We put this notion to rest last week when we sued Arthur Andersen for having issued false and

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misleading audit reports in the Waste Management debacle. Although the Commission did not charge Andersen with a violation of the auditor independence rules, the Commission's order did summarize some of the factors that may have played into Andersen's failure to make the hard decisions, including:

1. Andersen regarded Waste Management as a "crown jewel" client;
2. Until 1997, every CFO and CAO had previously worked for Andersen; and
3. Between 1991-97, Andersen billed Waste Management approximately $7.5 million in audit fees and $11.8 million in non-audit fees.

In my mind, this is the sort of information that should be disclosed to investors. The case should silence many of the critics of our new rules.

Executive Compensation

This past proxy season has also shed quite a bit of sunlight on executive compensation. As a result of Commission initiatives over the last decade, we have seen improved disclosure of executive compensation. Few investors seemed to take issue with executive compensation during the bull market. So long as shareholders profited from the rising value of their stock, it seemed acceptable that corporate executives be rewarded - in many cases, amply so - for their companies' performance.

But times have changed. This past year has generally brought about leaner times in the market. Yet while stocks have gone down in value, many officers' salaries continue to trend upwards. Now seems the time to realize the true value of our disclosure rules. How will shareholders react to lavish executive salaries when their share value no longer appreciates?

The current edition of Fortune magazine adds grist to the mill. The cover story contains the glaring headline: "Inside the Great CEO Pay Heist." According to the article, the number one earners in each of the past five years received compensation packages valued cumulatively at nearly $1.4 billion. Despite paying their executives a staggering average of $274 million a year, four of the five companies have under-performed. Last year, the CEO with the largest pay package received $381 million, if you include the $90 million Gulfstream jet. Now that is pay that I'd like SEC staffers to have parity with!

If you are offended by this data, then all I can say is that our execution compensation disclosure rules have succeeded. Such is the beauty of disclosure. The Commission need not make a judgment about the appropriate level of compensation for any given CEO - the marketplace will make that judgment. But it is our place to ensure that the marketplace has the relevant data to make a well-informed judgment. If I were a shareholder of a company that was lagging, I would want to know that my CEO was being paid $381 million. And thanks to SEC rules, as a shareholder of that company, I have a right to know.

On a related but separate note, I worry that some directors do not always fully discharge their duties. In the same issue of Fortune, several directors who sit on executive compensation committees anonymously admitted that the executive compensation committees were essentially "in the pocket of the CEOs." The article tells the story of an

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executive who ran his division into the ground. He was, according to the article, "the architect of some terrible deals" and "never seemed to have a handle on what was going on." He nonetheless received a large bonus. The chairman of the compensation committee admitted "this stuff is wrong" but said "we've got to do it." As elaborated on in the article, the committee believed it had to go along with management or else risk losing favor. Another compensation committee member tells the story that he wouldn't give the CEO the pay that the CEO wanted. Later, all the people on the board were rotated to new committees.

These admissions trouble me. Directors have an obligation to the company and its shareholders, not the CEO. Kow-towing to management and blindly signing off on large compensation packages is not a proper discharge of a director's duties. An individual too scared or shy to ask the tough questions and take tough - but justified - action, should not serve on the compensation committee and perhaps the board itself.

I remain curious to see how investors react to this year's proxy disclosures about executive compensation.

Option Repricings

The market decline has forced many companies, primarily high tech companies, to address the problem of "underwater" stock options. As a result, we have seen many companies reprice their employees' stock options. Some of the repricings we've all read about in the press have been done unilaterally. However, many issuers have structured the repricings as option "exchanges," that may come within the issuer tender offer rules under the Securities Exchange Act of 1934. These covered exchange offers generally involve options issued under "broad-based" plans that are open to rank-and-file employees as well as executive or senior officers of the issuer.

Unlike the situation where an issuer reprices its options unilaterally, option holders in an exchange offer have to make difficult and individual decisions. For example, the exchange offer may invite options holders to relinquish a fully or partially vested option in exchange for a new option to be granted, and priced, in six months time. Clearly this decision is an investment decision, not just a compensation decision, and the option holder is entitled to full and satisfactory disclosure.

Issuers conducting broad-based exchanges as tender offers have run into problems with some tender offer requirements. Their need to treat option holders differently in order to accomplish their compensation objectives makes it difficult for them to comply with the "all holders" and "best price" conditions under the issuer tender rules. To alleviate this situation, the Commission's Division of Corporation Finance issued an order this spring that exempts issuers from compliance with these two requirements under certain circumstances.

The treatment of broad-based option exchanges as tender offers has brought sunlight to the repricings, improving both the extent and the timing of public disclosure about these transactions.

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Conclusion

While the long-term impact of recent rules and guidance calling for increased disclosure cannot be predicted, the Commission's goal is to help establish the foundation for a reliable accounting and financial reporting system. The new information coming to light empowers audit committees and investors by providing them with additional tools with which to engage in active and vigilant corporate governance - activity that is essential to promoting the quality and integrity of financial reporting. Ultimately, greater sunlight on corporate actions and decisions will brighten all of corporate America.

http://www.sec.gov/news/speech/spch502.htm

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U.S. Securities and Exchange Commission

Exemptive Order
Securities Exchange Act of 1934

For issuer exchange offers that are conducted for compensatory purposes

The Division of Corporation Finance is aware of issuers conducting exchange offers for employee stock options. These exchange offers are conducted to reprice the employees' options for compensatory purposes. The structure of these exchange offers is based upon the compensation policies and practices of the issuers. The new options or other securities offered in exchange for existing options could be registered under the Securities Act of 1933 (Securities Act), but generally are offered in reliance on an exemption from registration, typically Section 3(a)(9) of the Securities Act. These exchange offers as commonly structured are subject to the issuer tender offer rule, Rule 13e-4 under the Securities Exchange Act of 1934 (Exchange Act), if the issuer has a class of equity securities registered under Section 12 or is required to file reports under Section 15(d) of the Exchange Act.

Issuers conducting these exchange offers often want the ability to treat option holders differently in order to accomplish their compensation objectives. This raises compliance issues under Rules 13e-4(f)(8)(i) and (ii) (the all holders and best price rules). In response to requests to accommodate the compensation policies and practices of issuers conducting these exchange offers, the Commission has already granted a number of exemptions from Rules 13e-4(f)(8)(i) and (ii) on a case-by-case basis. See Lante Corporation (Feb. 9, 2001); Amazon.com, Inc. (Feb. 28, 2001); Digimarc Corporation (Mar. 16, 2001); and LookSmart Ltd. (Mar. 20, 2001). In order to reduce the burdens and costs to issuers that otherwise must seek individual exemptions, the Commission hereby grants an exemption from Rules 13e-4(f)(8)(i) and (ii) for exchange offers for employee stock options that meet the following conditions:

1. the issuer is eligible to use Form S-8, the options subject to the exchange offer were issued under an employee benefit plan as defined in Rule 405 under the Securities Act, and the securities offered in the exchange offer will be issued under such an employee benefit plan;

2. the exchange offer is conducted for compensatory purposes;

3. the issuer discloses in the offer to purchase the essential features and significance of the exchange offer, including risks that option holders should consider in deciding whether to accept the offer; and

4. except as exempted in this order, the issuer complies with Rule 13e-4.

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This exemption eliminates the limitations that the all holders and best price rules place on issuers' ability to structure exchange offers in a manner consistent with their compensation policies and practices. The Division believes that these exchange offers do not present the same concerns caused by discriminatory treatment among security holders that Rules 13e-4(f)(8)(i) and (ii) were intended to address.

The foregoing exemption from Rule 13e-4(f)(8) is strictly limited to the circumstances described above. Issuers conducting these offers should consider the anti-fraud and anti-manipulation provisions of the federal securities laws, including Sections 10(b) and 14(e) of the Exchange Act and the rules thereunder. Responsibility for compliance with all applicable provisions of the federal securities laws rests with the issuers engaged in these transactions. The Division expresses no view with respect to any other questions that may arise in these transactions, including, but not limited to, the adequacy of disclosure in, and the applicability of any other federal or state laws to, these transactions.

For the Commission,
by the Division of Corporation Finance,
pursuant to delegated authority,

Mauri L. Osheroff
Associate Director
Division of Corporation Finance

http://www.sec.gov/divisions/corpfin/repricingorder.htm

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Update to the Current Issues and Rulemaking Projects Outline

The following is an update to the Division of Corporation Finance's Current Issues and Rulemaking Projects Outline dated November 14, 2000. When the Outline as a whole is revised, this update will be incorporated into it.

Option Exchange Offers

Introduction

On March 21, 2001, the Division of Corporation Finance, pursuant to delegated authority from the Commission, issued an exemptive order under the Securities Exchange Act of 1934 (Exchange Act) for issuer exchange offers that are conducted for compensatory purposes. The order exempts these exchange offers from Rules 13e-4(f)(8)(i) and (ii), the all holders and best price rules, so long as specified conditions are met.

- Exemptive Order

Background

The Division of Corporation Finance has become aware of issuers conducting exchange offers to reprice their employees' stock options. The structure of these exchange offers varies from issuer to issuer and is based upon their compensation policies and practices. Frequently these exchange offers will require option holders to agree to revised vesting or exercisability terms or to accept a reduced number of securities in exchange for receiving a lower exercise price. The new options or other securities offered in exchange for existing options may be registered under the Securities Act of 1933 (Securities Act), but generally are offered in reliance on an exemption from registration, typically Section 3(a)(9) of the Securities Act.

These offers commonly involve securities issued through broad-based plans, are open to a large number of employees, are not limited to executive or senior officers of the issuers, are not privately negotiated compensation arrangements, have fixed terms, and are open for a limited period of time. Unlike the situation where an issuer unilaterally reprices its options, the option holders have individual decisions to make. Further, the decision whether to accept the offer is an investment decision and not merely a compensation decision. These exchange offers are subject to the issuer tender offer rule, Rule 13e-4 under the Exchange Act, if the issuer has a class of equity securities registered under Section 12 or is required to file reports under Section 15(d) of the Exchange Act.

The exemptive order eliminates the limitations that the all holders and best price

rules place on issuers' ability to structure exchange offers consistent with their compensation policies and practices. This will reduce the burdens and costs to issuers that otherwise must seek individual exemptions from the Division. We believe that these exchange offers do not present the same concerns caused by discriminatory treatment among security holders that these rules were intended to address.

Disclosure and Processing

Issuers that are subject to Rule 13e-4 are reminded that the remaining provisions of Rule 13e-4, as well as Regulation 14E, apply to these exchange offers. A Schedule TO-I must be filed at the time the exchange offer commences, and the disclosure required by the schedule must be disseminated to option holders in accordance with Rule 13e-4. The disclosure items of the Schedule TO-I must be complied with in the offer to purchase only to the extent applicable. The items do not require a response in the offer to purchase if they are not applicable to the offer. The disclosure should set forth clearly the essential features and significance of the exchange offer, including risks that option holders should consider in deciding whether to accept the offer. The disclosure also should include financial information about the issuer, which generally is material to the option holders' investment decisions. See Item 10 of Schedule TO. The financial information in the disclosure may be in summary form if the issuer incorporates its financial statements by reference into the schedule and offer to purchase. See Instruction 6 to Item 10 of Schedule TO.

We understand that issuers contemplating option exchange offers are concerned that staff review may cause issuers to incur additional costs to disseminate revised materials in response to staff comments and also may cause offers to be extended. The Division always balances the necessity of staff review with the best use of staff resources. These types of exchange offers are conducted for compensatory purposes and are less likely to raise the concerns that often are present in non-compensatory tender offers. In this regard, the Division staff's decision to review these exchange offers will take into account the presence of the disclosure discussed above. Issuers should note that they are responsible for full compliance with Rule 13e-4 whether or not the staff reviews the filings. Issuers also are reminded of their disclosure obligations under Item 402 of Regulations S-K and S-B and under generally accepted accounting principles.

Issuers or their counsel should contact the Office of Mergers & Acquisitions at (202) 942-2920 if they have questions about the exemptive order or compensatory option exchange offers generally.

Additional Information:

http://www.sec.gov/divisions/corpfin/repricings.htm

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Division of Corporation Finance: Staff Legal Bulletin No. 14

Shareholder Proposals

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Summary: This staff legal bulletin provides information for companies and shareholders on rule 14a-8 of the Securities Exchange Act of 1934.

Supplementary Information: The statements in this legal bulletin represent the views of the Division of Corporation Finance. This bulletin is not a rule, regulation or statement of the Securities and Exchange Commission. Further, the Commission has neither approved nor disapproved its content.

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Note: *This bulletin is also available in MS Word format for ease in printing.*

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A. What is the purpose of this bulletin?

The Division of Corporation Finance processes hundreds of rule 14a-8 no-action requests each year. We believe that companies and shareholders may benefit from information that we can provide based on our experience in processing these requests. Therefore, we prepared this bulletin in order to

- explain the rule 14a-8 no-action process, as well as our role in this process;
- provide guidance to companies and shareholders by expressing our views on some issues and questions that commonly arise under rule 14a-8; and
- suggest ways in which both companies and shareholders can facilitate our review of no-action requests.

Because the substance of each proposal and no-action request differs, this bulletin primarily addresses procedural matters that are common to companies and shareholders. However, we also discuss some substantive matters that are of interest to companies and shareholders alike.

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We structured this bulletin in a question and answer format so that it is easier to understand and we can more easily respond to inquiries regarding its contents. The references to "we," "our" and "us" are to the Division of Corporation Finance. You can find a copy of rule 14a-8 in Release No. 34-40018, dated May 21, 1998, which is located on the Commission's website at www.sec.gov/rules/final/34-40018.htm.

B. Rule 14a-8 and the no-action process

1. What is rule 14a-8?

Rule 14a-8 provides an opportunity for a shareholder owning a relatively small amount of a company's securities to have his or her proposal placed alongside management's proposals in that company's proxy materials for presentation to a vote at an annual or special meeting of shareholders. It has become increasingly popular because it provides an avenue for communication between shareholders and companies, as well as among shareholders themselves. The rule generally requires the company to include the proposal unless the shareholder has not complied with the rule's procedural requirements or the proposal falls within one of the 13 substantive bases for exclusion described in the table below.

Substantive Basis	Description
Rule 14a-8(i)(1)	The proposal is not a proper subject for action by shareholders under the laws of the jurisdiction of the company's organization.
Rule 14a-8(i)(2)	The proposal would, if implemented, cause the company to violate any state, federal or foreign law to which it is subject.
Rule 14a-8(i)(3)	The proposal or supporting statement is contrary to any of the Commission's proxy rules, including rule 14a-9, which prohibits materially false or misleading statements in proxy soliciting materials.
Rule 14a-8(i)(4)	The proposal relates to the redress of a personal claim or grievance against the company or any other person, or is designed to result in a benefit to the shareholder, or to further a personal interest, which is not shared by the other shareholders at large.
Rule 14a-8(i)(5)	The proposal relates to operations that account for less than 5% of the company's total assets at the end of its most recent fiscal year, and for less than 5% of its net earnings and gross sales for its most recent fiscal year, and is not otherwise significantly related to the company's business.
Rule 14a-8(i)(6)	The company would lack the power or authority to implement the proposal.
Rule 14a-8(i)(7)	The proposal deals with a matter relating to the company's ordinary business operations.
Rule 14a-8(i)(8)	The proposal relates to an election for membership on the company's board of directors or analogous governing body.
Rule 14a-8(i)(9)	The proposal directly conflicts with one of the company's own proposals to be submitted to shareholders at the same meeting.

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Rule 14a-8(i)(10)	The company has already substantially implemented the proposal.
Rule 14a-8(i)(11)	The proposal substantially duplicates another proposal previously submitted to the company by another shareholder that will be included in the company's proxy materials for the same meeting.
Rule 14a-8(i)(12)	The proposal deals with substantially the same subject matter as another proposal or proposals that previously has or have been included in the company's proxy materials within a specified time frame and did not receive a specified percentage of the vote. Please refer to questions and answers F.2, F.3 and F.4 for more complete descriptions of this basis.
Rule 14a-8(i)(13)	The proposal relates to specific amounts of cash or stock dividends.

2. How does rule 14a-8 operate?

The rule operates as follows:

- the shareholder must provide a copy of his or her proposal to the company by the deadline imposed by the rule;
- if the company intends to exclude the proposal from its proxy materials, it must submit its reason(s) for doing so to the Commission and simultaneously provide the shareholder with a copy of that submission. This submission to the Commission of reasons for excluding the proposal is commonly referred to as a no-action request;
- the shareholder may, but is not required to, submit a reply to us with a copy to the company; and
- we issue a no-action response that either concurs or does not concur in the company's view regarding exclusion of the proposal.

3. What are the deadlines contained in rule 14a-8?

Rule 14a-8 establishes specific deadlines for the shareholder proposal process. The following table briefly describes those deadlines.

120 days before the release date disclosed in the previous year's proxy statement	Proposals for a regularly scheduled annual meeting must be received at the company's principal executive offices not less than 120 calendar days before the release date of the previous year's annual meeting proxy statement. Both the release date and the deadline for receiving rule 14a-8 proposals for the next annual meeting should be identified in that proxy statement.
14-day notice of defect(s)/response to notice of defect(s)	If a company seeks to exclude a proposal because the shareholder has not complied with an eligibility or procedural requirement of rule 14a-8, generally, it must notify the shareholder of the alleged defect(s) within 14 calendar days of receiving the proposal. The shareholder then has 14 calendar days after receiving the notification to respond. Failure to cure the

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	defect(s) or respond in a timely manner may result in exclusion of the proposal.
80 days before the company files its definitive proxy statement and form of proxy	If a company intends to exclude a proposal from its proxy materials, it must submit its no-action request to the Commission no later than 80 calendar days before it files its definitive proxy statement and form of proxy with the Commission unless it demonstrates "good cause" for missing the deadline. In addition, a company must simultaneously provide the shareholder with a copy of its no-action request.
30 days before the company files its definitive proxy statement and form of proxy	If a proposal appears in a company's proxy materials, the company may elect to include its reasons as to why shareholders should vote against the proposal. This statement of reasons for voting against the proposal is commonly referred to as a statement in opposition. Except as explained in the box immediately below, the company is required to provide the shareholder with a copy of its statement in opposition no later than 30 calendar days before it files its definitive proxy statement and form of proxy.
Five days after the company has received a revised proposal	If our no-action response provides for shareholder revision to the proposal or supporting statement as a condition to requiring the company to include it in its proxy materials, the company must provide the shareholder with a copy of its statement in opposition no later than five calendar days after it receives a copy of the revised proposal.

In addition to the specific deadlines in rule 14a-8, our informal procedures often rely on timely action. For example, if our no-action response requires that the shareholder revise the proposal or supporting statement, our response will afford the shareholder seven calendar days from the date of receiving our response to provide the company with the revisions. In this regard, please refer to questions and answers B.12.a and B.12.b.

4. What is our role in the no-action process?

Our role begins when we receive a no-action request from a company. In these no-action requests, companies often assert that a proposal is excludable under one or more parts of rule 14a-8. We analyze each of the bases for exclusion that a company asserts, as well as any arguments that the shareholder chooses to set forth, and determine whether we concur in the company's view.

The Division of Investment Management processes rule 14a-8 no-action requests submitted by registered investment companies and business development companies.

Rule 14a-8 no-action requests submitted by registered investment companies and business development companies, as well as shareholder responses to those requests, should be sent to

U.S. Securities and Exchange Commission
Division of Investment Management
Office of Chief Counsel
450 Fifth Street, N.W.

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Washington, D.C. 20549

All other rule 14a-8 no-action requests and shareholder responses to those requests should be sent to

U.S. Securities and Exchange Commission
Division of Corporation Finance
Office of Chief Counsel
450 Fifth Street, N.W.
Washington, D.C. 20549

5. What factors do we consider in determining whether to concur in a company's view regarding exclusion of a proposal from the proxy statement?

The company has the burden of demonstrating that it is entitled to exclude a proposal, and we will not consider any basis for exclusion that is not advanced by the company. We analyze the prior no-action letters that a company and a shareholder cite in support of their arguments and, where appropriate, any applicable case law. We also may conduct our own research to determine whether we have issued additional letters that support or do not support the company's and shareholder's positions. Unless a company has demonstrated that it is entitled to exclude a proposal, we will not concur in its view that it may exclude that proposal from its proxy materials.

6. Do we base our determinations solely on the subject matter of the proposal?

No. We consider the specific arguments asserted by the company and the shareholder, the way in which the proposal is drafted and how the arguments and our prior no-action responses apply to the specific proposal and company at issue. Based on these considerations, we may determine that company X may exclude a proposal but company Y cannot exclude a proposal that addresses the same or similar subject matter. The following chart illustrates this point by showing that variations in the language of a proposal, or different bases cited by a company, may result in different responses.

As shown below, the first and second examples deal with virtually identical proposals, but the different company arguments resulted in different responses. In the second and third examples, the companies made similar arguments, but differing language in the proposals resulted in different responses.

Company	Proposal	Bases for exclusion that the company cited	Date of our response	Our response
PG&E Corp.	Adopt a policy that independent directors are appointed to the audit, compensation and nomination committees.	Rule 14a-8(b) only	Feb. 21, 2000	We did not concur in PG&E's view that it could exclude the proposal. PG&E did not demonstrate that the shareholder failed to satisfy the rule's minimum

				ownership requirements. PG&E included the proposal in its proxy materials.
PG&E Corp.	Adopt a bylaw that independent directors are appointed for all future openings on the audit, compensation and nomination committees.	Rule 14a-8(i)(6) only	Jan. 22, 2001	We concurred in PG&E's view that it could exclude the proposal. PG&E demonstrated that it lacked the power or authority to implement the proposal. PG&E did not include the proposal in its proxy materials.
General Motors Corp.	Adopt a bylaw requiring a *transition to* independent directors for each seat on the audit, compensation and nominating committees as openings occur (emphasis added).	Rules 14a-8(i)(6) and 14a-8(i)(10)	Mar. 22, 2001	We did not concur in GM's view that it could exclude the proposal. GM did not demonstrate that it lacked the power or authority to implement the proposal or that it had substantially implemented the proposal. GM included the proposal in its proxy materials.

7. Do we judge the merits of proposals?

No. We have no interest in the merits of a particular proposal. Our concern is that shareholders receive full and accurate information about all proposals that are, or should be, submitted to them under rule 14a-8.

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8. Are we required to respond to no-action requests?

No. Although we are not required to respond, we have, as a convenience to both companies and shareholders, engaged in the informal practice of expressing our enforcement position on these submissions through the issuance of no-action responses. We do this to assist both companies and shareholders in complying with the proxy rules.

9. Will we comment on the subject matter of pending litigation?

No. Where the arguments raised in the company's no-action request are before a court of law, our policy is not to comment on those arguments. Accordingly, our no-action response will express no view with respect to the company's intention to exclude the proposal from its proxy materials.

10. How do we respond to no-action requests?

We indicate either that there appears to be some basis for the company's view that it may exclude the proposal or that we are unable to concur in the company's view that it may exclude the proposal. Because the company submits the no-action request, our response is addressed to the company. However, at the time we respond to a no-action request, we provide all related correspondence to both the company and the shareholder. These materials are available in the Commission's Public Reference Room and on commercially available, external databases.

11. What is the effect of our no-action response?

Our no-action responses only reflect our informal views regarding the application of rule 14a-8. We do not claim to issue "rulings" or "decisions" on proposals that companies indicate they intend to exclude, and our determinations do not and cannot adjudicate the merits of a company's position with respect to a proposal. For example, our decision not to recommend enforcement action does not prohibit a shareholder from pursuing rights that he or she may have against the company in court should management exclude a proposal from the company's proxy materials.

12. What is our role after we issue our no-action response?

Under rule 14a-8, we have a limited role after we issue our no-action response. In addition, due to the large number of no-action requests that we receive between the months of December and February, the no-action process must be efficient. As described in answer B.2, above, rule 14a-8 envisions a structured process under which the company submits the request, the shareholder may reply and we issue our response. When shareholders and companies deviate from this structure or are unable to resolve differences, our time and resources are diverted and the process breaks down. Based on our experience, this most often occurs as a result of friction between companies and shareholders and their inability to compromise. While we are always available to facilitate the fair and efficient application of the rule, the operation of the rule, as well as the no-action process, suffers when our role changes from an issuer of responses to an arbiter of disputes. The following questions and answers are examples of how we view our limited role after issuance of our no-action response.

a. If our no-action response affords the shareholder additional time to provide documentation of ownership or revise the proposal, but the company does not believe that the documentation or revisions comply with our no-action response, should the company submit a new no-action request?

No. For example, our no-action response may afford the shareholder seven days to provide documentation demonstrating that he or she satisfies the minimum ownership requirements contained in rule 14a-8(b). If the shareholder provides the required documentation eight days after receiving our no-action response, the company should not submit a new no-action request in order to exclude the proposal. Similarly, if we indicate in our response that the shareholder must provide factual support for a sentence in the

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supporting statement, the company and the shareholder should work together to determine whether the revised sentence contains appropriate factual support.

b. If our no-action response affords the shareholder an additional seven days to provide documentation of ownership or revise the proposal, who should keep track of when the seven-day period begins to run?

When our no-action response gives a shareholder time, it is measured from the date the shareholder receives our response. As previously noted in answer B.10, we send our response to both the company and the shareholder. However, the company is responsible for determining when the seven-day period begins to run. In order to avoid controversy, the company should forward a copy of our response to the shareholder by a means that permits the company to prove the date of receipt.

13. Does rule 14a-8 contemplate any other involvement by us after we issue a no-action response?

Yes. If a shareholder believes that a company's statement in opposition is materially false or misleading, the shareholder may promptly send a letter to us and the company explaining the reasons for his or her view, as well as a copy of the proposal and statement in opposition. Just as a company has the burden of demonstrating that it is entitled to exclude a proposal, a shareholder should, to the extent possible, provide us with specific factual information that demonstrates the inaccuracy of the company's statement in opposition. We encourage shareholders and companies to work out these differences before contacting us.

14. What must a company do if, before we have issued a no-action response, the shareholder withdraws the proposal or the company decides to include the proposal in its proxy materials?

If the company no longer wishes to pursue its no-action request, the company should provide us with a letter as soon as possible withdrawing its no-action request. This allows us to allocate our resources to other pending requests. The company should also provide the shareholder with a copy of the withdrawal letter.

15. If a company wishes to withdraw a no-action request, what information should its withdrawal letter contain?

In order for us to process withdrawals efficiently, the company's letter should contain

- a statement that either the shareholder has withdrawn the proposal or the company has decided to include the proposal in its proxy materials;
- if the shareholder has withdrawn the proposal, a copy of the shareholder's signed letter of withdrawal, or some other indication that the shareholder has withdrawn the proposal;
- if there is more than one eligible shareholder, the company must provide documentation that all of the eligible shareholders have agreed to withdraw the proposal;
- if the company has agreed to include a revised version of the proposal in its proxy materials, a statement from the shareholder that he or she accepts the revisions; and
- an affirmative statement that the company is withdrawing its no-action request.

C. Questions regarding the eligibility and procedural requirements of the rule

Rule 14a-8 contains eligibility and procedural requirements for shareholders who wish to

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include a proposal in a company's proxy materials. Below, we address some of the common questions that arise regarding these requirements.

1. To be eligible to submit a proposal, rule 14a-8(b) requires the shareholder to have continuously held at least $2,000 in market value, or 1%, of the company's securities entitled to be voted on the proposal at the meeting for at least one year by the date of submitting the proposal. Also, the shareholder must continue to hold those securities through the date of the meeting. The following questions and answers address issues regarding shareholder eligibility.

a. How do you calculate the market value of the shareholder's securities?

Due to market fluctuations, the value of a shareholder's investment in the company may vary throughout the year before he or she submits the proposal. In order to determine whether the shareholder satisfies the $2,000 threshold, we look at whether, on any date within the 60 calendar days before the date the shareholder submits the proposal, the shareholder's investment is valued at $2,000 or greater, based on the average of the bid and ask prices. Depending on where the company is listed, bid and ask prices may not always be available. For example, bid and ask prices are not provided for companies listed on the New York Stock Exchange. Under these circumstances, companies and shareholders should determine the market value by multiplying the number of securities the shareholder held for the one-year period by the highest *selling* price during the 60 calendar days before the shareholder submitted the proposal. For purposes of this calculation, it is important to note that a security's highest selling price is not necessarily the same as its highest closing price.

b. What type of security must a shareholder own to be eligible to submit a proposal?

A shareholder must own company securities entitled to be voted on the proposal at the meeting.

Example

> **A company receives a proposal relating to executive compensation from a shareholder who owns only shares of the company's class B common stock. The company's class B common stock is entitled to vote only on the election of directors. Does the shareholder's ownership of only class B stock provide a basis for the company to exclude the proposal?**
>
> Yes. This would provide a basis for the company to exclude the proposal because the shareholder does not own securities entitled to be voted on the proposal at the meeting.

c. How should a shareholder's ownership be substantiated?

Under rule 14a-8(b), there are several ways to determine whether a shareholder has owned the minimum amount of company securities entitled to be voted on the proposal at the meeting for the required time period. If the shareholder appears in the company's records as a registered holder, the company can verify the shareholder's eligibility independently. However, many shareholders hold their securities indirectly through a broker or bank. In the event that the shareholder is not the registered holder, the shareholder is responsible for proving his or her eligibility to submit a proposal to the company. To do so, the shareholder must do one of two things. He or she can submit a written statement from the record holder of the securities verifying that the shareholder has owned the securities continuously for one year as of the time the shareholder submits

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the proposal. Alternatively, a shareholder who has filed a Schedule 13D, Schedule 13G, Form 4 or Form 5 reflecting ownership of the securities as of or before the date on which the one-year eligibility period begins may submit copies of these forms and any subsequent amendments reporting a change in ownership level, along with a written statement that he or she has owned the required number of securities continuously for one year as of the time the shareholder submits the proposal.

(1) Does a written statement from the shareholder's investment adviser verifying that the shareholder held the securities continuously for at least one year before submitting the proposal demonstrate sufficiently continuous ownership of the securities?

The written statement must be from the record holder of the shareholder's securities, which is usually a broker or bank. Therefore, unless the investment adviser is also the record holder, the statement would be insufficient under the rule.

(2) Do a shareholder's monthly, quarterly or other periodic investment statements demonstrate sufficiently continuous ownership of the securities?

No. A shareholder must submit an affirmative written statement from the record holder of his or her securities that specifically verifies that the shareholder owned the securities *continuously* for a period of one year as of the time of submitting the proposal.

(3) If a shareholder submits his or her proposal to the company on June 1, does a statement from the record holder verifying that the shareholder owned the securities continuously for one year as of May 30 of the same year demonstrate sufficiently continuous ownership of the securities as of the time he or she submitted the proposal?

No. A shareholder must submit proof from the record holder that the shareholder continuously owned the securities for a period of one year as of the time the shareholder submits the proposal.

d. Should a shareholder provide the company with a written statement that he or she intends to continue holding the securities through the date of the shareholder meeting?

Yes. The shareholder must provide this written statement regardless of the method the shareholder uses to prove that he or she continuously owned the securities for a period of one year as of the time the shareholder submits the proposal.

2. In order for a proposal to be eligible for inclusion in a company's proxy materials, rule 14a-8(d) requires that the proposal, including any accompanying supporting statement, not exceed 500 words. The following questions and answers address issues regarding the 500-word limitation.

a. May a company count the words in a proposal's "title" or "heading" in determining whether the proposal exceeds the 500-word limitation?

Any statements that are, in effect, arguments in support of the proposal constitute part of the supporting statement. Therefore, any "title" or "heading" that meets this test may be counted toward the 500-word limitation.

b. Does referencing a website address in the proposal or supporting statement violate the 500-word limitation of rule 14a-8(d)?

No. Because we count a website address as one word for purposes of the 500-word limitation, we do not believe that a website address raises the concern that rule 14a-8(d) is intended to address. However, a website address could be subject to exclusion if it refers readers to information that may be materially false or misleading, irrelevant to the subject matter of the proposal or otherwise in contravention of the proxy rules. In this regard, please refer to question and answer F.1.

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3. Rule 14a-8(e)(2) requires that proposals for a regularly scheduled annual meeting be received at the company's principal executive offices by a date not less than 120 calendar days before the date of the company's proxy statement released to shareholders in connection with the previous year's annual meeting. The following questions and answers address a number of issues that come up in applying this provision.

a. How do we interpret the phrase "before the date of the company's proxy statement released to shareholders?"

We interpret this phrase as meaning the approximate date on which the proxy statement and form of proxy were first sent or given to shareholders. For example, if a company having a regularly scheduled annual meeting files its definitive proxy statement and form of proxy with the Commission dated April 1, 2001, but first sends or gives the proxy statement to shareholders on April 15, 2001, as disclosed in its proxy statement, we will refer to the April 15, 2001 date as the release date. The company and shareholders should use April 15, 2001 for purposes of calculating the 120-day deadline in rule 14a-8(e)(2).

b. How should a company that is planning to have a regularly scheduled annual meeting calculate the deadline for submitting proposals?

The company should calculate the deadline for submitting proposals as follows:

- start with the release date disclosed in the previous year's proxy statement;
- increase the year by one; and
- count back 120 calendar days.

Examples

If a company is planning to have a regularly scheduled annual meeting in May of 2003 and the company disclosed that the release date for its 2002 proxy statement was April 14, 2002, how should the company calculate the deadline for submitting rule 14a-8 proposals for the company's 2003 annual meeting?

- The release date disclosed in the company's 2002 proxy statement was April 14, 2002.
- Increasing the year by one, the day to begin the calculation is April 14, 2003.
- "Day one" for purposes of the calculation is April 13, 2003.
- "Day 120" is December 15, 2002.
- The 120-day deadline for the 2003 annual meeting is December 15, 2002.
- A rule 14a-8 proposal received after December 15, 2002 would be untimely.

If the 120th calendar day before the release date disclosed in the previous year's proxy statement is a Saturday, Sunday or federal holiday, does this change the deadline for receiving rule 14a-8 proposals?

No. The deadline for receiving rule 14a-8 proposals is always the 120th calendar day before the release date disclosed in the previous year's

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proxy statement. Therefore, if the deadline falls on a Saturday, Sunday or federal holiday, the company must disclose this date in its proxy statement, and rule 14a-8 proposals received after business reopens would be untimely.

c. How does a shareholder know where to send his or her proposal?

The proposal must be received at the company's principal executive offices. Shareholders can find this address in the company's proxy statement. If a shareholder sends a proposal to any other location, even if it is to an agent of the company or to another company location, this would not satisfy the requirement.

d. How does a shareholder know if his or her proposal has been received by the deadline?

A shareholder should submit a proposal by a means that allows him or her to determine when the proposal was received at the company's principal executive offices.

4. Rule 14a-8(h)(1) requires that the shareholder or his or her qualified representative attend the shareholders' meeting to present the proposal. Rule 14a-8(h)(3) provides that a company may exclude a shareholder's proposals for two calendar years if the company included one of the shareholder's proposals in its proxy materials for a shareholder meeting, neither the shareholder nor the shareholder's qualified representative appeared and presented the proposal and the shareholder did not demonstrate "good cause" for failing to attend the meeting or present the proposal. The following questions and answers address issues regarding these provisions.

a. Does rule 14a-8 require a shareholder to represent in writing before the meeting that he or she, or a qualified representative, will attend the shareholders' meeting to present the proposal?

No. The Commission stated in Release No. 34-20091 that shareholders are no longer required to provide the company with a written statement of intent to appear and present a shareholder proposal. The Commission eliminated this requirement because it "serve[d] little purpose" and only encumbered shareholders. We, therefore, view it as inappropriate for companies to solicit this type of written statement from shareholders for purposes of rule 14a-8. In particular, we note that shareholders who are unfamiliar with the proxy rules may be misled, even unintentionally, into believing that a written statement of intent is required.

b. What if a shareholder provides an unsolicited, written statement that neither the shareholder nor his or her qualified representative will attend the meeting to present the proposal? May the company exclude the proposal under this circumstance?

Yes. Rule 14a-8(i)(3) allows companies to exclude proposals that are contrary to the proxy rules, including rule 14a-8(h)(1). If a shareholder voluntarily provides a written statement evidencing his or her intent to act contrary to rule 14a-8(h)(1), rule 14a-8(i)(3) may serve as a basis for the company to exclude the proposal.

c. If a company demonstrates that it is entitled to exclude a proposal under rule 14a-8(h)(3), can the company request that we issue a no-action response that covers both calendar years?

Yes. For example, assume that, without "good cause," neither the shareholder nor the shareholder's representative attended the company's 2001 annual meeting to present the shareholder's proposal, and the shareholder then submits a proposal for inclusion in the company's 2002 proxy materials. If the company seeks to exclude the 2002 proposal under rule 14a-8(h)(3), it may concurrently request forward-looking relief for any proposal(s) that the shareholder may submit for inclusion in the company's 2003 proxy materials. If we

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grant the company's request and the company receives a proposal from the shareholder in connection with the 2003 annual meeting, the company still has an obligation under rule 14a-8(j) to notify us and the shareholder of its intention to exclude the shareholder's proposal from its proxy materials for that meeting. Although we will retain that notice in our records, we will not issue a no-action response.

5. In addition to rule 14a-8(h)(3), are there any other circumstances in which we will grant forward-looking relief to a company under rule 14a-8?

Yes. Rule 14a-8(i)(4) allows companies to exclude a proposal if it relates to the redress of a personal claim or grievance against the company or any other person or is designed to result in a benefit to the shareholder, or to further a personal interest, that is not shared by the other shareholders at large. In rare circumstances, we may grant forward-looking relief if a company satisfies its burden of demonstrating that the shareholder is abusing rule 14a-8 by continually submitting similar proposals that relate to a particular personal claim or grievance. As in answer C.4.c, above, if we grant this relief, the company still has an obligation under rule 14a-8(j) to notify us and the shareholder of its intention to exclude the shareholder's proposal(s) from its proxy materials. Although will retain that notice in our records, we will not issue a no-action response.

6. What must a company do in order to exclude a proposal that fails to comply with the eligibility or procedural requirements of the rule?

If a shareholder fails to follow the eligibility or procedural requirements of rule 14a-8, the rule provides procedures for the company to follow if it wishes to exclude the proposal. For example, rule 14a-8(f) provides that a company may exclude a proposal from its proxy materials due to eligibility or procedural defects if

- within 14 calendar days of receiving the proposal, it provides the shareholder with written notice of the defect(s), including the time frame for responding; and

- the shareholder fails to respond to this notice within 14 calendar days of receiving the notice of the defect(s) or the shareholder timely responds but does not cure the eligibility or procedural defect(s).

Section G.3 - Eligibility and Procedural Issues, below, contains information that companies may want to consider in drafting these notices. If the shareholder does not timely respond or remedy the defect(s) and the company intends to exclude the proposal, the company still must submit, to us and to the shareholder, a copy of the proposal and its reasons for excluding the proposal.

a. Should a company's notices of defect(s) give different levels of information to different shareholders depending on the company's perception of the shareholder's sophistication in rule 14a-8?

No. Companies should not assume that any shareholder is familiar with the proxy rules or give different levels of information to different shareholders based on the fact that the shareholder may or may not be a frequent or "experienced" shareholder proponent.

b. Should companies instruct shareholders to respond to the notice of defect(s) by a specified date rather than indicating that shareholders have 14 calendar days after receiving the notice to respond?

No. Rule 14a-8(f) provides that shareholders must respond within 14 calendar days of receiving notice of the alleged eligibility or procedural defect(s). If the company provides a specific date by which the shareholder must submit his or her response, it is possible that the deadline set by the company will be shorter than the 14-day period required by rule 14a-8(f). For example, events could delay the shareholder's receipt of the notice. As such, if a company sets a specific date for the shareholder to respond and that date does not result in the shareholder having 14 calendar days after receiving the notice to respond, we do not believe that the company may rely on rule 14a-8(f) to exclude the proposal.

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c. Are there any circumstances under which a company does not have to provide the shareholder with a notice of defect(s)? For example, what should the company do if the shareholder indicates that he or she does not own at least $2,000 in market value, or 1%, of the company's securities?

The company does not need to provide the shareholder with a notice of defect(s) if the defect(s) cannot be remedied. In the example provided in the question, because the shareholder cannot remedy this defect after the fact, no notice of the defect would be required. The same would apply, for example, if

- the shareholder indicated that he or she had owned securities entitled to be voted on the proposal for a period of less than one year before submitting the proposal;
- the shareholder indicated that he or she did not own securities entitled to be voted on the proposal at the meeting;
- the shareholder failed to submit a proposal by the company's properly determined deadline; or
- the shareholder, or his or her qualified representative, failed to attend the meeting or present one of the shareholder's proposals that was included in the company's proxy materials during the past two calendar years.

In all of these circumstances, the company must still submit its reasons regarding exclusion of the proposal to us and the shareholder. The shareholder may, but is not required to, submit a reply to us with a copy to the company.

D. Questions regarding the inclusion of shareholder names in proxy statements

1. If the shareholder's proposal will appear in the company's proxy statement, is the company required to disclose the shareholder's name?

No. A company is not required to disclose the identity of a shareholder proponent in its proxy statement. Rather, a company can indicate that it will provide the information to shareholders promptly upon receiving an oral or written request.

2. May a shareholder request that the company not disclose his or her name in the proxy statement?

Yes. However, the company has the discretion not to honor the request. In this regard, if the company chooses to include the shareholder proponent's name in the proxy statement, rule 14a-8(l)(1) requires that the company also include that shareholder proponent's address and the number of the company's voting securities that the shareholder proponent holds.

3. If a shareholder includes his or her e-mail address in the proposal or supporting statement, may the company exclude the e-mail address?

Yes. We view an e-mail address as equivalent to the shareholder proponent's name and address and, under rule 14a-8(l)(1), a company may exclude the shareholder's name and address from the proxy statement.

E. Questions regarding revisions to proposals and supporting statements

In this section, we first discuss the purpose for allowing shareholders to revise portions of a proposal and supporting statement. Second, we express our views with regard to

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revisions that a shareholder makes to his or her proposal before we receive a company's no-action request, as well as during the course of our review of a no-action request. Finally, we address the circumstances under which our responses may allow shareholders to make revisions to their proposals and supporting statements.

1. Why do our no-action responses sometimes permit shareholders to make revisions to their proposals and supporting statements?

There is no provision in rule 14a-8 that allows a shareholder to revise his or her proposal and supporting statement. However, we have a long-standing practice of issuing no-action responses that permit shareholders to make revisions that are minor in nature and do not alter the substance of the proposal. We adopted this practice to deal with proposals that generally comply with the substantive requirements of the rule, but contain some relatively minor defects that are easily corrected. In these circumstances, we believe that the concepts underlying Exchange Act section 14(a) are best served by affording an opportunity to correct these kinds of defects.

Despite the intentions underlying our revisions practice, we spend an increasingly large portion of our time and resources each proxy season responding to no-action requests regarding proposals or supporting statements that have obvious deficiencies in terms of accuracy, clarity or relevance. This is not beneficial to all participants in the process and diverts resources away from analyzing core issues arising under rule 14a-8 that are matters of interest to companies and shareholders alike. Therefore, when a proposal and supporting statement will require detailed and extensive editing in order to bring them into compliance with the proxy rules, we may find it appropriate for companies to exclude the entire proposal, supporting statement, or both, as materially false or misleading.

2. If a company has received a timely proposal and the shareholder makes revisions to the proposal before the company submits its no-action request, must the company accept those revisions?

No, but it *may* accept the shareholder's revisions. If the changes are such that the revised proposal is actually a different proposal from the original, the revised proposal could be subject to exclusion under

- rule 14a-8(c), which provides that a shareholder may submit no more than one proposal to a company for a particular shareholders' meeting; and
- rule 14a-8(e), which imposes a deadline for submitting shareholder proposals.

3. If the shareholder decides to make revisions to his or her proposal after the company has submitted its no-action request, must the company address those revisions?

No, but it *may* address the shareholder's revisions. We base our no-action response on the proposal included in the company's no-action request. Therefore, if the company indicates in a letter to us and the shareholder that it acknowledges and accepts the shareholder's changes, we will base our response on the revised proposal. Otherwise, we will base our response on the proposal contained in the company's original no-action request. Again, it is important for shareholders to note that, depending on the nature and timing of the changes, a revised proposal could be subject to exclusion under rule 14a-8(c), rule 14a-8(e), or both.

4. If the shareholder decides to make revisions to his or her proposal after the company has submitted its no-action request, should the shareholder provide a copy of the revisions to us?

Yes. All shareholder correspondence relating to the no-action request should be sent to us and the company. However, under rule 14a-8, no-action requests and shareholder responses to those requests are submitted to us. The proposals themselves are not submitted to us. Because proposals are submitted to companies for inclusion in their proxy materials, we will not address revised proposals unless the company chooses to

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acknowledge the changes.

5. When do our responses afford shareholders an opportunity to revise their proposals and supporting statements?

We may, under limited circumstances, permit shareholders to revise their proposals and supporting statements. The following table provides examples of the rule 14a-8 bases under which we typically allow revisions, as well as the types of permissible changes:

Basis	Type of revision that we may permit
Rule 14a-8(i)(1)	When a proposal would be binding on the company if approved by shareholders, we may permit the shareholder to revise the proposal to a recommendation or request that the board of directors take the action specified in the proposal.
Rule 14a-8(i)(2)	If implementing the proposal would require the company to breach existing contractual obligations, we may permit the shareholder to revise the proposal so that it applies only to the company's future contractual obligations.
Rule 14a-8(i)(3)	If the proposal contains specific statements that may be materially false or misleading or irrelevant to the subject matter of the proposal, we may permit the shareholder to revise or delete these statements. Also, if the proposal or supporting statement contains vague terms, we may, in rare circumstances, permit the shareholder to clarify these terms.
Rule 14a-8(i)(6)	Same as rule 14a-8(i)(2), above.
Rule 14a-8(i)(7)	If it is unclear whether the proposal focuses on senior executive compensation or director compensation, as opposed to general employee compensation, we may permit the shareholder to make this clarification.
Rule 14a-8(i)(8)	If implementing the proposal would disqualify directors previously elected from completing their terms on the board or disqualify nominees for directors at the upcoming shareholder meeting, we may permit the shareholder to revise the proposal so that it will not affect the unexpired terms of directors elected to the board at or prior to the upcoming shareholder meeting.
Rule 14a-8(i)(9)	Same as rule 14a-8(i)(8), above.

F. Other questions that arise under rule 14a-8

1. May a reference to a website address in the proposal or supporting statement be subject to exclusion under the rule?

Yes. In some circumstances, we may concur in a company's view that it may exclude a website address under rule 14a-8(i)(3) because information contained on the website may be materially false or misleading, irrelevant to the subject matter of the proposal or otherwise in contravention of the proxy rules. Companies seeking to exclude a website address under rule 14a-8(i)(3) should specifically indicate why they believe information contained on the particular website is materially false or misleading, irrelevant to the subject matter of the proposal or otherwise in contravention of the proxy rules.

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2. Rule 14a-8(i)(12) provides a basis for a company to exclude a proposal dealing with substantially the same subject matter as another proposal or proposals that previously has or have been included in the company's proxy materials. How does rule 14a-8(i)(12) operate?

Rule 14a-8(i)(12) operates as follows:

a. First, the company should look back three calendar years to see if it previously included a proposal or proposals dealing with substantially the same subject matter. If it has not, rule 14a-8(i)(12) is not available as a basis to exclude a proposal from this year's proxy materials.

b. If it has, the company should then count the number of times that a proposal or proposals dealing with substantially the same subject matter was or were included over the preceding five calendar years.

c. Finally, the company should look at the percentage of the shareholder vote that a proposal dealing with substantially the same subject matter received the last time it was included.

- If the company included a proposal dealing with substantially the same subject matter only once in the preceding five calendar years, the company may exclude a proposal from this year's proxy materials under rule 14a-8(i)(12)(i) if it received less than 3% of the vote the last time that it was voted on.
- If the company included a proposal or proposals dealing with substantially the same subject matter twice in the preceding five calendar years, the company may exclude a proposal from this year's proxy materials under rule 14a-8(i)(12)(ii) if it received less than 6% of the vote the last time that it was voted on.
- If the company included a proposal or proposals dealing with substantially the same subject matter three or more times in the preceding five calendar years, the company may exclude a proposal from this year's proxy materials under rule 14a-8(i)(12)(iii) if it received less than 10% of the vote the last time that it was voted on.

3. Rule 14a-8(i)(12) refers to calendar years. How do we interpret calendar years for this purpose?

Because a calendar year runs from January 1 through December 31, we do not look at the specific dates of company meetings. Instead, we look at the calendar year in which a meeting was held. For example, a company scheduled a meeting for April 25, 2002. In looking back three calendar years to determine if it previously had included a proposal or proposals dealing with substantially the same subject matter, any meeting held in calendar years 1999, 2000 or 2001 - which would include any meetings held between January 1, 1999 and December 31, 2001 - would be relevant under rule 14a-8(i)(12).

Examples

A company receives a proposal for inclusion in its 2002 proxy materials dealing with substantially the same subject matter as proposals that were voted on at the following shareholder meetings:

Calendar Year	1997	1998	1999	2000	2001	2002	2003
Voted on?	Yes	No	No	Yes	No	-	-
Percentage	4%	N/A	N/A	4%	N/A	-	-

May the company exclude the proposal from its 2002 proxy materials in reliance on rule 14a-8(i)(12)?

Yes. The company would be entitled to exclude the proposal under rule 14a-8(i)(12)(ii). First, calendar year 2000, the last time the company included a proposal dealing with substantially the same subject matter, is within the prescribed three calendar years. Second, the company included proposals dealing with substantially the same subject matter twice within the preceding five calendar years, specifically, in 1997 and 2000. Finally, the proposal received less than 6% of the vote on its last submission to shareholders in 2000. Therefore, rule 14a-8(i)(12)(ii), which permits exclusion when a company has included a proposal or proposals dealing with substantially the same subject matter twice in the preceding five calendar years and that proposal received less than 6% of the shareholder vote the last time it was voted on, would serve as a basis for excluding the proposal.

If the company excluded the proposal from its 2002 proxy materials and then received an identical proposal for inclusion in its 2003 proxy materials, may the company exclude the proposal from its 2003 proxy materials in reliance on rule 14a-8(i)(12)?

No. Calendar year 2000, the last time the company included a proposal dealing with substantially the same subject matter, is still within the prescribed three calendar years. However, 2000 was the only time within the preceding five calendar years that the company included a proposal dealing with substantially the same subject matter, and it received more than 3% of the vote at the 2000 meeting. Therefore, the company would not be entitled to exclude the proposal under rule 14a-8(i)(12)(i).

4. How do we count votes under rule 14a-8(i)(12)?

Only votes for and against a proposal are included in the calculation of the shareholder vote of that proposal. Abstentions and broker non-votes are not included in this calculation.

Example

A proposal received the following votes at the company's last annual meeting:

- **5,000 votes for the proposal;**
- **3,000 votes against the proposal;**
- **1,000 broker non-votes; and**
- **1,000 abstentions.**

How is the shareholder vote of this proposal calculated for purposes of rule 14a-8(i)(12)?

This percentage is calculated as follows:

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$$\frac{\text{Votes for the Proposal}}{\text{(Votes Against the Proposal + Votes for the Proposal)}} = \text{Voting Percentage}$$

Applying this formula to the facts above, the proposal received 62.5% of the vote.

$$\frac{5{,}000}{3{,}000 + 5{,}000} = .625$$

G. How can companies and shareholders facilitate our processing of no-action requests or take steps to avoid the submission of no-action requests?

Eligibility and procedural issues

1. Before submitting a proposal to a company, a shareholder should look in the company's most recent proxy statement to find the deadline for submitting rule 14a-8 proposals. To avoid exclusion on the basis of untimeliness, a shareholder should submit his or her proposal well in advance of the deadline and by a means that allows the shareholder to demonstrate the date the proposal was received at the company's principal executive offices.

2. A shareholder who intends to submit a written statement from the record holder of the shareholder's securities to verify continuous ownership of the securities should contact the record holder before submitting a proposal to ensure that the record holder will provide the written statement and knows how to provide a written statement that will satisfy the requirements of rule 14a-8(b).

3. Companies should consider the following guidelines when drafting a letter to notify a shareholder of perceived eligibility or procedural defects:

- provide adequate detail about what the shareholder must do to remedy all eligibility or procedural defects;
- although not required, consider including a copy of rule 14a-8 with the notice of defect(s);
- explicitly state that the shareholder must respond to the company's notice within 14 calendar days of receiving the notice of defect(s); and
- send the notification by a means that allows the company to determine when the shareholder received the letter.

4. Rule 14a-8(f) provides that a shareholder's response to a company's notice of defect(s) must be postmarked, or transmitted electronically, no later than 14 days from the date the shareholder received the notice of defect(s). Therefore, a shareholder should respond to the company's notice of defect(s) by a means that allows the shareholder to demonstrate when he or she responded to the notice.

5. Rather than waiting until the deadline for submitting a no-action request, a company should submit a no-action request as soon as possible after it receives a proposal and determines that it will seek a no-action response.

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6. Companies that will be submitting multiple no-action requests should submit their requests individually or in small groups rather than waiting and sending them all at once. We receive the heaviest volume of no-action requests between December and February of each year. Therefore, we are not able to process no-action requests as quickly during this period. Our experience shows that we often receive 70 to 80 no-action requests a week during our peak period and, at most, we can respond to 30 to 40 requests in any given week. Therefore, companies that wait until December through February to submit all of their requests will have to wait longer for a response.

7. Companies should provide us with all relevant correspondence when submitting the no-action request, including the shareholder proposal, any cover letter that the shareholder provided with the proposal, the shareholder's address and any other correspondence the company has exchanged with the shareholder relating to the proposal. If the company provided the shareholder with notice of a perceived eligibility or procedural defect, the company should include a copy of the notice, documentation demonstrating when the company notified the shareholder, documentation demonstrating when the shareholder received the notice and any shareholder response to the notice.

8. If a shareholder intends to reply to the company's no-action request, he or she should try to send the reply as soon as possible after the company submits its no-action request.

9. Both companies and shareholders should promptly forward to each other copies of all correspondence that is provided to us in connection with no-action requests.

10. Due to the significant volume of no-action requests and phone calls we receive during the proxy season, companies should limit their calls to us regarding the status of their no-action request.

11. Shareholders who write to us to object to a company's statement in opposition to the shareholder's proposal also should provide us with copies of the proposal as it will be printed in the company's proxy statement and the company's proposed statement in opposition.

Substantive issues

1. When drafting a proposal, shareholders should consider whether the proposal, if approved by shareholders, would be binding on the company. In our experience, we have found that proposals that are binding on the company face a much greater likelihood of being improper under state law and, therefore, excludable under rule 14a-8(i)(1).

2. When drafting a proposal, shareholders should consider what actions are within a company's power or authority. Proposals often request or require action by the company that would violate law or would not be within the power or authority of the company to implement.

3. When drafting a proposal, shareholders should consider whether the proposal would require the company to breach existing contracts. In our experience, we have found that proposals that would result in the company breaching existing contractual obligations face a much greater likelihood of being excludable under rule 14a-8(i)(2), rule 14a-8(i)(6), or both. This is because implementing the proposals may require the company to violate law or may not be within the power or authority of the company to implement.

4. In drafting a proposal and supporting statement, shareholders should avoid making unsupported assertions of fact. To this end, shareholders should provide factual support for statements in the proposal and supporting statement or phrase statements as their opinion where appropriate.

5. Companies should provide a supporting opinion of counsel when the reasons for exclusion are based on matters of state or foreign law. In determining how much weight to afford these opinions, one factor we consider is whether counsel is licensed to practice law in the jurisdiction where the law is at issue. Shareholders who wish to contest a company's

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reliance on a legal opinion as to matters of state or foreign law should, but are not required to, submit an opinion of counsel supporting their position.

H. Conclusion

Whether or not you are familiar with rule 14a-8, we hope that this bulletin helps you gain a better understanding of the rule, the no-action request process and our views on some issues and questions that commonly arise during our review of no-action requests. While not exhaustive, we believe that the bulletin contains information that will assist both companies and shareholders in ensuring that the rule operates more effectively. Please contact us with any questions that you may have regarding information contained in the bulletin.

http://www.sec.gov/interps/legal/cfslb14.htm

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May 7, 2001

Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549
Attention: Jonathan G. Katz, Secretary

Re: Disclosure of Equity Compensation Plan Information
File No. S7-04-01

Ladies and Gentlemen:

This letter responds to the Commission's request for written comments on proposed amendments regarding disclosure relating to equity compensation plans contained in Release No. 33-7944; 34-43892 (January 26, 2001) (the "*Release*"). We generally support the proposal to require additional disclosure in this area, but suggest specific changes in the requirements for that disclosure. We believe that the additional disclosures respond to the concerns expressed by investors regarding equity compensation arrangements and will increase the accountability of corporate management in making equity awards.

This letter has been prepared by members of the Subcommittee on Employee Benefits, Executive Compensation and Section 16 (the "Subcommittee") of the Committee on Federal Regulation of Securities (the "Committee") of the Section of Business Law (the "Section") of the American Bar Association. A draft of this letter has been circulated for comment among the members of the Subcommittee, the Chairs and Vice-Chairs of the Committee, other subcommittees and task forces of the Committee, members of the Advisory Committee of the Committee and the officers of the Section. The substantial majority of those members of the Committee who have reviewed the letter in draft form have indicated general agreement with the views expressed. However, this letter does not represent the official position of the American Bar Association, the Section, the Committee or the Subcommittee, nor does it necessarily reflect the views of all of the individuals who have reviewed it or of their firms.

General Comments

We note that the Commission has taken account of many of the recommendations developed by a task force (the "*Task Force*") of the New York Stock Exchange ("*NYSE*") established to study and recommend changes to the NYSE's broadly-based plan standard. The Task Force concluded that it was difficult to obtain accurate information about the level of dilution from equity compensation plans from disclosures currently required under SEC rules, and that the information that was available was not consistently available in any one place or format in corporate disclosure documents. To partly address these concerns, the Task Force designated a special drafting group to develop proposed changes in SEC disclosure standards to remedy the dilution information gap. The Task Force recommended that the NYSE formally propose to the SEC, and the NYSE did propose, amendments to the Regulation S-K disclosure requirements for equity compensation. The Task Force expressed its belief that the proposed disclosure changes would give stockholders and analysts in one place the information needed to make dilution calculations, would enhance the ability of investors to analyze equity compensation arrangements and would have a beneficial impact on shareholder education and effective corporate governance. The Task Force also stated that the proposed changes would permit investors to determine which plans had previously been approved by shareholders and enable them to obtain copies of all compensation plans and arrangements involving significant equity awards.

We acknowledge the efforts made, and contribution to the public dialogue on the issue of equity compensation disclosure, by the NYSE through the two years of work of its Task Force. This issue is of concern to institutional investors and other stockholders and is of importance to effective corporate governance. We believe that disclosure of the type proposed in the Release is appropriate to facilitate the ability of stockholders to make accurate calculations of dilution, including potential future dilution, resulting from awards under equity compensation arrangements. We also believe that this disclosure will have a beneficial impact on shareholder education and effective corporate governance. Moreover, we believe that the recommended changes will not significantly increase disclosure costs or burdens on registrants. However, we believe that the proposed disclosure requirements need to be strengthened and clarified in the following ways:

- The required disclosure should be included in the registrant's proxy statement every year.
- Disclosure of the weighted average exercise price of outstanding awards should be required.
- Plan information should be aggregated in three separate categories.

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- Information should be included for plans and individual arrangements that provide compensatory equity grants to consultants and other service providers.
- The disclosure requirements attributable to individual arrangements should be modified.
- All plans (other than assumed plans pursuant to which no new awards are to be made and plans below a materiality threshold) should be required to be filed as exhibits to the Form 10-K.

These and other matters are discussed in further detail below.

Location of Disclosure

We recommend that the new disclosure proposed in the Release be required to be presented in the registrant's proxy statement every year, whether or not an equity compensation plan is submitted for stockholder approval. Stockholders should not be required to go to the Annual Report on Form 10-K in some years and the proxy statement in other years to obtain equity plan disclosure. Additionally, this would avoid confusion by issuers of the filing requirements. Board decisions regarding a company's equity plans are relevant to shareholders' voting decisions in the election of directors even when compensation plans are not submitted for stockholder approval. We believe that the proposed equity plan disclosure is most appropriate in proxy statements relating to the election of directors or the adoption or amendment of an equity compensation plan. As such, we suggest that the requirement for such disclosure be placed in Schedule 14A, Item 8, rather than in Form 10-K, Item 12 and Schedule 14A, Item 10, as proposed. This could be accomplished by amending the first clause of Item 8 of Schedule 14A to read:

Item 8. Compensation of Directors and Executive Officers: Equity Compensation Plans

> Furnish the information required by Item 201(d) and Item 402 of Regulation S-K if action is to be taken with regard to:... [new language underlined]

The additional disclosures should be confined to proxy statements subject to the SEC proxy rules as relevant to the election of directors. Accordingly, we do not believe that registrants that are not subject to the proxy rules (*e.g.*, foreign private issuers and others reporting under Section 15(d) of the Securities Exchange Act of 1934) should be required to present the equity plan disclosure information in their Annual Reports on Form 10-K, 20F or 40-F. Nor do we believe that similar disclosure should be required in registration statements under the Securities Act of 1933, as amended. To the extent that dilution information is important to investors, Item 506 of Regulation S-K already requires information about the immediate dilution to investors and about outstanding options, and information about the possible effects of future sales of securities is generally included to the extent that it is material.

Disclosure of Economic Dilution

We recommend that an additional column be added to the "*Equity Compensation Plan Information*" table to indicate the weighted-average exercise price of outstanding options, warrants or rights held by all persons who received awards under "plans," as defined in the Instructions to Item 201(d) (as we propose to modify them below). This information would permit stockholders to determine the *economic* impact of potential dilution. Although this information is currently required to be reported in the footnotes to the registrant's financial statements in accordance with FASB Statement No. 123, *Accounting for Stock-Based Compensation* (October 1995), we believe that it would be appropriate to include similar information in the proposed Equity Compensation Plan Information table, as it would make this table more comprehensive without placing an undue burden on registrants. However, we believe that the Commission should not require disclosure of information by ranges of exercise prices for outstanding options, because this level of detail is less meaningful and is best left to the financial statement footnotes. Rather, the table should simply provide the weighted-average exercise price for all outstanding options.

The Task Force recommended separate disclosure for stock awards. A stock award, which is typically made as a stock bonus or as a stock purchase for a nominal price (such as par value), may be more dilutive than options, warrants or rights and should be separately identified depending on the number of shares subject to awards and the respective purchase or exercise prices of such awards. We believe that this disclosure should be done by footnote to avoid the distortion that would arise when a company has a flexible plan without a sublimit, but does not use stock awards at all or to any significant extent. Accordingly, we recommend that footnotes be added to the Equity Compensation Plan Information table to separately identify the availability of stock awards (whether restricted or otherwise) under the plan or individual arrangement, as distinguished from options, warrants or rights. With respect to shares available for future grant, the entries in that column should be footnoted to show whether shares are available for grant as stock awards or as options. This may be a portion of the total shares shown, if there is a separate stock award plan or a sublimit, or it may be all of

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the shares, if no separate plan or sublimit has been established. In addition, the entries in the column disclosing the total number of shares granted during the last fiscal year should be footnoted to disclose the number of such shares that were issued as stock awards.

Aggregation of Information

We recommend that the Equity Compensation Plan Information table aggregate information about plans that the registrant maintains in three separate categories. We believe that requiring information to be separately included in the table for each plan would be unduly burdensome on registrants and would not yield meaningful information. The burden would be particularly large on registrants that use separate plans for subsidiaries and affiliates and that assume plans maintained by entities that they acquire. For some registrants, separate information could run to dozens of line items. The Task Force recommended the presentation of aggregate information, albeit in somewhat different categories from the ones that we suggest. We believe that the equity plan disclosure would be enhanced by aggregating this information in the following three categories:

- plan(s) and individual arrangements previously approved by shareholders;
- plan(s) and individual arrangements submitted for a vote at the meeting to which the proxy statement relates; and
- plan(s) and individual arrangements that have not been approved by shareholders and are not being submitted for a vote at the meeting to which the proxy statement relates.

Awards Covered

The instruction to proposed Item 201(d) of Regulation S-K should be revised to make clear that the required disclosure must cover any compensatory awards (including those to consultants) that are accounted for under the relevant accounting guidance of SFAS No. 123, *Accounting for Stock-Based Compensation*, or APB Opinion No. 25, *Accounting for Stock Issued to Employees*.

Individual Arrangements

As discussed above in the section entitled "Aggregate Information," we recommend that individual arrangements be aggregated with plans. If the Commission does not agree with our recommendation, we suggest that proposed Item 201(d)(2)(ii) be modified to require the information in proposed columns (c) and (d) of the table proposed by the Commission, as well as the weighted average exercise price of outstanding awards (see discussion in "Economic Dilution" above), for individual arrangements, rather than the information in the Commission's proposed columns (b) and (e).

The information in proposed columns (b) (number of securities authorized for issuance under the plan) and (e) (number of securities remaining available for future issuance) is not appropriate for individual arrangements. By definition, these individual arrangements are entered into on an *ad hoc* basis. If an issuer authorized a specific number of shares for "individual arrangements" in advance, the arrangements would collectively constitute a "plan" disclosed under proposed Item 201(d)(2)(i) rather than (ii). By contrast, the information that is available and meaningful, *i.e*., the actual awards in the past year (proposed column (c)), is not proposed to be required for individual arrangements. We believe that this is precisely the information that is relevant for those arrangements.

We do not believe that separate disclosure should be required for individual awards that constitute 25% or more of the total individual awards (proposed Item 201(d)(4)). To the extent that such information is relevant, it is generally included in the option grants table required by Regulation S-K, Item 402(c). If the Commission believes that such disclosure is beneficial and that proposed Item 201(d)(4) should be retained, we believe that the use of information disclosed pursuant to proposed Item 201(d)(2)(ii)(B) (total "authorized") as the denominator in the calculation of 25% is not meaningful for individual awards for the reasons discussed above (*i.e.*, there would be no future shares available for grant). Rather, we believe that the denominator used for calculations under proposed Item 201(d)(2)(ii)(B) should be actual awards granted.

Amendment of Item 601 Exhibit Filing Requirements

We recommend that Item 601 of Regulation S-K be amended to require that any plan pursuant to which equity compensation may be awarded, whether or not to any executive officer of the registrant, be filed by the registrant as an exhibit to the Annual Report on Form 10-K. Currently, Item 601(d)(10)(iii)(A) of Regulation S-K states only that any management contract and any compensatory plan in which any director or named executive officer participates shall be deemed material and is required to be filed. Other plans and arrangements (*i.e.*, plans and arrangements in which other executive officers participate) are only required to be filed under Item 601(d)(10)(iii)(A) of Regulation S-K if material in

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amount or significance.

The Task Force recommended that all plans in which any officer or director participated should be filed. The Task Force also recommended that plans that permitted equity awards to any other employee having a value that was expected to exceed $100,000 should be filed. While we believe that it may be appropriate to establish some threshold of materiality in order to avoid the need to file immaterial plans, we are not convinced that the Task Force's recommendation is the correct standard. The Commission should consider an appropriate materiality threshold, which could be based on a percentage of outstanding shares. The threshold could be applied on both an individual and aggregate basis.

We recommend that the exhibit filing requirement be limited to plans under which new awards may be made in the future to any employee or consultant. Thus, plans that are assumed in an acquisition transaction would not be required to be filed unless new awards were permitted to be granted under such plans. We would also exclude from the exhibit filing requirement any tax-qualified retirement plans that meet the requirements of Section 401(a) of the Internal Revenue Code. In addition, individual compensatory arrangements should not be required to be filed unless otherwise required to be filed pursuant to Item 601(d)(10)(A) or (B).

Although our proposed new exhibit filing requirement may result in some additional exhibits being filed by many registrants, we believe that this proposed exhibit filing requirement would not impose an undue burden on issuers, and would provide useful information for those investors who want more detailed information about plans, such as whether the plan permits the granting of below-market stock options or the repricing of outstanding options.

Format for Disclosure

Consistent with the concept of Plain English, we agree that disclosure of equity compensation plans under proposed Item 201(d) (1) and (2) of Regulation S-K should be presented in tabular format, with the modifications described above. A properly constructed table would make the information easier to interpret and to compare with similar information for other companies. Reducing the line items by aggregating plans also would contribute to that objective. We have attached a suggested simplified and revised format for the table as Exhibit A to this letter. This format incorporates our comments in this letter, as well as certain minor changes to column headings and the addition of explanatory footnotes.

The information regarding plans is more appropriately presented in narrative format as required by proposed Item 201(d)(3). As discussed above, we suggest deleting proposed subsection (4) of Item 201(d).

Specific Language Changes

We have attached to this comment letter as Exhibit B revised language for proposed Item 201(d) of Regulation S-K. Conforming changes should also be made to proposed Item 201(d) of Regulation S-B.

We appreciate the opportunity to comment on the Commission's proposals on equity compensation disclosure. Members of the Subcommittees are available to discuss with the Staff the comments contained in this letter.

Respectfully submitted,

Stanley Keller
Chair, Committee on Federal Regulation of Securities

Scott P. Spector
Chair, Subcommittee on Employee Benefits, Executive Compensation and Section 16

Anne (Polly) G. Plimpton
Vice Chair, Subcommittee on Employee Benefits, Executive Compensation and Section 16

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EXHIBIT A

Proposed Revised Table Format

EQUITY COMPENSATION PLAN INFORMATION

	Total Number of Shares as of Fiscal Year End				
Category of Plans	**(a) Authorized for Issuance [1]**	**(b) Remaining Available for Future Grant[2]**	**(c) Subject to Outstanding Options[3]**	**(d) Weighted Average Exercise Price per Share[4]**	**(e) Total Number of Shares Granted During Last Fiscal Year[5]**
Plan(s) and individual arrangements being voted on at this meeting[6]					
Plan(s) and individual arrangements previously approved by shareholders[7]					
Plan(s) and individual arrangements not approved by shareholders[7]					
TOTAL					

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[1] Includes all shares reserved by the Board of Directors for issuance under the plan or individual arrangement over the term of the plan or individual arrangement, whether already issued pursuant to stock awards or option exercises, subject to outstanding but unexercised options or remaining available for future grant of stock awards or options, regardless of whether expired or cancelled awards may be returned to the plan or individual arrangement for future grant. Where the plan or individual arrangement authorizes a percentage of the registrant's outstanding stock in lieu of or in addition to a specified number of shares, this should be indicated by footnote. For plans assumed by the registrant in an acquisition, this number should include only the shares that remain available for future grant of stock awards or options by the registrant following the acquisition.

[2] For each entry in this column, indicate by footnote how many of such shares may be awarded in the form of stock (as opposed to options). This would include stock bonuses and restricted stock that may be sold at less than fair market value.

[3] Also includes shares that are reserved for exercise under outstanding stock appreciation rights ("SARs"), warrants and other rights that may be settled in stock. If the SARs, warrants or other rights are in tandem with options, they are to be accounted for as a single award.

[4] Represents the aggregate exercise price of all outstanding SARs, options, warrants and other rights that may be settled in stock, divided by the total number of shares subject to such outstanding SARs, options, warrants and rights.

[5] Includes (i) shares subject to SARs, options, warrants and other rights that may be settled in stock that were granted under the plan(s) and individual arrangements during the last fiscal year and (ii) shares that were awarded in the form of stock (as opposed to options) under the plan(s) during the last fiscal year. For each entry in this column, indicate by footnote how many of such shares fall into category (ii). If the SARs, warrants or other rights are in tandem with options, they are to be accounted for as a single award.

[6] If no plans are being voted on at the meeting to which the proxy statement relates, this row may be omitted. If a plan amendment is being voted on at the meeting, this row should include information on all shares under the plan, not just the additional shares covered by the amendment.

[7] Do not include plans or individual arrangements that expired or were terminated prior to the last fiscal year unless there are options, SARs, warrants or other rights that remained outstanding under the plan or individual arrangement during the fiscal year.

EXHIBIT B

Proposed Revised Language for Item 201(d)

of Regulation S-K

§229.201 (Item 201) Market price of and dividends on the registrant's common equity and related stockholder matters.

****

(d) Securities authorized for issuance under equity compensation plans.

(1) In the tabular format set forth below, provide the information specified in paragraph (d)(2) of this Item as of the end of the most recently completed fiscal year with respect to compensation plans and individual compensation arrangements of the registrant under which equity securities of the registrant are authorized for issuance, aggregated as follows:

(i) Plan(s) and individual arrangements being voted on at the meeting to which the proxy statement relates;

(ii) Plans(s) and individual arrangements previously approved by shareholders; and

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(iii) Plan(s) and individual arrangements not previously approved by shareholders and not being voted on at the meeting to which the proxy statement relates pursuant to (d)(2)(i) above.

EQUITY COMPENSATION PLAN INFORMATION

[See Exhibit A for chart and footnotes]

(2) The table shall include the following information as of the end of the most recently completed fiscal year:

(i) For each of the three categories of plans and individual arrangements:

(A) The number of securities authorized by the Board of Directors for issuance under the plans and individual arrangements over the term of the plan or individual arrangement, including shares already issued, shares subject to outstanding but unexercised options, stock appreciation rights ("SARs"), warrants and other rights that may be settled in stock, and shares remaining available for future grant of stock awards, options, SARs, warrants and other rights that may be settled in stock, regardless of whether expired or cancelled awards may be returned to the plan or individual arrangement for future grant (column (a));

(B) Other than securities to be issued upon the exercise of outstanding options, SARs, warrants or other rights that may be settled in stock, the number of securities remaining available for future grant of stock awards, options, SARs, warrants and other rights that may be settled in stock under the plans and individual arrangements (column (b)).

(C) The number of securities issuable upon the exercise of outstanding options, SARs, warrants and other rights that may be settled in stock under the plans and individual arrangements (column (c));

(D) The weighted average exercise price of the outstanding rights set forth in column (c) (column (d)); and

(E) The number of securities issued pursuant to equity awards made under the plans and individual arrangements during the most recently completed fiscal year, plus the number of securities to be issued upon the exercise of options, SARs, warrants or other rights that may be settled in stock granted under the plan during the most recently completed fiscal year (column (e)).

(3) For each plan that was adopted during the most recently completed fiscal year that (i) was not previously approved by the shareholders and (ii) is not being submitted to the shareholders for a vote at the meeting to which the proxy statement relates, describe briefly, in narrative form, the material features of the plan.

Instructions to Item 201(d).

1. For purposes of this paragraph, the term plan shall be defined in accordance with Item 402(a)(7)(ii) of Regulation S-K (§229.402(a)(7)(ii)). Disclosure shall be provided for all plans and individual arrangements that provide for compensatory equity awards to employees, directors, consultants or other service providers.

2. No disclosure is required under this Item with respect to (i) any plan, contract, authorization or arrangement, whether or not set forth in any formal documents, for the issuance of warrants or rights on substantially similar terms to all security holders of the registrant generally that does not discriminate in favor of officers or directors of the registrant; (ii) plans or arrangements relating to awards that are not accounted for under SFAS 123 or APB 25; or (iii) plans that are qualified under ERISA and tax-qualified retirement plans that meet the requirements of Section 401(a) of the Internal Revenue Code.

3. Except where it is part of a document that is incorporated by reference into a prospectus or report, the information required by this paragraph (d) need not be provided in a registration statement filed under the Securities Act of 1933 or in a report filed under the Securities Exchange Act of 1934.

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February 9, 2001

Richard Aber, Senior Vice President
Sara Nelson Bloom, Associate General Counsel
The Nasdaq Stock Market, Inc,
1801 K Street, NW, 8th Floor
Washington, DC 20006

Re: Nasdaq Request for Comments on Stock Options Proposals

Dear Mr. Aber and Ms. Bloom:

This letter has been written by the undersigned, each of whom is a member of the Subcommittee on Employee Benefits, Executive Compensation and Section 16 of the Committee on Federal Regulation of Securities of the Business Law Section of the American Bar Association ("ABA") or of the Federal Regulation of Securities Subcommittee of the Employee Benefits Committee of the Tax Section of the ABA, in response to the invitation by The Nasdaq Issuer Affairs Committee for comments on a proposal (the "Proposal") to change listing standards regarding shareholder approval of equity compensation plans and specifically the possible adoption by The Nasdaq National Market ("Nasdaq") of standards for Nasdaq issuers similar to those in the Proposal. The Proposal includes a possible approach to a dilution standard developed by a task force (the "Task Force") of the New York Stock Exchange ("NYSE") at the direction of the Securities and Exchange Commission ("SEC") which, we understand, has not been approved by the NYSE Board at this time, pending further discussion with the SEC and Nasdaq. This letter represents our individual views and not those of the ABA, either of the Sections or any of their committees or subcommittees.

In summary, we believe it is not necessary to make changes to the existing system for shareholder approval of equity compensation plans until there has been an opportunity to obtain the benefits of the new disclosure rule proposed by the SEC in Release No. 33-7944; 34-43892 (the "Release"). We believe that the enhanced disclosure about equity compensation plans contemplated by the Release will address some of the shareholder concerns that have been expressed by giving shareholders a more accurate picture of the entire landscape of equity compensation, enabling them to have a more meaningful role in the shareholder approval process and increasing corporate accountability. The information made available by the enhanced disclosure will assist in identifying whether there are potential abuses of existing rules and allow for a more thorough analysis of potential dilution. This in turn will help identify what further rulemaking is required to address shareholder concerns while preserving management flexibility.[1]

[1] Although we recommend deferring action on certain aspects of the Proposal, we wish to acknowledge the efforts made, and contribution to the public dialog on this issue of concern to institutional investors and of critical

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We believe that equity compensation plans primarily for executive officers and directors should continue to be approved by shareholders. However, we believe that Nasdaq Market Place Rule 4310(a)(25)(H) (the "Nasdaq Rule"), modified and clarified as we discuss below, remains the appropriate standard for shareholder approval of equity compensation arrangements at this time. The Nasdaq Rule, combined with the customary corporate governance practice of requiring independent director approval of awards to executive officers and the disclosure proposals referred to above, provides shareholders of Nasdaq issuers with protection from the potential for self-dealing.

We are concerned that Nasdaq's adoption of the Proposal at this time, particularly the requirement for shareholder approval for all equity awards that exceed a single, arbitrary threshold dilution level, even if no directors or officers are participating, could handicap management of Nasdaq issuers and substantially disadvantage those issuers compared to mature industrial companies, where equity awards are typically not as widespread through the employee population, and to private companies, which are not subject to similar rules. The Proposal's restrictions, in our judgment, would raise serious issues of corporate governance that require further consideration with the benefit of additional information, since they would intrude on management's flexibility in designing compensation arrangements that meet a particular company's competitive needs.

Detailed reasons for our views are set forth below.

A. Proposed Disclosure Enhancements; Release No. 33-7944; 34-43892

The NYSE Task Force has confirmed that it is difficult to obtain accurate information about the level of dilution from equity compensation plans. The requisite information is not consistently available in any one place or format in corporate disclosure documents and is not currently mandated by specific SEC disclosure requirements. To address this concern, the Task Force designated a special drafting group that developed proposed changes in SEC disclosure standards to remedy the dilution information gap. The Task Force recommended that the NYSE formally propose to the SEC that the disclosure requirement relating to equity compensation contained in SEC Regulation S-K be amended.

The disclosure changes proposed by the Task Force would, for the first time, give shareholders and analysts, in one place, the information relevant to making their own dilution calculations. These changes would facilitate both analysis and application of institutional investor dilution guidelines in voting decisions. The Task Force indicated that it believed these disclosure changes would enhance the ability of investors to analyze equity compensation arrangements and would have a beneficial impact on shareholder education and effective corporate governance. In addition to providing needed information to evaluate dilution, the proposed

importance to corporate governance, by the NYSE through the two years of work of its Task Force and the academic studies it commissioned.

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changes to disclosure would permit investors to determine which plans have previously been approved by shareholders and enable them to obtain copies of all compensation plans and arrangements involving significant equity awards.

The Release adopts some, but not all, of the disclosure proposals that the NYSE Task Force made. Although we have not yet fully evaluated the proposals contained in the Release and may recommend to the SEC certain modifications, including inclusion of certain additional disclosures contemplated by the Task Force, we believe that these proposed changes move in the right direction. The additional disclosure will assist shareholders who wish to understand equity compensation arrangements more fully and will promote greater management accountability for equity awards. Most importantly, it will also provide valuable information to determine whether rule changes are necessary and, if so, what form they should take.

B. Continued Appropriateness of Nasdaq's Current Rule

The Nasdaq Rule requires shareholder approval for plans that include officers and directors, and we generally agree with this requirement as a way of addressing concerns about self-dealing. There is an exception to this requirement for broad based equity plans, which Nasdaq has interpreted as plans in which a majority of the participants are not officers or directors. Through this exception, Nasdaq issuers are permitted to adopt equity plans for rank and file employees, which plans may also include officer and director participants provided they do not receive a majority of the grants. In the past there has been some uncertainty about the application of the Nasdaq Rule necessitating ad hoc determinations based on conversations with Nasdaq staff members. Nasdaq should take this opportunity to codify its interpretation of the broad based plan exception, with the changes suggested below.

The NYSE version of the broad based plan exception provides that:

(1) at least a majority of the company's full-time employees in the United States, who are "exempt employees," as defined under Fair Labor Standards Act of 1938 (i.e., employees who are exempt from being paid for overtime), must be "eligible to receive stock or options under the plan" and

(2) at least a majority of the shares of stock or shares of stock underlying options awarded under the plan, during the shorter of the three-year period commencing on the date the plan is adopted by the company or the term of the plan, must be awarded to employees who are not officers or directors of the company.

The first requirement of the definition prescribes a numerical eligibility test against which the qualification of a plan as "broadly-based" is to be measured. The second requirement of the definition contains a usage test, which seeks to ensure that stock options and similar grants will be broadly dispersed within the broad based plan. The new SEC disclosure rule is likely to affect

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to some degree current practices under these requirements. Subject to the experience gained under the new rule, we would make the following recommendations:

First, we suggest that Nasdaq consider increasing the percentage of shares that must be granted to employees who are not officers or directors (to an amount such as 80% of the plan). This change would reduce the circumstances under which these plans could be used for inappropriate self-dealing. Second, we suggest that the employee base against which the eligibility test is to be applied should not be determined by reference to "non-exempt" employees as defined in the Fair Labor Standards Act of 1938 because that is not easy to understand and not an appropriately "abroad" standard.[2] This change would not only make the rule easier to understand, but would be more appropriate for Nasdaq issuers, which generally do not maintain alternate compensation arrangements for these employees. Third, Nasdaq should require that all plans that have not been approved by shareholders be approved by independent directors. This would ensure that self-dealing would be minimized. Fourth, we recommend measuring compliance over a rolling three year period throughout the life of the plan rather than over the period of three years or the life of the plan if shorter, a change which we understand that the NYSE has just proposed. Finally, Nasdaq should take this opportunity to codify its view of the definition of an "officer."

We believe that the broad based plan exception has been operating in the manner intended, and that there is little or no evidence that these plans have been abused by Nasdaq issuers. Further, while the NYSE broad based plan exception would require that only a majority of the company's full-time employees be eligible to participate and that a majority of the shares be awarded to employees who are not officers or directors, our experience is that our Nasdaq issuer clients generally do not permit officers or directors to participate in discretionary broad based plans. Moreover, we believe that most Nasdaq issuers, for corporate, securities law and tax reasons, have generally permitted officers and directors to receive significant equity awards only pursuant to shareholder approved plans.

C. The Need for Directors and Management to Retain Flexibility in Equity Compensation

The Nasdaq Rule appropriately balances the potential for inappropriate self-dealing and the requirement of the board of directors and management of a company to operate the company on a day-to-day basis. The management of the business of a corporation, including the responsibility for retaining and providing incentives to key employees, is charged to the board of directors and the officers of the corporation. Responsibility for awards to senior officers of the corporation is typically assigned to the corporation's board of directors or compensation committee. Failing to attract and retain key employees capable of developing and executing the

[2] In general "exempt" employees are salaried employees in an executive, administrative or professional capacity. According to the Department of Labor statistics cited in SEC Release 34-41479 (June 4, 1999) approximately 25% of employees are "exempt" as defined under the Fair Labor Standards Act. Thus a plan could be "broad based" under the NYSE exception if only 12.5% of the employees are eligible.

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appropriate corporate strategy would have a material adverse effect on the business of a corporation.

We are concerned that adoption of the Proposal for Nasdaq issuers would be inconsistent with sound corporate governance principles and could place material limitations on the directors' authority to determine and provide appropriate compensation to key employees and impair their ability to take actions that are necessary to protect and promote the interest of the company and its shareholders. In today's competitive employment market, companies often need to act swiftly to hire and retain quality employees. Due to the increasing demand for qualified employees, a company's inability to offer competitive compensation packages to existing or potential employees (without waiting for the next shareholders' meeting) may result in material employee attrition and jeopardize the company's ability to manage its business and its growth. Management needs sufficient flexibility in this area to implement programs that are in the ultimate best interests of shareholders.

Moreover, with respect to the senior officers of the corporation, the directors and, particularly the independent compensation committee, are most qualified to determine at any point when an increase in overall shareholder value resulting from equity grants to key employees outweighs any share ownership dilution that may result from increases in the number of shares authorized under equity compensation plans. If shareholders believe that the directors' actions are inappropriate, they can take that into account when the directors stand for reelection or when the company submits future compensation proposals for shareholder approval.

There are often significant barriers to obtaining shareholder approval, within or without the annual meeting context. The need to add shares to a plan often arises unexpectedly, such as following a corporate acquisition where equity awards are granted to the new employees retained in the post-acquisition combined company. The Nasdaq Rule enables a company to grant shares following an acquisition. To require special meetings to approve a share reserve increase because of the acquisition, where shareholder approval of the acquisition was not otherwise required or contemplated, would unduly restrict the issuer in accomplishing the acquisition.

The Nasdaq Rule also permits Nasdaq issuers to react in a timely manner to competitive market situations where, for example, an industry or market-wide stock price decline occurs (such as occurred after March 2000), where the issuer urgently seeks to retain employees who may have competing job offers. The alternative of requesting shareholder approval is not feasible when time is of the essence. Awards that are contingent on shareholder approval trigger adverse accounting consequences. FASB Interpretation No. 44, interpreting APB 25 "Accounting for Certain Transactions Involving Stock Compensation," issued in March, 2000, specifically provides that a company that issues equity awards subject to shareholder approval would be required to accrue a compensation charge if the value of the company's equity increases between the date of the equity award and the date of shareholder approval. Having an adequate pool of shares available for additional grants to key employees is even more important because repricing

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of outstanding options may no longer be an acceptable alternative due to accounting as well as corporate governance concerns.

Simply stated, the Nasdaq Rule should be retained substantially in its present form with the modifications we suggest above, pending implementation of improved disclosure.

D. Problems with a One-Size-Fits-All Dilution Cap for Nasdaq Issuers

We are not commenting in this letter on the merits of the Proposal for NYSE issuers. Rather, even if the Proposal were appropriate for NYSE issuers, we believe there are differences in the nature of the typical Nasdaq issuer that make the Proposal unsuitable for Nasdaq issuers. A larger number of Nasdaq issuers will be a younger, rapidly growing company, which may only recently have become a publicly held company. There is a large spectrum of development among Nasdaq issuers; some would qualify to list on the NYSE, others are barely able to maintain their Nasdaq listing. Nasdaq issuers tend to be technology-based companies, where equity incentive compensation has generally played a larger role. One of the assumptions of the current NYSE rule is that the employees of NYSE companies who are excluded from the broad based plans are compensated by other forms of compensation or benefits, such as cash, medical benefits or retirement packages. Employees of Nasdaq issuers, unlike the employees of the more mature issuers on the NYSE, generally receive a higher proportion of their compensation in the form of equity compensation. More importantly, these Nasdaq issuers often do not have the cash resources to offer alternative cash compensation arrangements. The use of equity in these companies, particularly in technology sectors, is the standard way of incentivizing and competing for employees. If an issuer does not have sufficient equity available to grant to employees, it is at a critical disadvantage vis-à-vis mature issuers who are more able to use cash-based compensation programs, as well as pre-IPO companies who are free to offer option packages without similar restraints.

The Proposal would require shareholder approval for the adoption of all plans or grants except plans or grants that fall within a ten- percent "basket," measured against the shareholder approved plans. A plan that falls within the ten percent basket is one under which "the maximum aggregate number of shares of stock that could be issued would not exceed, together with the then Potential Dilution of all other plans that have not been approved by shareholders and outstanding "Inducement Options" and "Acquisition Options" (as defined in the Proposal), ten percent of the Potential Dilution of all plans." The Proposal defines the term "Potential Dilution" as "the maximum aggregate number of shares of stock currently authorized for issuance including both the number of shares available for grants and the number of shares underlying outstanding grants (i.e., unexercised and unexpired)".

We do not believe that any one-size-fits-all dilution cap is appropriate for Nasdaq issuers. For a mature company, which has a large market capitalization and whose equity compensation program may not cover the entire work force, a ten- percent basket might be quite generous. Mature companies are much more likely to compensate their workforce in cash and

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other traditional non-equity related arrangements, such as qualified and nonqualified pension plans. However, for less mature companies, most of whose workforce receives a substantial component of compensation in the form of equity compensation, a ten- percent “basket” or even a much larger dilution cap may be too small. The right amount of the cap cannot be easily defined in a one-size-fits all manner, and certainly cannot be arbitrarily defined as only 10% of the company’s shareholder-approved plan.

Moreover, we do not believe it is possible to know what dilution cap would be appropriate in all cases, or to readily define dilution. It should be noted that the Task Force itself, in submitting its report and recommendation to the NYSE, stated that there has been almost no scholarly research on how to measure dilution or identify appropriate levels or “flow rates” of potential dilution caused by stock option and similar equity compensation plans.[3]

We believe that the fact that the Task Force, as illustrated by the conclusions of the Academic Study, was unable to define dilution in a meaningful way indicates that any one-size-fits-all dilution cap approach to non-shareholder approved equity awards would not be appropriate as a general matter and particularly for Nasdaq issuers. Rather, additional information and analysis is needed before a meaningful dilution standard, with the requisite flexibility to accommodate different circumstances, can be developed, should a dilution cap prove necessary.

E. Conclusion

We strongly support the prompt adoption of changes that would require comprehensive disclosure of equity compensation programs in order to provide shareholders with more useful information and enhance corporate accountability. We believe that experience with improved disclosure is necessary before any major changes to the Nasdaq Rule are made.

---

[3] The Task Force commissioned an Academic Study, entitled “Measuring Dilution from Stock-Based Compensation,” that focused on the measurement of dilution to the holdings of existing shareholders and not on the measurement of the value to existing shareholders of the services that might be received in exchange for such dilution.

The Academic Study considered issues including, but not limited to:

(1) whether dilution should be measured on (a) an historical basis to the present, based on actual shares issuances under plans, or (b) on a future basis, either by measuring “overhang” (for example, by measuring options issued and not exercised or expired plus options available for future grants under existing and currently proposed plans) or by measuring “run-rate” (for example, by measuring the annual rate at which options are authorized to be granted in future years);

(2) whether plans that do not involve the issuance of shares, but whose payment is based on share price such as phantom stock and stock appreciation rights plans, should be included in dilution measurements;

(3) whether dilution measurements should include repurchases of shares by companies as an offset to dilution as a general matter and, more specifically, whether the shareholder approval policy should apply to plans funded by treasury shares held by companies;

(4) whether adjustments should be made for dilution measurement purposes to the total number of outstanding shares when that number increases as a result of issuances of shares for cash or to make acquisitions of other companies, or changes as a result of mergers or consolidations; and

(5) whether a dilution standard should include all plans of a company or only those plans that have not been approved by shareholders.

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We also believe that the Nasdaq Rule has worked reasonably well for Nasdaq issuers. We believe it would be premature for Nasdaq to adopt the Proposal for Nasdaq issuers at this time. We are concerned that adoption of the Proposal would interfere with the ability of directors to fulfill their responsibility to manage the business and would competitively disadvantage Nasdaq companies against both mature companies and pre-IPO private companies. Rather, we recommend that Nasdaq await experience with the new disclosure rules and, for the present, consider modifications to the broad based plan exception to increase the percentage of shares that must be granted to employees who are not officers or directors (to an amount such as 80% of the plan), to broaden the employee base, to require that independent directors adopt such plans if officers can participate and to make certain other technical changes and codification to this exception. We believe that these clarifications and changes, together with improved disclosure, will go a long way toward addressing shareholder concerns while additional information and analysis is developed to determine whether further rule changes are necessary.

One or more of the undersigned would be pleased to meet with you, if appropriate, to more fully discuss the views expressed in this letter.

Very truly yours,

Pamela Baker
Sharon J. Hendricks
Keith F. Higgins
Stanley Keller
Gloria W. Nusbacher
Anne G. Plimpton
Louis Rorimer
Ann Yvonne Walker

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DEVELOPMENTS IN SECURITIES LAW DISCLOSURE

JUNE 2001

By

Herbert S. Wander

Katten Muchin Zavis

Chicago, IL

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DEVELOPMENTS IN SECURITIES LAW DISCLOSURE

JUNE 2001

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I. INTRODUCTION

Disclosure has always been central to the federal securities laws. In the beginning, the thrust was focused on disclosure in Securities Act of 1933 ("Securities Act") registration statements. Over time, current ongoing disclosure by public issuers has become an increasingly important topic for a number of reasons: the trading markets have grown exponentially and the Securities Exchange Act of 1934 ("Exchange Act") has been repeatedly strengthened, requiring more issuers to publicly report more frequently.

Once an issuer is public, it must file periodic reports with the Securities and Exchange Commission ("SEC" or "Commission") -- yearly, quarterly, upon the happening of a material event and when proxies are solicited. The trading markets, moreover, demand more frequent disclosure than the SEC mandated reports, namely, press releases, road shows, analyst calls and conferences. Not only does the market expect more current disclosure, it has also shown a great appetite for forward looking information which had been essentially "outlawed" until the 1970's. Corresponding to this growth in current disclosure has been the growth in class action securities fraud cases against issuers, their executives, directors, underwriters and analysts when the price of the stock falls precipitously. The $100 million jury verdict against Apple Computer executives in 1991 shocked Corporate America into an awareness that any arguable mistake in disclosure regarding a multitude of corporate developments could result in personal financial ruin. Although set aside, the verdict illustrated the perils of once-common promotional statements and disclosure practices.

This article identifies emerging trends in securities law disclosure, updates disclosure developments and provides guidance to issuers and their securities law advisors. Timely disclosure and materiality remain bitterly disputed in the courts, even after the Supreme Court's

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[*] Herbert S. Wander is a partner at Katten Muchin Zavis in Chicago. The author thanks Meridith L. Grashoff, an associate at Katten Muchin Zavis, for her help in the recent revisions to this article.

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landmark 1986 decision in Basic Inc. v. Levinson. Subsequent to Basic, the Supreme Court decision in Virginia Bankshares confirmed that management statements of reasons, opinions or beliefs may be actionable as misstatements of material fact.

Attaining a completely safe disclosure policy is virtually impossible. Issuers may take some comfort from various post-Basic cases challenging the disclosure of merger negotiations and other business developments, which confirm the traditional rule that issuers have no general duty to disclose material information simply because it exists. Unfortunately, several cases erroneously suggest that issuers have a continual duty to update statements which, although accurate when made, may have become misleading due to subsequent developments. The courts and Congress, moreover, have recently assisted issuers in satisfying their disclosure obligations as discussed in more detail in this article.

A multitude of disclosure issues are involved, among them:

- Is there a duty to disclose outside of the SEC required filings?
- Are opinions or beliefs of management actionable?
- What information is "material," especially in light of the SEC SAB 99?
- What are the liabilities for publishing forward looking information that does not come true?
- Is there a duty to update previously disclosed information which was accurate when released?
- How does an issuer satisfy its obligations to provide meaningful MD&A?
- Is there an obligation to provide a list of risks factors in public releases and SEC filings and, if so, how are these to be crafted?
- What are the safe harbor boundaries of the Private Securities Litigation Reform Act of 1995 ("Reform Act") for forward looking information?
- How will Regulation FD (Fair Disclosure) impact the market generally, and how will it affect the relationship between issuers and market analysts?

The manner of disclosing corporate developments is currently a much examined topic, as indicated by the passage of the Reform Act and its safe harbor for forward looking statements. Other potential pitfalls are presented by the duty not to mislead, the "Bespeaks Caution" doctrine and the duty to update. These topics are examined in this article in Section III.

The SEC's 1989 Management's Discussion and Analysis Interpretive Release and the

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enforcement actions against Caterpillar, Inc., Bank of Boston and Sony are analyzed in Section IV of the article, evidencing the SEC's continued concern with disclosure matters and, more importantly, indicating that the SEC construes the MD&A as a quarterly disclosure vehicle for all material trends and uncertainties affecting an issuer's results of operation and financial condition.

Financial analysts have taken on a central role in the public offerings of securities and the day-to-day operations of the capital markets. In particular, communications between issuers and analysts ensure that information is widely disseminated in the marketplace, however, with the recent adoption of Regulation FD, which seeks to eliminate the selective disclosure of material information by public companies, the analysts' role in the market may be minimized. The interaction between an issuer and the financial analysts is fraught with risks and issuers should exercise care as described in Section V.

Other topics discussed in this article include road shows (Section VI), Plain English (Section VII), Regulation S (Section VIII), disclosure of management misconduct and government investigations (Section IX), disclosure of stock accumulation programs and "greenmail" negotiations (Section X), disclosure of environmental liabilities (Section XI), settlement in "T+3" (Section XII), and charges to the NASD's "free-riding" interpretation (Section XIII).

In the past, articles addressing disclosure obligations began with a discussion of formal line-item disclosure requirements. In later years, articles began with discussions of materiality as the emphasis shifted to the Supreme Court's decision in Basic. There is now a trend to begin not with Basic, but with a 'basic' discussion of formal disclosure obligations. This article thus opens with a discussion of the formal SEC line-item disclosure requirements and the self-regulatory organizations' disclosure requirements and proceeds to discuss the issues described above.

In November 1998, the SEC published its long awaited "aircraft carrier" release[1] (proposing major changes in the way securities are offered and sold under the Securities Act of 1933) and a companion release (proposing to update and simplify the rules applicable to tender offers, mergers and acquisitions, and other similar transactions) (the "M&A Release").[2] The M&A Release was universally applauded and was adopted in October, 1999, with an effective date of January 24, 2000.[3] The aircraft carrier release, had it been adopted as proposed, would have generated substantial changes to the registration and offerings process. More than a year has passed since the aircraft carrier release and it has not been adopted.

Brian Lane, the Director of the Corporate Finance Division of the SEC, has argued that the benefits of the proposal have been overlooked or discounted, that the criticisms are unduly

1/ SEC Release No. 33-7606 (November 3, 1998).

2/ SEC Release No. 33-7607 (November 3, 1998).

3/ SEC Release No. 33-7760 (October 22, 1999).

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harsh and that the proposal fixes a number of existing serious problems under the Securities Act.[4] The proposal has generated considerable controversy, and will not be adopted in its current form. Recognizing that the aircraft carrier release is in trouble, Brian Lane reemphasized in a farewell address to the ABA Committee on Federal Regulation of Securities just prior to retirement that broad reform, as proposed by the aircraft carrier release, is appropriate rather than patching the current system. He goes on to suggest that perhaps a series of separate proposals might be more acceptable than the aircraft carrier release and suggests seven possible areas for achieving a possible consensus, namely, board certification, pre-sale delivery of prospectus, filing transactional information, filing written communications, secondary shelf registrations, Exxon Capital transactions and disqualifications for certain persons.[5] This article does not discuss these releases.

II. DISCLOSURE 2001

An analysis of the case law reveals that there is neither a judicial nor a statutory requirement that issuers disclose material information simply because it exists.[6] There are three limited exceptions to the general rule that issuers have no affirmative duty to disclose. Issuers must disclose material facts only:

(1) as mandated by a line-item of an SEC periodic report;

(2) prior to trading in their own securities; and

(3) to correct a prior statement that remains viable in the market and was inaccurate at the time it was made.

Of course, Basic and the cases discussed below also teach that once an issuer chooses to make any public statement as to any material fact, it undertakes a duty to speak truthfully and not mislead. In addition, the recent SEC Staff Accounting Bulletin on materiality imposes on the company and its auditors the potentially onerous duty to look at the entirety of statements made

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4/ See *Remarks by* Brian Lane at the Nineteenth Annual Ray Garrett, Jr., Corporate and Securities Law Institute/The Corporate Counsel Center of Northwestern University School of Law held April 22, 1999, entitled "The Securities Act Reform Project: Improving Capital Formation in Our Markets." (Web site http://www.sec.gov/news/speeches/spch275.htm).

5/ See "Views Into the Crystal Ball," by Brian Lane, given at the American Bar Association Committee on Federal Regulation of Securities on November 13, 1999.

6/ See Basic v. Levinson, 479 U.S. 880 (1988); Staffin v. Greenberg, 672 F.2d 1196 (3d Cir. 1982); SEC v. Texas Gulf Sulphur, 401 F.2d 833 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969). A good faith decision by management to delay disclosure of material developments during the interim between periodic reports is protected by the business judgment rule. This rule is especially appropriate where the information has not been verified sufficiently to give management full confidence in its accuracy. See e.g., Financial Indus. Funds v. McDonnell Douglas Corp., 474 F.2d 514 (10th Cir. 1973), cert. denied, 414 U.S. 874 (1973) (issuer's decision to delay announcement of steep drop in interim earnings was a reasonable exercise of business judgment).

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together to determine whether or not misstatements are material.[7]

Although the Securities Act and the Exchange Act do not impose general affirmative disclosure obligations, they do contain mandatory filing and reporting requirements. In addition to the periodic disclosure requirements promulgated by the SEC under the Securities Act, there are three other general sources pertaining to disclosure obligations for a public company: (1) the antifraud provisions of the federal securities law (primarily Rule 10b-5); (2) the requirements of the various self-regulatory organizations (i.e., New York Stock Exchange, American Stock Exchange, Nasdaq National Market); and (3) state law. The SEC periodic disclosure requirements and the requirements of the various self-regulatory organizations will be discussed briefly below.

A. The "Line-Item" Duty to Disclose

1. SEC Filing Requirements

Section 12 of the Exchange Act requires the registration of certain securities with the SEC. Once a company registers with the Commission under Section 12, the company is required thereafter to file a Form 10-K on an annual basis, a Form 10-Q on a quarterly basis, and a Form 8-K upon the occurrence of certain significant events. To augment periodic reporting disclosures, the SEC has adopted the MD&A, Item 303 of Regulation S-K, which requires issuers to provide information in the periodic reports on financial conditions, operations and prospects in light of recent corporate developments.[8]

a. Form 10-K

An issuer must file its annual report within 90 days after its fiscal year-end on Form 10-K. Form 10-K includes full, audited financial statements. In addition, Item 1 of Form 10-K requires a description of the registrant's business in accordance with Item 101 of Regulation S-K. Item 3 requires, in accordance with Item 103 of Regulation S-K, a description of material pending legal proceedings outside the ordinary course of business, to which the issuer or subsidiary is a party. Item 7 requires the registrant to include an MD&A section, in accordance with Item 303(a) of regulation S-K. This includes a description of current and historical information, as well as trends and forward looking information (see discussion infra Section IV).

7/ SEC SAB 99: Materiality August 12, 1999 (hereinafter referred to as "SAB 99") .

8/ See discussion infra Section IV.

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b. Form 10-Q

An issuer must also file its quarterly reports within 45 days after the end of each of the first three quarters of the issuer's fiscal year on Form 10-Q. Form 10-Q, among other things, requires the issuer to disclose any material changes in the company's financial condition with respect to the most recent fiscal year-to-date period.

c. Form 8-K

After the occurrence of certain material developments, an issuer must file a Form 8-K within either 15 days or 5 days, depending on the event. These material developments include: (1) change in control of registrant; (2) acquisition or disposition of assets; (3) bankruptcy or receivership; (4) changes in registrant's certifying accountants; (5) other events "that the registrant deems of importance to securities holders"; (6) resignations of registrant's directors; (7) financial statement and exhibits; and (8) change in fiscal year.

2. Self-Regulatory Organizations' Disclosure Obligations

The timely disclosure policies of the stock exchanges and NASD probably provide the most definite expression of an affirmative duty to disclose. These policies are stated below.

a. The New York Stock Exchange

The New York Stock Exchange ("NYSE") Listed Company Manual states that listed companies are "expected to release quickly to the public any news or information which might reasonably be expected to materially affect the market for its securities."[9] This duty is not absolute, however. Under certain circumstances, there may be valid business reasons to delay certain disclosures. In these cases, the company should "weigh the fairness to both present and potential shareholders who at any given moment may be considering buying or selling the company's stock."[10]

[9/] NYSE Listed Company Manual §202.05.

[10/] Id. at § 202.06(A).

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b. The American Stock Exchange

The American Stock Exchange ("ASE") similarly provides for a timely disclosure obligation and a business judgment exception. As noted in the ASE Company Guide: "A listed company is required to make immediate public disclosure of all material information concerning its affairs, except in unusual circumstances."[11] "Unusual circumstances" may include instances "[w]hen immediate disclosure would prejudice the ability of the company to pursue its corporate objectives" or when the facts of a situation are in a "state of flux and a more appropriate moment for disclosure is imminent."[12]

c. Nasdaq National Market

The Nasdaq National Market ("Nasdaq") requires companies whose securities are registered with it to "make prompt disclosure to the public through the news media of any material information that would reasonably be expected to affect the value of its securities or influence investors' decisions . . . "[13]

The SEC, however, has approved an amendment to these requirements. As of April 15, 1994, issuers need not make public disclosure of material events "where it is possible to maintain confidentiality of those events and immediate disclosure would prejudice the ability of the issuer to pursue its objectives."[14]

B. Informal Disclosures -- What the Courts Are Saying

The Supreme Court's decision in Basic Inc. v. Levinson[15] remains the most important decision on materiality and timely disclosure since 1988. The Basic decision confirmed that issuers may refuse to comment on pending merger negotiations, but may not deny the existence of, or otherwise affirmatively mislead investors regarding the terms of, any existing negotiations. Because the decision also adopted the "fraud-on-the-market" theory as a substitute for proof of direct reliance, it is especially important that issuers and their counsel understand the Basic opinion and formulate a coherent policy

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11/ ASE Company Guide § 401(a).

12/ Id. at § 402, 4-3 to 4-4.

13/ NASD Manual, Rule 4310(c)(16).

14/ Rel. No. 34-33510 (Jan. 24, 1994), 59 Fed. Reg. 4736 (Feb. 1, 1994).

15/ 108 S. Ct. 978 (1988). For a detailed analysis of the Basic decision, see Herbert Wander & Russell Pallesen, Timely Disclosure After Basic, 21 Sec. & Com. Reg. 109 (1988).

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regarding the timing and content of corporate disclosure. The Basic decision and the Supreme Court's subsequent decision in Virginia Bankshares are summarized below, together with several Court of Appeals decisions which apply the Supreme Court's rulings on materiality and timely disclosure in a preliminary merger or takeover context.

1. Basic Inc. v. Levinson

In Basic, plaintiffs, who had sold their Basic stock in the open market shortly before Basic's merger with Combustion Engineering, Inc. was announced, claimed that Basic's failure to disclose the existence of preliminary merger negotiations with Combustion Engineering violated Rule 10b-5. The plaintiffs also alleged that Basic had defrauded them by making public "no corporate developments" statements while actually engaged in merger talks. Basic maintained that the merger discussions were not material and that the company was not subject to a duty to disclose because it was not trading in its securities.

a. Materiality

With respect to materiality under Rule 10b-5, the Supreme Court in Basic:

- Rejected the notion that merger negotiations are not, as a matter of law, material until the parties reach an agreement-in-principle on price and structure.[16]

- Determined that the materiality of contingent or speculative events, such as merger negotiations, must be determined on a case-by-case basis and "will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity."[17]

- Confirmed that an omitted fact is material if there is a substantial likelihood that a reasonable investor would have considered it important "as having significantly altered the total mix of information made available."[18]

16/ But see infra Section IV.B.2.

17/ 108 S. Ct. at 987 (citing SEC v. Texas Gulf Sulphur, 401 F.2d 833 (2d Cir. 1968)).

18/ Id. at 983 (citing TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)).

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b. Duty to Disclose

Although the Supreme Court specifically elected not to address what it described as "the rubric of an issuer's duty to disclose," properly interpreted, the Basic decision does provide considerable guidance regarding appropriate disclosure conduct. More specifically, the Supreme Court in Basic:

- Indicated in a footnote that issuers may refuse comment regarding impending mergers.
- Noted that "no comment" statements are generally the functional equivalent of silence and, absent a duty to disclose, are not misleading under Rule 10b-5.
- Left undisturbed the general rule that, absent insider trading or prior inaccurate disclosures, issuers need not make interim disclosure regarding corporate events, even if material.[19]
- Determined that an issuer which voluntarily chooses to make any public statement as to a material fact, such as a "no corporate developments" statement, undertakes a duty to speak truthfully and not mislead.
- The Supreme Court held that Basic's "no corporate developments" statements may have violated the duty not to mislead, and remanded the case to the district court for a determination whether the merger discussions were material under the probability/magnitude balancing test, based upon all the facts and circumstances.

2. The Progeny of Basic

The Supreme Court's Basic decision, as expanded by Virginia Bankshares, discussed below, obligates lower courts to undertake a fact-intensive, case-by-case inquiry to determine the materiality of contingent corporate developments such as merger negotiations. Commentators feared that the Supreme Court's fact-specific materiality analysis would preclude dismissal of many Rule 10b-5 actions on a motion for summary judgment. Coupled with the Supreme Court's adoption of the fraud-on-

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[19] Since the right to deny comment regarding material corporate developments presumes that issuers have no initial duty to disclose, the Supreme Court implicitly rejected the notion of a general duty to disclose by sanctioning the "no comment" response to merger inquiries.

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the-market theory of reliance, which facilitates certification of securities fraud class actions, it was suggested that the decision would flood the federal courts with a wave of securities fraud lawsuits.

Clearly, there has been a significant increase in the number of cases filed challenging corporate disclosure practices since Basic. However, in the takeover context, the lower courts generally have applied the Basic analysis to alleged omissions relating to merger negotiations in a manner consistent with traditional concepts of materiality and timely disclosure.

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a. No Duty to Disclose

i) Taylor v. First Union Corporation of South Carolina

The Fourth Circuit determined in Taylor v. First Union Corporation of South Carolina[20] that defendants First Union Corporation and Southern Bancorporation, Inc. had no obligation under Rule 10b-5 to disclose highly tentative merger discussions prior to plaintiffs' sale of their Southern stock to First Union. The Fourth Circuit reversed a jury verdict and entered judgment for the defendant banks after determining that discussions between the two banks regarding the possibility of a merger were too preliminary, contingent and speculative to be considered material under the probability/magnitude balancing test adopted in Basic.

In February 1984, after a bitter dispute, Southern forced Bennie Taylor to resign as a director and agreed to repurchase the Taylors' Southern stock. However, after Southern refused to repurchase the Taylors' shares above the market price, the Taylors initiated negotiations with First Union and eventually sold their Southern stock to First Union for $18 per share. First Union neglected to advise the Taylors that First Union had previously approached Southern to discuss a merger between the two banks if interstate banking ever became legal in South Carolina. Sixteen months later, after interstate banking was declared constitutional, First Union renewed its discussions with Southern and eventually purchased all outstanding stock of Southern for $33 per share. The Taylors sued both Southern and First Union, claiming that the banks had conspired to withhold from them information regarding the potential merger in order to acquire their shares at less than true value.

This case is not typical of disclosure disputes. It did not involve alleged omissions or misrepresentations by an issuer repurchasing its own shares; rather, the issue was whether one company could purchase shares of a second company from the second company's shareholders without disclosing that it had contacted the second company regarding a possible merger. The court determined that First Union had no general duty to disclose material facts, under either South Carolina state fiduciary laws or federal securities laws, prior to purchasing stock of Southern from

[20] 857 F.2d 240 (4th Cir. 1988), cert. denied, 489 U.S. 1080 (1989).

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a Southern shareholder.[21] Although the Fourth Circuit recognized that a merger is of unique significance in the life of a corporation, the court stated:

> Those in business routinely discuss and exchange information on matters which may or may not eventuate in some future agreement. Not every such business conversation gives rise to legal obligations.[22]

The court also noted that First Union had made no prior statements to the Taylors that would have been rendered misleading by First Union's failure to disclose the merger contacts.

The Fourth Circuit also held that the merger discussions were not material under the Basic standard. The court noted that not only had there been no agreement on price and structure, but there was no evidence of board resolutions, actual negotiations, or instructions to investment bankers to facilitate a merger. Furthermore, the merger was contingent upon a change of banking laws beyond the control of the parties. The court concluded that the discussions, at most, resulted in a vague agreement to establish a relationship.[23]

ii) Jackvony v. RIHT Financial Corporation

The First Circuit applied the Basic analysis in a more traditional manner in Jackvony v. RIHT Financial Corporation,[24] a case arising from the stock/cash election merger of Columbus National Bank into Hospital Trust. Mr. Jackvony, a shareholder

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21/ See also Holstein v. Armstrong, 751 F. Supp. 746 (N.D. Ill. 1990), where the court held that officers and directors of UAL did not violate Rule 10b-5 by failing to publicly disclose a takeover proposal by Marvin Davis because defendants had not traded UAL stock and had not made misleading statements regarding the takeover proposal. The court noted that Basic had held that material information need not always be disclosed and that, absent a separate duty to disclose, silence could not be considered "misleading" in and of itself.

22/ 857 F.2d at 244.

23/ Had the Taylors sold their stock to Southern, as initially intended, Southern may have had a duty to disclose material information because it would have been trading in its own securities. See SEC v. Texas Gulf Sulphur, 401 F.2d 833 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969) (insiders must disclose material information or abstain from trading). The Fourth Circuit's materiality analysis would then have been more critical to the outcome of the decision.

24/ 873 F.2d 411 (1st Cir. 1989).

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of Columbus, claimed that Hospital Trust should have disclosed its "general interest" in facilitating a future merger with a larger bank prior to closing the acquisition/merger with Columbus. He alleged that had he known that Hospital Trust considered itself a potential takeover target at the time of the merger he would have elected to take more Hospital Trust shares instead of cash for his Columbus stock. Hospital Trust eventually was acquired at a premium by another bank.

The First Circuit affirmed a directed verdict for Hospital Trust, holding that a company's "general interest" in a merger could not be considered material information absent specific "pre-merger" events. Hospital Trust did consider itself a potential takeover target and officers and directors of Hospital Trust had discussed amongst themselves the possibility of seeking a merger with another bank as a defensive tactic. However, unlike the situation in Basic, Hospital Trust had not received any concrete offers and had not engaged in specific discussions with a potential suitor. Rather, Hospital Trust directors and officers had merely expressed concern internally about being acquired in the broader context of considering various options for the future. In addition, due to the environment of deregulation and uncertainty regarding interstate banking, the informed public was aware of the general possibility of mergers and acquisitions in the banking industry. Therefore, the court concluded that Hospital Trusts' alleged omissions could not have altered the "total mix" of information available to investors.

iii) Hartford Fire Insurance Company v. Federated Department Stores, Inc.

In the celebrated decision of Hartford Fire Insurance Company v. Federated Department Stores, Inc.,[25] the District Court for the Southern District of New York confirmed that under the Basic approach, pre-negotiation merger prospects or hypothetical takeover possibilities would not be considered material for Rule 10b-5 purposes. In Hartford, bondholders of Federated Department Stores sued, claiming that Federated had failed to disclose in the bond offering the possibility that Federated could be acquired in a highly leveraged takeover which would increase the risk of the bonds. Federated had considered itself a

[25] 723 F. Supp. 976 (S.D.N.Y. 1989).

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takeover candidate for some time before the issuance of the bonds, and was eventually acquired by Campeau U.S. in a highly leveraged hostile transaction. Shortly thereafter the investment grade of the bonds plummeted from low-risk to "junk" status.

The district court noted the novelty of the factual context in Hartford, but determined that the inquiry was still quite "basic" — was the omitted information material in light of the totality of facts and circumstances? The district court first examined the probability that a takeover of Federated would occur. Because Federated had shown no interest in being acquired and had even implemented defensive measures to thwart a potential bidder, the court found a low probability that another company would acquire Federated. At the time Federated issued the bonds, no bidder had been identified and no discussions had occurred. Furthermore, as in Taylor, the court found that the consummation of a takeover was ultimately beyond Federated's control. In sum, a takeover of Federated was speculative and contingent.

As for the potential magnitude of any future takeover of Federated, the court noted that Federated could not have determined the structure of a takeover, the amount of debt an acquirer would cause Federated to incur, or the effect of any transaction on the investment grade of the bonds. Finally, the court found that the omitted information would not have altered the "total mix" of information available to investors because Federated had long been considered an attractive takeover candidate, both in the press and in the financial community.

The district court quoted Jackvony at length and concluded that its decision was on "all fours" with Jackvony. In both cases a general concern about possible acquisitions existed, but was not disclosed, no specific pre-merger events had occurred, and the investing public was aware of the takeover environment of the industry.[26] In response to plaintiff's argument that the fact-intensive nature of the Basic inquiry precluded summary judgment, the district court noted that the Supreme Court in Basic

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[26] 723 F. Supp. at 988-89; See also Savage v. Federated Department Stores, Inc. Retirement Income & Thrift Incentive, Civ. Act. No. 88-4444 (D.N.J.), aff'd, 893 F.2d 1331 (3d Cir. 1989) (omitted information cannot be considered misleading, and thus give rise to a duty to disclose, if that information is already available in the marketplace). For a detailed analysis of this proposition in fraud-on-the-market cases, see In re Apple Securities Litigation, 886 F.2d 1109 (9th Cir. 1989), cert. denied, Schneider v. Apple Computer, Inc., 110 S. Ct. 3229 (1990), discussed infra Section III.B.1.

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specifically stated that summary judgment would be appropriate where a prospective merger was too inchoate to be material.

b. The Duty Not to Mislead

i) In re Columbia Securities Litigation

The case of In re Columbia Securities Litigation[27] is a misguided decision that, nonetheless, illustrates that the right to remain silent is not a license to mislead. Former Columbia shareholders who sold their shares in the open market prior to the merger of Columbia and Sony sued Sony and its Chairman and President challenging that Sony defrauded them by falsely denying the existence of ongoing merger discussions with Columbia. The plaintiff's case was based on three separate public statements made by Sony in Forbes, the New York Times, and in a Reuters dispatch which specifically and affirmatively denied that any merger negotiations with Columbia had occurred. The district court denied the defendant's motion to dismiss, finding that the statements made by Sony were potentially misleading.[28] Additionally, the court rejected Sony's argument that the merger discussions were immaterial as a matter of law because the possibility of completing the merger had not reached a "more likely than not" status.

The most disturbing aspect of this case is the absence of any basis for finding that Sony owed any fiduciary duties whatsoever to the shareholders of Columbia. This case is similar to the Taylor case, discussed above, where the court correctly held that an acquiring company owes no general duty to disclose to the shareholders of a target company. The only difference is that in Taylor the acquiring company remained silent regarding merger discussions, while in this case, Sony made voluntary statements falsely denying the existence of discussions.

Courts have found a duty not to mislead in the private context where parties sit down in face-to-face negotiations for the purchase of securities.[29] Columbia represents the first decision

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27/ 747 F. Supp. 237 (S.D.N.Y. 1990).

28/ In a later opinion in this litigation, Fed. Sec. L. Rep. (CCH) ¶98,238 (S.D.N.Y. 1994), the District Court once again rejected Sony's arguments and denied its motion for summary judgment on the same grounds.

29/ See e.g., Rowe v. Maremont Corp., 850 F.2d 1226 (7th Cir. 1988); Folger Adam Co. v. PMI Indus. Inc., Fed. Sec. L. Rep. (CCH) ¶ 96,131 (2d Cir. 1991). For a discussion of disclosure obligations in the

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where such obligations would be imposed in the public context through the fraud on the market theory — even though Sony and the plaintiffs never were party to a securities purchase transaction. Given that tender offer rules impose specific and strict guidelines of conduct in the public arena, the decision in Columbia appears an unwarranted extension of the fraud on the market theory.

ii) SEC v. Borman

In 1991, the SEC initiated proceedings against the former Chairman and CEO of Borman's alleging that he violated the securities laws by causing the company to issue a "no corporate developments" press release while actually engaged in acquisition negotiations with Great Atlantic & Pacific Tea Company. The press release challenged in SEC v. Borman[30] was made in response to an inquiry by the New York Stock Exchange. The company denied knowing the reason for increased activity in the company's stock when, in fact, it was pursuing merger talks with A&P. Although the company did not affirmatively deny that it might seek an acquisition in the future, by abandoning a strict "no comment" approach the company provided the SEC with a basis to initiate a civil action proceeding. The case reaffirms the importance of consistently maintaining a "no comment" posture while in the midst of merger talks.

c. Slips of the Tongue and Pen Are Dangerous

As the following cases demonstrate, one or two line statements in live interviews can result in serious consequences for the issuer when its officials respond to questions regarding merger discussions and plans. The same is true for short written statements that are basically true and are probably not meant to deceive, but can be interpreted in more than one manner. The Buxbaum and MCI cases illustrate the pitfalls of oral answers in an interview. The Quaker decision on remand, however, involves

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private context, see Herbert Wander & Russell Pallesen, Securities Law Disclosure by Public and Private Companies, 4 The Corp. Analyst 1, 9 (1991).

[30] Civ. Act. 91-0567 (D.D.C. 1991).

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written statements concerning the company's "guideline" for its debt to capitalization ratio.[31]

i) Buxbaum, et al. v. Deutsche Bank, A.G., et al.

The U.S. District Court in the Southern District of New York broadly interpreted Basic as protecting shareholders from offhand remarks given in any interview in Buxbaum v. Deutsche Bank, A.G.[32] In an interview with a foreign publication, the CEO of Deutsche Bank denied talks of a takeover of Bankers Trust, following which the stock of Bankers Trust fell by approximately 10%. When Deutsche Bank did takeover Bankers Trust one month later, accusations of misrepresentation and fraud on behalf of Deutsche Bank surfaced, and this lawsuit alleged that the statement had been given in a direct attempt to lower the stock price, thus lowering the ultimate purchase price paid by Deutsche Bank by nearly $7 million. Declining to accept Deutsche Bank's response that, given its understanding of "takeover discussions" to mean that the talks being held were not yet material or substantive, the court found the CEO's remarks to be materially misleading and it denied a motion to dismiss the claim.

In distinguishing this case from a Fourth Circuit case in which the Circuit Court affirmed a District Court dismissal[33], the court in Deutsche Bank made it clear that the specific wording is of the utmost importance and stressed the necessity of using extreme caution in giving any information that may later be interpreted by the market. LCI involved a situation in which an officer of the defendant company stated it was not for sale, but soon thereafter merged with another company

ii) MCI Worldcom, Inc. Securities Litigation

In response to a question regarding the possibility of a merger following the registration of the domain name "skytelworldcom.com" that was linked back to MCI, MCI

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[31] Weiner v. The Quaker Oats Co., Fed. Sec. L. Rep. (CCH) ¶91,266 (N. D. Ill. 2000). The Quaker case is discussed in more detail at III. F. 6, *infra*.

[32] Fed. Sec. L. Rep. (CCH) ¶90,969 (March 6, 2000).

[33] Phillips v. LCI, International, Inc., 190 F.3d 609 (4th Cir. 1999). In LCI, as opposed to Deutsche Bank, the officer at LCI that stated LCI was not for sale was technically speaking the whole truth, as when it merged soon thereafter, it remained as the surviving corporation, thereby avoiding having been "for sale."

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responded that "the action is not an indication of official company intention."[34] The stock price of SkyTel dropped immediately, and MCI soon thereafter acquired SkyTel. Ruling that this statement went beyond the permissible "no comment," the District Court for the Eastern District of New York found that the market's interpretation of the remark as meaning that MCI had no intention of acquiring SkyTel was reasonable. The court therefore denied MCI's motion to dismiss.[35]

Distinguishing MCI from LCI, the District Court found the timing and specific language and the remarks to be important. The court found MCI more akin to Deutsche Bank and, like the District Court in Deutsche Bank, determined that the statements were false or misleading as well as being material.[36]

iii) Weiner v. The Quaker Oats Co.

The central issue in the Quaker cases is the duty to update.[37] The cases, however, also provide a good lesson on how to disclose company guidelines and avoid misinterpretation. Quaker repeatedly stated that its "guideline [for debt-to-

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[34] Fed. Sec. L. Rep. (CCH) ¶90,950 (April 13, 2000). For a more detailed discussion of the Buxbaum and MCI Worldcom, Inc. cases, see Maryann A. Waryjas, "Disclosure Without Fear", Shareholder Value Magazine, Oct/Nov 2000, p. 64-7.

[35] *Contra* Elliot Assocs. v. Covance, Inc. Fed. Sec. L. Rep. (CCH) ¶91,269 (S. Dist. N.Y. 2000) (holding that defendant company's statement regarding the status of a proposed merger as "on track" were not actionable after the merger was not completed and defendant's motion to dismiss was granted because there is no duty to update optimisitic opinions). *But cf.* Eisenstadt v. Centel Corp. Fed. Sec. L. Rep. (CCH) ¶99,458 (7th Cir. 1997) (noting that after the Private Securities Litigation Reform Act of 1995 there may be no more legal duty to update prior statements).

[36] The SEC recently announced that the reach of the US securities laws is not confined to the borders of the US. On September 28, 2000, the SEC brought and settled its first enforcement action against a foreign issuer for intentionally making a series of false statements regarding merger negotiations. The SEC charged E.ON AG, a German company, with making materially false denials regarding merger discussions with Viag AG, another German company, when in fact it was engaged in merger negotiations with Viag. Because E.ON has American Depositary Shares listed on the NYSE, the SEC applied the same antifraud rules and standards to the foreign issuer that it does to US issuers. The SEC reasoned that false statements made overseas can impact US investors as much as statements issued in the US. Though the E.ON situation represents more than a mere "slip of the tongue" because the company made multiple denials of merger negotiations and many of E.ON's senior management knowingly approved the false public statements, foreign issuers must be aware that overseas statements may now result in liability under the US securities laws. See Mark S. Bergman, *Securities Enforcement: Non-US Company Sued for False Public Statements Made During Merger Negotiations*, Insights, Volume 14, Number 11, pg. 13, November 2000.

[37] Fed. Sec. L. Rep. (CCH) ¶91,266 (N. D. Ill. 2000). The Quaker case is discussed in more detail at III. F. 6, *infra*.

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capitalization ratio] will be in the upper-60 percent range."[38] Quaker also disclosed that "[w]e continually seek opportunities to acquire businesses that offer profitable future growth."[39] When Quaker announced the acquisition of Snapple, the market reacted negatively because, it is alleged, Quaker used debt to finance the acquisition and exceeded its publicly announced debt-to-capitalization ratio.[40] Quaker's internal analysis of the Snapple acquisition also included plans to divest other assets to reduce any debt incurred in a leveraged acquisition of Snapple.[41] In fact, within six months after the announcement of the Snapple acquisition, Quaker sold two businesses for $1.425 billion and its leverage ratio returned to the upper-60 percent range.[42] On these facts, Quaker may prevail before a jury but, in hindsight, it would have been preferable to expressly state that the leverage guideline was a long term goal that could be exceeded temporarily. Also in hindsight, this omission was not probably meant to mislead but rather was an oversight or the authors believed the omitted information was implicit in the statements made. Moreover, the negative market reaction to the Snapple announcement could be attributed to other factors. Nevertheless, this case emphasizes the need to fully consider the market reaction – even if irrational – to public disclosures or omissions and the need to consider whether in light of the possible negative market response the statements should be expanded.[43]

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[38] Id.

[39] Id.

[40] Id.

[41] Id.

[42] Id.

[43] The statements made in the Virginia Bankshares decision discussed in the next section (II. C., infra) are also relevant to this issue. There, the statements that the freeze out merger would provide "high value" and a "fair price" were held to be misstatements. In the context of a complex proxy statement, these statements, probably written by the lawyers, were most likely not meant to mislead: they were just insufficiently vetted.

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C. Statements of Reasons, Opinions, or Beliefs: Virginia Bankshares, Inc. v. Sandberg

The Supreme Court's decision in Virginia Bankshares, Inc. v. Sandberg[44] builds upon the foundation of materiality analysis established in Basic. Plaintiffs successfully maintained that statements by management in a proxy statement that a proposed "freeze-out" merger would provide a "high value" and a "fair" price may have been false and deceptive statements of material facts. The Supreme Court held that statements by management of reasons, opinions or beliefs — even though conclusory in form — may be material facts that could give rise to misstatement liability under the federal securities laws.

The Court rejected the bank's defense that the statements regarding fairness were too indefinite to constitute material facts. Instead, Justice Souter concluded that "such conclusory terms in the commercial context are reasonably understood to rest on a factual basis that justifies them as accurate, the absence of which renders them misleading." He also dismissed the defendants' "federalization" argument, concluding that:

> Although a corporate transaction's "fairness" is not, as such, a federal concern, a proxy statement's claim of fairness presupposes a factual integrity that federal law is expressly concerned to preserve.[45]

To be actionable, opinions, beliefs and forecasts must be both wrong and deceptive. In a concurring opinion, Justice Scalia described this two-analysis as follows:

> As I understand the court's opinion, the statements "In the opinion of the Directors, this is a high value for the shares" would produce liability if in fact it was not a high value and the directors knew that. It would not produce liability if in fact it was not a high value but the Directors honestly believed otherwise.

Although the holding spoke only to liability under Rule 14a-9, the Supreme Court's analysis already has had an impact in Rule 10b-5 cases involving projections and other forward looking statements.[46]

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44 111 S. Ct. 2749 (1991). The Supreme Court also held that shareholders whose vote was not required by law to approve the transaction cannot establish causation of damages and therefore lack standing to sue.

45 Id. at n.6. Several courts have construed Virginia Bankshares and discussed the federalization of state law issue. See e.g., Mendell v. Greenberg, 938 F.2d 1528 (2d Cir. 1991) and In re PHLCORP, Fed. Sec. L. Rep. (CCH) ¶ 96,808 (S.D.N.Y. 1992).

46 See Hanon v. Dataproducts Corp., Fed. Sec. L. Rep. (CCH) ¶ 96,808 (S.D.N.Y. 1992), discussed infra Section III.B.2.

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D. Is Materiality Still Alive?

Disclosure requirements have traditionally been limited by a materiality standard. The understanding of materiality taken from the Basic and Virginia Bankshares courts thrived, allowing registrants to disclose only those things that fell within a seemingly clear definition of "material." Statements, and even misstatements, not thought to be of material importance to the average investor, have not historically required correction or raised an inference of improper or unethical disclosure.[47] Materiality was often thought of as a quantitative standard, whereby a misstatement or omission that did not result in an excess of a 5% mistake in the financial statements was not deemed "material." Very few courts analyzed each statement qualitatively, preferring a more mechanical process.[48]

The use of an elastic materiality standard has generally worked well. The SEC, however, was not content with the state of affairs and has launched two assaults on materiality as we have known the concept for decades. First, in 1999 the staff issued its famous SAB 99 and, in 2000, the Commission redefined materiality in its Release adopting Regulation FD.

The SEC staff in 1999 gave materiality a new definition that requires each item or statement to be looked at as material if, *in the light of all the surrounding circumstances*, the magnitude of the item is such that it is probable that the judgment of a reasonable person would be changed or influenced by the inclusion or correction of the item.[49] The SEC has clouded the meaning of materiality by rejecting bright line quantitative standards and substituting qualitative standards, including the following, before determining whether or not something is material:

- whether the misstatement arises from an item capable of precise measurement or whether it arises from an estimate and, if so, the degree of imprecision inherent in the estimate;
- whether the misstatement masks a change in earnings or other trends;
- whether the misstatement hides a failure to meet analysts' consensus expectations for the enterprise;

47/ See John M. Fedders. *Qualitative Materiality: The Birth, Struggles, and Demise of an Unworkable Standard*, Catholic University L. Rev., Vol. 48, Fall 1998, for an overall discussion of the history of materiality in SEC disclosure requirements. See also Buxbaum v. Deutsche Bank, supra fn 31, in which the District Court in the Southern District of New York looked carefully at the reaction in the press and in the market in finding a statement given in an interview to be material.

48/ See, e.g., SEC v. Joseph Schlitz Brewing Co., 452 F.Supp. 824 (E.D. Wis. 1978).

49/ SAB Release No. 99. The staff argues that SAB 99 is limited to accounting matters and does not alter the definition of materiality. As we shall see, the courts are following SAB 99 in anti-fraud civil liability cases and most commentators believe that it does at least expand the definition of materiality.

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- whether the misstatement affects the registrant's compliance with regulatory requirements; and
- whether the misstatement involves concealment of an unlawful transaction.[50]

Requiring a registrant and its auditors to look at an overview of all surrounding circumstances is demanding, mainly because it may erase the materiality standard and force registrants to disclose items seen by them as entirely immaterial for fear of a potentially subjective qualitative analysis and hindsight analysis. The SAB also suggests that potential market reaction to the misstatement is another factor to be considered in determining materiality supporting the fear of a look-back analysis.[51] This analysis, "although tricky, would be highly fact-driven and would rely heavily on whether a 'reasonable person' - or investor, on this point - would consider the item important."[52] While "'there's no one ... that wouldn't like bright lines'... it is just not a feasible standard where materiality is concerned."[53]

Courts will find it difficult to interpret this standard because the SEC requires an exactitude that is probably impossible to meet and invites one to find creative ways to distinguish their facts from the SEC's SAB. Indeed, in a case decided shortly before the SAB (but published at just about the same time), the court held that a 1.7% misstatement in amount of revenues was immaterial, although the court also did look at movements in stock price, as an indicator of market reaction, following a correction of the misstatement.[54] On appeal, however, the Second Circuit ruled that the district court erred in finding that a misstatement of an amount equaling 1.7% of pre-tax revenues was immaterial as a matter of law.[55] The Second Circuit reasoned that materiality

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50/ Id.

51/ See, e.g., Ganino v. Citizens Utilities Company, Fed. Sec. L. Rep. (CCH) ¶ 90,535 (1999).

52/ *SEC Legal Chief Tries to Clarify Guidance on Materiality of Misstated Income Figures*, Securities Regulation & Law Report, Vol. 31, No. 42. p. 1444.

53/ Id.

54/ Ganino at 92,687.

55 See Ganino v. Citizens Utilities, Fed. Sec. L. Rep. (CCH) ¶91,210 (2000); compare Shuster v. Symmetricon, Inc., Fed. Sec. L. Rep. (CCH) ¶91,206 (2000). In Shuster, a post-SAB 99 decision, the district court appears to have disregarded SAB 99 by adopting a quantitative materiality standard by ruling that the recording of a contingent contract as a sale would be immaterial as a matter of law because such sale represented only 2% of the quarterly revenues. In this case, the court relied upon the lower court decision in Ganino, which adopted the quantitative materiality standard before being reversed on appeal. The ultimate ruling of immateriality in Shuster is probably correct even under SAB 99 materiality standards, which take into consideration both quantitative and qualitative factors. The court, however, should have considered the application of SAB 99 to lend support to the finding of immateriality based on a small percentage of revenues.

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determinations depend on "all relevant circumstances of the particular case," as it invoked the reasoning of Basic, which rejected the determination of materiality based on numerical formulas as a bright line rule.[56] In conclusion, though the court noted that SAB 99 is not the law, it did indicate that the SAB is consistent with the Basic analysis and is accordingly a persuasive guide in determining the materiality of misstatements and omissions.[57]

Similarly, the trend rejecting a mathematical basis for materiality determinations continued in a September 2000 federal district court decision.[58] In this case, plaintiffs alleged that defendant Unisys knowingly made misleading statements about long term contracts with British Telecommunications and the United States Government in violation of section 10(b).[59] Unisys defended its position on the ground that the contracts were not material since each contract represented less than .6% of Unisys' annual revenue.[60] The court, however, rejected the idea that materiality determinations should be based on mathematical formulas and thresholds.[61] Though the two contracts at issue in this case each represented less than 1% of the defendant's revenues, the court reasoned that information regarding the contracts may be important to a reasonable investor and such information may significantly alter the "total mix" of information available to the investor.[62] Accordingly, the court ruled that misleading statements regarding the revocability of the contracts may be material despite the contracts' low value.[63] Even accepting the idea that materiality depends on all the relevant circumstances, the courts at some point should take cases away from juries.

In Anderson v. Abbott Laboratories, another district court also adopted the new materiality standard and ruled that the failure of a pharmaceutical company ("Abbott") to disclose specific details of an ongoing FDA investigation and the receipt of an FDA warning letter was not material.[64] The court reasoned that Abbott's omission is only material when the disclosure of the FDA's investigation would be viewed by the reasonable investor as significantly altering the total mix of information available about

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[56] Id.

[57] Id.

[58] See In re Unisys Corp. Securities Litigation, Fed. Sec. L. Rep. (CCH) ¶91,218 (2000).

[59] Id.

[60] Id.

[61] Id.

[62] Id.

[63] Id.

[64] See Anderson v. Abbott Laboratories, et al., Fed. Sec. L. Rep. (CCH) ¶91,340 (N.D. IL 2001).

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Abbott.[65] In this case, the court determined that the history of monitoring , negotiations and inspections between Abbott and the FDA rendered the nondisclosure of yet another FDA investigation inconsequential.[66] Furthermore, the court noted that their determination of non-materiality was affirmed by the lack of market reaction to the eventual disclosure of another FDA investigation.[67] The court concluded that if reasonable investors believed the FDA investigation and warning letter altered the total mix of information available about Abbott, there would have been a greater market reaction.[68]

Accounting firms have also incorporated the 1999 Release in the representation letter it requires clients to deliver by removing from the letter any reference to specific amount thresholds in defining materiality. While in previous years, the representation generally included a definition of "material" as "any items referred to in this letter, either individually or collectively in the aggregate, involving potential amounts of more than $250,000," the representation in 1999 reads:

> Certain representations in this letter are described as being limited to those matters that are material. Items are considered material, regardless of size, if they involve an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.

Importantly, clients are being asked to also represent that the effects of the uncorrected financial statement misstatements summarized in the accompanying schedule are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

Regulation FD has also added to the materiality confusion.[69] The release adopting FD lists a number of rather standard, non-controversial, non-exclusive items that are often, but not always, considered material, such as mergers, bankruptcies, stock splits and changes in management. The release, however, in its most controversial paragraph cautions issuers to avoid providing selective information concerning anticipated earnings—higher, lower or the same as has been forecasted. This take on materiality

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[65] See Id. pg.95,948.

[66] See Id.

[67] See Id.

[68] See Id.

[69] See infra Section V.

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places insiders in an awkward position. They will almost always have more information than is publicly disclosed about anticipated earnings, and if as FD argues this is material, when will they ever be allowed to buy or sell securities? Perhaps new Rule 10b-5-1 is the solution.

These recent developments concerning materiality are also causing the courts to focus on "when" the determination of materiality is to be made. In Ganino, the Second Circuit ruled that the relevant time period for assessing the materiality of a misstatement is the time the alleged misstatement occurred.[70] The court reasoned that the "determination of materiality is to be made upon all the facts as of the time of the transaction and not upon a 20-20 hindsight view long after the event."[71] In contrast, the Third Circuit recently ruled that materiality determinations are best made in the context of an efficient securities market.[72] As a result, important information regarding the company is immediately reflected in the price of the company's stock, and the materiality of such information may be assessed "post hoc" by studying the movement in the price of such stock during the period following the disclosure of the information.[73] Under this approach, if the price of the stock is altered after the disclosure of information, it is presumed that such information is material, conversely, if the disclosure has no effect on the price of the stock, such information is deemed immaterial as a matter of law.[74]

It is also clear that the court in Buxbaum v. Deutsche Bank was heavily influenced by the stock price decline when it determined that a statement denying the existence of merger discussions was material.[75] Moreover, the implementation of Regulation FD may well result in more stock price volatility as material information hits the market all at once. As qualitative factors become more important, it is unavoidable that courts will be influenced by a stock price reaction when deciding materiality issues.

Finally, are all these developments causing "loss causation" to become a surrogate for materiality? In other words, if an allegedly false announcement does not cause the stock to move and, therefore, security holders are not injured, is this another way to say the announcement is not material? This is illustrated in a 2000 federal district court

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70 See Ganino v. Citizens Utilities, Fed. Sec. L. Rep. (CCH) ¶ 91,210 (2000).

71 Id.

72 See, Oran v. Stafford, Fed. Sec. L. Rep. (CCH) ¶ 91,205 (2000). The court relied on the reasoning set forth in Burlington as it stated that "information important to reasonable investors…is immediately incorporated into the stock price." See id. (citing 114F.3d at 1425).

73 Id.

74 Id.

75 Fed. Sec. L. Rep. (CCH) ¶ 90,969 (2000).

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opinion, In re Northern Telecom Ltd. Securities Litigation.[76] There, the plaintiffs purchased Nortel stock during a time when defendant Nortel issued statements and press releases regarding the strength of its products, its use of advanced technologies, its ability to obtain long-term contracts and its projected growth in earnings.[77] Subsequent to the making of these statements, the defendant reported projected shortfalls and restructuring plans.[78] Nortel's share price then dropped.[79] As a result, plaintiffs brought suit alleging that the previous statements were material misrepresentations, which inflated, or maintained, the share price.[80] Both plaintiffs and defendants agreed that to support a 10b-5 action, the plaintiffs were required to prove that the allegedly false statements inflated Nortel's share price—loss causation.[81] The court, on a motion for summary judgment, examined the analysis of each party's expert and concluded the plaintiffs failed to raise a disputed issue of fact as to causation.[82] The court also ruled that the statements at issue were either immaterial or reasonably based.[83] To this court, at least, the market reaction to the disclosures was largely determinative of both loss causation and materiality.

E. Summary of Disclosure Obligations

The cases summarized above demonstrate that the Supreme Court's adoption of a flexible and fact-specific approach to materiality in Basic affirms the traditional concepts of disclosure obligations under the federal securities laws. Plaintiffs still bear the burden of proving first, that the issuer had a duty to disclose, because it was either trading in its securities or had made prior inaccurate disclosures, and second, that the information allegedly omitted was material. Moreover, these decisions illustrate that Basic does not stand for the proposition that materiality is automatically a question for the jury. Courts have in the past removed the issue of materiality from the domain of the jury.[84] Some of the more recent decisions and the issuance of SAB 99, however, have prompted the

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76 Fed. Sec. L. Rep. (CCH) ¶ 91,228 (2000).

77 Id.

78 Id.

79 Id.

80 Id.

81 Id.

82 Id.

83 Id.

84/ As discussed in Section III below, some cases involving other business developments, such as product obsolescence or the difficulties of new product development, may reflect a tendency by the lower courts to leave questions of materiality for a jury. The issue in these decisions is whether omissions of negative developments could render other affirmative statements made by the defendants materially misleading.

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courts to lean towards letting juries decide the materiality question. The practical lesson of Basic and its progeny: Adopt and maintain a consistent "No Comment" policy on all contingent business developments.

The timing of "when" materiality should be determined has evolved into a central issue and a moving target for courts' differing views regarding this subject. It is time to revisit the role and definition of materiality.

III. DISCLOSURE OF GENERAL BUSINESS DEVELOPMENTS AND RISKS

A. Introduction

The principles of timely disclosure and materiality derived from Basic and the merger cases are equally applicable to other corporate developments, such as the onset of financial instability, difficulties with product introductions and transitions, and the potential need to write down major assets. The celebrated $100 million securities fraud verdict against two executives of Apple Computer, arising out of a controversial promotional program for two new products in 1982, served as a wake-up call to corporate officials. The message: decisions as to the timing and content of disclosure for all manner of corporate developments are fraught with risks which could result in personal financial liability.

Some of the important developments, discussed in detail below, include:

- Duty Not to Mislead. The Apple Computer case is illustrative of a number of federal cases in which plaintiffs have challenged issuers' disclosure of general business developments in executive news interviews, press conferences and releases, as well as annual reports, registration statements and the various periodic reports required under the Exchange Act. In several of these cases plaintiffs allege that management intentionally misled investors by failing to disclose difficulties, such as problems with new products or excessive inventory levels, when promoting these new products or making predictions or general optimistic statements about a company's future performance. Other cases allege a failure to adequately explain the financial significance of identified problems such as plant deterioration or obsolete products.

  As in the Basic progeny cases, the issue before the courts in these "duty not to mislead" cases generally is whether the defendants are entitled to an order of dismissal or summary judgment. Certain of these decisions suggest that, in light of the fact-intensive materiality analysis advocated by the Supreme Court in Basic, lower courts may be more hesitant to grant summary judgment or dismissal, especially where the issue is whether the alleged omissions would render other statements misleading. The Ninth Circuit's decision in the Convergent Technologies case, discussed below, proves that issuers can prevail in duty not to mislead and omissions class actions. It is still difficult, however, to provide

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clients with specific bullet-proof advice when preparing disclosure documents because there are so many cases in this area with such different results. More recently, the "Bespeaks Caution" cases, discussed below, indicate that issuers are successful in defeating such class actions if they have included specific cautionary language in their disclosure documents. The Reform Act, discussed below, attempted to even the playing field by restricting early stage discovery, revising the class-action rules by requiring stricter pleading and a higher degree of scienter as well as introducing a safe-harbor for certain forward looking statements.

- Projections. In 1994, the SEC considered material changes to its safe-harbor rules for forward looking information. This effort stalled, but Congress surprised everyone by adopting a safe-harbor for forward looking information in the Reform Act. This congressional effort was prompted by a series of cases by the plaintiffs' bar attacking general optimistic statements as somehow confirming specific prior projections that may have become unattainable. This congressional effort, moreover, was necessitated by the SEC's policy to encourage, and even to require projections, as in the MD&A, while at the same time refraining from adopting a meaningful safe-harbor rule. The Reform Act took its cue from the "Bespeaks Caution" doctrine that had developed to allow issuers to avoid liability for optimistic statements when accompanied with specific cautionary language. Despite these favorable developments, forward looking statements remain subject to attack by plaintiffs using 20/20 hindsight.

- Duty to Update. Another disclosure controversy involves the so-called "duty to update." A panel of the First Circuit Court of Appeals in the Polaroid case had suggested that during the period between interim reports issuers have a duty to update statements which, although accurate when made, become misleading due to subsequent developments.[85] This case must be distinguished from those decisions in which issuers are held liable for failing to correct statements which are false and misleading based upon facts and circumstances at the time of issuance. The panel's opinion in Polaroid was subsequently withdrawn and its findings were rejected by the full court. Nonetheless, issuers should be aware that two other decisions hold that issuers must continually update previously made forward looking statements. Hopefully, the cases that suggest there is a continual duty to update do not represent the law, as they contradict the traditional doctrine that issuers have no general obligation between interim SEC reports to disclose material facts. Indeed, the Reform Act implies that the duty to update no longer exists, and this view has been affirmed by the Seventh Circuit.[86]

85/ Backman v. Polaroid Corp., Fed. Sec. L. Rep. (CCH) ¶ 94,899 (1st Cir.), opinion withdrawn, judgment of the court of appeals vacated, opinion en banc, 910 F.2d 10 (1st Cir. 1990), discussed infra Section III.F.1.

86/ See Stransky v. Cummins Engine, Fed. Sec. L. Rep (CCH) ¶98,668 (7th Cir. 1995) and Eisenstadt v. Centel Corp., Fed. Sec. L. Rep. (CCH) ¶99,458 (7th Cir. 1997); but see Weiner v. Quaker Oats Co., Fed. Sec. L. Rep. (CCH) ¶99,563 (3d Cir. 1997) discussed below in Section III.F. 5-6.

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- Analysts. Issuers also face certain risks when communicating with analysts. For example, selective disclosures to analysts may be viewed as unlawful tipping in violation of Rule 10b-5. Further, while a corporation generally has no duty to review or comment on analysts' reports, if the issuer chooses to review or correct drafts of reports or otherwise, the issuer may become "sufficiently entangled" with the analysts' statements so as to assume a duty to correct the statements. A significant number of recent cases also charge that management misled the market by making overly optimistic statements on roadshows and to analysts. In fact, analysts themselves have been named as defendants. Moreover, with the recent enactment of Regulation FD on October 23, 2000, the selective disclosure of material information between the issuer and analyst is now prohibited as the rule promotes the dissemination of material information to analysts and the investing public simultaneously.

- MD&A Allegations. In light of the SEC's 1989 MD&A Interpretative Release emphasizing an issuer's quarterly disclosure obligations, the plaintiff's bar has added allegations of inadequate MD&A to Rule 10b-5 actions. Plaintiffs have infrequently included such MD&A allegations with Rule 10b-5 claims.[87]

- The Reform Act. In late 1995, Congress -- over President Clinton's veto -- adopted the Reform Act in recognition that the litigation explosion was, among other things, adversely affecting capital formation. The Act, as mentioned above, provides a safe-harbor for projections under certain circumstances, requires specific scienter, stricter pleading and discovery rules, new rules for class-actions and limits early discovery.

- Securities Litigation Uniform Standards Act of 1998. On November 3, 1998, President Clinton signed this Act into law, making federal courts the exclusive venue for most securities class actions.

Applying Rule 10b-5 to the above situations requires continuous rethinking. Simply the sheer number of cases--in many instances involving huge damage claims--is an indication that the system was (and may still be) broken. Rule 10b-5 is used to micromanage corporate disclosure rather than to control fraudulent conduct. The broad interpretations of Rule 10b-5 and the courts' bias in favor of letting juries decide disputed factual issues does not work in our current environment. The Reform Act was in fact designed to remedy this situation. This environment consists of:

- Volatile markets where stock prices are driven by a significant number of factors beyond issuer disclosure -- e.g., index funds, program trading, etc.

[87] See In re Verifone Sec. Lit., 11 F.3d 865,870 (9th Cir. 1993); Wallace v. Systems & Computing Technology Corp., Fed. Sec. L. Rep. (CCH) ¶99,578 (E.D.Pa. 1997) ("It is an open issue whether violations of Item 303 create an independent cause of action for private plaintiffs."); Steckman v. Hart Brewing, Inc. Id. ¶90,205 (9th Cir. 1998) (a violation of Item 303 can support a claim under Sections 11 and 12(a)(2) of the Securities Act).

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- Analysts have an extraordinary influence on stock prices--they can make or break a company's market price.

- There are, moreover, many different kinds of money managers who fall in and out of love quickly. These managers look to different types of information, e.g., growth versus value. In addition, there are "momentum" managers and, to counter them, "winner's curse" managers.

- Competitive influences, the quickness with which corporate developments occur and the stock market reaction to events are far more intensified than just a decade ago.

- Many of the claims involve companies who are on the frontier of technology where their market prices are almost wholly reflective of potential future success. If these companies fail to achieve their goals for reasons other than defective disclosure, their stock prices can plummet.

- I have cautioned issuers to make certain that public disclosure corresponds to internal memos. In practice, however, this is difficult to achieve because it is hard to review all internal memos each time a public disclosure is made and often internal memos are themselves inconsistent. E-mail and voice mail messages sent internally have compounded this problem. This is a leading reason for denial of a motion for summary judgment.

- We must also take into consideration the imprecision of the English language. Consider how many cases are won or lost on the basis of a few words taken from a dense disclosure document.[88]

- The information explosion -- both in terms of amount and real time -- creates more volatility than previously experienced. Regulation FD will most likely also add to market volatility.

- The release of statistical and economic information on almost a daily basis fuels market volatility and has produced a cottage industry that tries to predict what the Federal Reserve will do with interest rates based upon the economic data.

We are also involved in a never ending game of one-upmanship. The courts and Congress in 1995, however, have both explicitly and instinctively tried to limit the number of disclosure claims that survive motions to dismiss or motions for summary judgment. For example, in Central Bank the Supreme Court explicitly expressed the goal

88/ See e.g., Virginia Bankshares, supra notes 34 and 35 and accompanying text; see also Slip of the Tongue section supra II.C.c.

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of narrowing the scope of actionable claims beyond the pleading stage[89]. Even before adoption of the Reform Act, the lower courts limited disclosure claims by applying the "Bespeaks Caution" doctrine,[90] holding that puffing does not constitute actionable conduct,[91] and requiring plaintiffs to plead with particularity.[92]

Each time a court establishes a gate, however, the resourceful plaintiffs' bar reacts by altering the scope of their claims. This is illustrated by a number of decisions issued in mid-1994.[93] In round one, the courts in Anderson v. Clow[94] and In re Ross Systems Securities Litigation[95] dismissed plaintiffs' disclosure claims, with leave to amend some of the claims. In these cases, plaintiffs charged faulty predictions, false statements made on roadshows, to analysts and in investment publications. Plaintiffs attempted to avoid basing their claims on particular issuer representations and instead focused on the "fraud on the market" theory. The court explained the theory:

> In a fraud on the market case, the plaintiff claims he was induced to trade stock not by any particular representations made by corporate insiders, *but by the artificial stock price set by the market in light of statements made by the insiders as well as all other material public information* (italics in original).[96]

On the heels of these decisions favorable to defendants came a number of unfavorable decisions involving very similar types of allegations--and thus began round two. Both Kaplan v. Rose[97] and In re Software Toolworks Inc. Securities Litigation[98] reversed lower court decisions dismissing plaintiffs' claims on summary judgment motions. In Kaplan it

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89/ See Central Bank, N.A. v. First Interstate Bank, N.A., 114 S. Ct. 1439 (1994).

90/ See e.g., In re Stac Electronic Securities Litigation, Fed. Sec. L. Rep. (CCH) ¶99,272 (9th Cir. 1996); In re World of Wonder Securities Litigation, infra notes 184-188 and accompanying text.

91/ See e.g., Jakobe v. Rawlings Sporting Goods, Fed. Sec. L. Rep. (CCH) ¶99,406 (E.D.Mo. 1996); Northern Telecom Ltd. Securities Litigation, Fed. Sec. L. Rep. (CCH) ¶98,390 (S.D.N.Y. 1994).

92/ See e.g., In re Time Warner Securities Litigation, infra notes 336-337 and accompanying text; Morin v. Trupin, Fed. Sec. L. Rep. (CCH) ¶97,302 (S.D.N.Y. 1993).

93/ It is interesting to note that many of these cases involve California high-tech companies and that only a few law firms are involved in a majority of the cases.

94/ Fed. Sec. L. Rep. (CCH) ¶98,367 (S.D. Cal. 1994).

95/ Fed. Sec. L. Rep. (CCH) ¶98,363 (N.D. Cal. 1994).

96/ Anderson v. Clow, supra note 51, at 90,515, quoting In re Apple Computer Securities Litigation, supra note 26.

97/ Fed. Sec. L. Rep. (CCH) ¶98,422 (9th Cir. 1994).

98/ Fed. Sec. L. Rep. (CCH) ¶98,426 (9th Cir. 1994).

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was a sweeping reversal while in Software Toolworks only a few of many claims were sent back to the district court.[99]

Not only is predictability impossible under these cases, but more importantly, from a counseling standpoint, those with the best intentions are doomed to failure since companies are dammed whether they disclose too much or too little--it is simply impossible to describe with 100% accuracy future plans and projections, and yet also describe all the potential pitfalls that exist both internally and externally.

We appear to be watching an old-time prize fight with unlimited rounds. Plaintiffs' pleadings move to a new level in response to favorable decisions. In Stark v. Present[100], for instance, we find essentially the same "fraud on the market" allegations in great detail including charts, tables, and extensive quotes from disclosure documents, press releases, and analyst reports; but we also see that the analyst is personally named as a defendant and the issuers' counsel is named as essentially a non-defendant aider and abetter.[101] The complaint is carefully crafted to avoid the pleading deficiencies in Anderson and Ross Systems. If the court reacts negatively to the plaintiffs' claims, we can be certain that a new form of pleading will eventually emerge.

The Reform Act seeks to improve the whole process and to encourage meaningful forward looking and honest disclosure without subjecting issuers to the sometimes devastating costs, disruption, and adverse market effect of suits that attempt to compensate investors for essentially market risks investors should assume. As of June 1999, it remains to be seen whether the Act will be successful.

B. The Duty Not to Mislead

When an issuer is required to disclose information under a specific line-item of a periodic report or if the issuer voluntarily addresses a particular development, it must disclose all facts necessary to make the disclosure accurate on its face and on the whole not misleading.[102] This "duty not to mislead" prohibits issuers from making unqualified statements regarding new products or business prospects where the issuer has identified

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99/ See O'Sullivan v. Trident Microsystems, Inc., Fed. Sec. L. Rep. (CCH) ¶98,116 (N.D. Cal. 1994), which is also representative of those decisions where defendants prevail on motions to dismiss with respect to almost all of the claims, but one or two claims sneak through, thus leading to a jury trial on the merits--or settlement. See also In re Seagate Technology II Securities Litigation, infra note 66 and accompanying text.

100/ No. 94-5712 (C.D. Cal. filed Aug. 22, 1994).

101/ Id. Again the case is brought by a prominent plaintiffs' law firm. The decision to not name issuers' counsel as a defendant is most likely a reaction to the Supreme Court's decision in Central Bank.

102/ Basic Inc. v. Levinson, 108 S. Ct. 978, 985 n.13 (1988) (citing SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 862 (2d Cir. 1968)).

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specific adverse developments relating thereto. A wide range of disclosures can trigger this obligation to speak with complete candor.

Historically, courts have given issuers broad discretion in making general, positive public statements about the company's performance and new products, particularly outside of formal reports filed with the SEC. The Apple Computer case and several other cases discussed below indicated that the courts for a period of time took a harder line with respect to informal public statements previously considered innocuous "puffing." More recent cases, however, have retreated from the harsher standard prevalent in the late 1980's and early 1990's. Although the cases take varying positions on this issue, as a counseling matter, clients should be advised to use caution with respect to promotional disclosures.

Issuers should therefore scrutinize their promotional press releases and statements, focusing on the following key questions:

- Does the market understand the risks inherent in new product development, the continued viability of old products, or the condition of property, plants and equipment?
- Has the company identified any specific problems or difficulties--or has the company experienced similar difficulties in the past--which could diminish the prospects of the product or business development in general?
- Do the press releases and statements identify such potential risks and difficulties?
- Are the statements consistent with internal memorandum and reports on the product or business development?

If the answer to any one of these questions is "no," then those persons responsible for corporate disclosure should reassess the company's promotional statements to assure that they are accurate and not misleading in the totality of circumstances.

Another interesting aspect of these cases is their treatment of alleged omissions where plaintiffs assert a "fraud-on-the-market" theory of reliance. In one case, the court held that issuers need not disclose material information which is otherwise made available to the market from third-party sources. The court considered the market to be aware of facts disseminated with sufficient intensity and credibility by securities analysts and the press. Consequently, issuers may be excused from liability for omissions of those facts in a fraud-on-the-market case. On the other hand, some courts have indicated that the market considers management disclosure more credible than that of analysts and that analysts' discussions of general risks will not counter omissions by management of more specific information.

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1. In re Apple Computer Securities Litigation

The relatively infamous case In re Apple Computer Securities Litigation[103] illustrates the perils management faces when promoting new products. At issue were several optimistic statements made by executives of Apple Computer during 1982 in press releases and interviews about two new products which the company was readying for commercial release — a business computer named "Lisa" and a compatible disc drive named "Twiggy." An Apple press release introducing Twiggy claimed "[it] represents three years of research and development and has undergone extensive testing and design verification during the past year." The Wall Street Journal quoted Apple Chairman Steven Jobs as stating, "Lisa is going to be phenomenally successful the first year out of the chute."

During the period when Apple management touted its new products Apple stock soared to almost $63 per share. Twiggy, in fact, had several significant design problems and was replaced before Lisa hit the market. Lisa proved to be a commercial failure and Apple eventually discontinued the product. When Apple's stock price plummeted to $17, plaintiffs brought a class action alleging that Apple's officers had misled the market about the capabilities and prospects of Twiggy and Lisa, recklessly ignoring problems which detracted from their public statements.

a. The $100 Million Jury Verdict

In May 1991, a jury in the federal district court in Northern California found the vice chairman of Apple and another former executive personally liable for approximately $100 million for securities fraud for their role in the company's promotional campaign for these new products. The jury ruled that the two executives had defrauded investors by recklessly misrepresenting through unqualified public promotional statements the capabilities and readiness of the Twiggy disc drive. In a truly inexplicable verdict, the jury actually exonerated the company of wrongdoing but found the two executives personally liable.

In September 1991, Judge James Ware set aside the jury's verdict as "confused" and "internally inconsistent." Judge Ware ruled that there was no substantial evidence that the two men knowingly or recklessly made any false or misleading statements. Judge Ware also rejected the plaintiffs' argument that the jury's verdict against the individual executives

103/ 886 F.2d 1109 (9th Cir. 1989), cert. denied, Schneider v. Apple Computer, Inc., 110 S. Ct. 3229 (1990).

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should be construed as a ruling against Apple. The jury verdict shows the vagaries of complex securities litigation. Although the Apple case has raised the consciousness and blood pressure of many corporate executives responsible for disclosure policy, the district court proceedings actually offer little guidance on disclosure issues.

b. The Prior Ninth Circuit Decision

As is typical of federal securities law class actions, the Apple case has a long and distinguished history. In an earlier decision in 1987, the district court had granted summary judgment for the defendants on all counts. On appeal, the Ninth Circuit upheld the lower court's grant of summary judgment with respect to Apple's statements about Lisa, but reversed the lower court with respect to Apple's statements about Twiggy. The Ninth Circuit remanded the case for the jury trial described above, at which the two Apple officials were found liable for securities fraud. The Ninth Circuit's opinion on the initial appeal is enlightening for its analysis of an issuer's disclosure obligations when promoting or "touting" new products, and accordingly merits a brief review.

i) Twiggy - Unqualified Public Optimism

The Ninth Circuit held that there was a triable issue as to whether information concerning technical difficulties with Twiggy, acknowledged in internal Apple reports, was material information which "undermined Apple's unqualified public optimism" and should have been disclosed. The court rejected Apple's contention that the market at large understood that any computer product announced for future availability was in the development stage. The court found that reasonable investors could read Apple's statements to imply that Twiggy was complete, when in reality problems had arisen which would necessitate months of delay. Apparently, the jury on remand agreed, at least with respect to the individual defendants.

ii) Lisa - No Fraud on the Market

With respect to the alleged omissions regarding problems with Lisa, however, the Ninth Circuit affirmed summary judgment for Apple. The court found that extensive press coverage of the risks involved with Lisa shielded Apple from liability for its omissions regarding difficulties with the product. At the time Apple was touting Lisa, and often in the same articles where Apple's statements appeared, the press widely publicized Lisa's

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risks and underlying problems. Over twenty articles appeared in such publications as The Wall Street Journal and Business Week detailing Lisa's progress and potential difficulties. The court concluded:

> In a fraud on the market case, the defendant's failure to disclose material information may be excused where that information has been made credibly available to the market by other sources.[104]

The Ninth Circuit stressed the limits of its holding in Apple, and indicated that an individual plaintiff who could establish actual reliance on Apple's statements promoting Lisa could have a claim under Rule 10b-5. Further, even where plaintiffs assert that an issuer committed a fraud on the market, press coverage generally will not substitute for corporate disclosures. The investing public places too much emphasis on statements made by corporate insiders. To counter failure by a corporation to disclose material facts, information must be otherwise conveyed to the public with "sufficient intensity and credibility."[105] The unique and sustained focus by the press on Lisa's risks in Apple met that standard.

104/ Id. at 1115. In their petition for certiorari to the Supreme Court, plaintiffs asserted that this finding created a separate standard of materiality for fraud on the market cases. To the contrary, the Court's finding in Apple suggests that, even though omitted information may be material, plaintiffs cannot claim they relied on a defrauded market when the market possessed, and presumably the stock price reflected, the allegedly omitted information.

105/ Attempts by defendants to apply this analysis to support motions to dismiss have been unsuccessful and illustrate the potentially narrow application of this holding. In these cases, the courts have held that the question of whether information has been made available to the market from third party sources with "sufficient intensity and credibility" is a question for the trier of fact and, regardless, general third party information does not substitute for specific information that may be known only to an issuer. See Ballan v. Upjohn Company, Fed. Sec. L. Rep. (CCH) ¶97,319 (W.D. Mich. 1992) (although the market may have been aware of certain side-effects of a particular drug, the disclosure by the company of specific test results could have significantly altered the total mix of information) and In re Aldus Securities Litigation, Fed. Sec. L. Rep. (CCH) ¶97,376 (W.D. Wash. 1993) (the market's general awareness of the age and
(continued . . .)

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characteristics of a computer software company's products did not necessarily absolve the company from liability for the failure to disclose specific problems with these products in the face of optimistic projections being made by the company and analysts about the company's prospects).

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2. Hanon v. Dataproducts Corp.

The case Hanon v. Dataproducts Corp.[106] is one of the most interesting of the business development cases since Apple Computer. In Hanon, the plaintiffs alleged that Dataproducts misled investors by improperly touting a new computer printer even though it was aware the printer had severe technical problems. Citing Virginia Bankshares, the Ninth Circuit confirmed that projections and statements of belief may be actionable to the extent that any one of three implied factual assertions is inaccurate: (1) that the statement is genuinely believed, (2) that there is a reasonable basis for that belief, and (3) that the speaker is not aware of any undisclosed facts tending to seriously undermine the accuracy of the statement.[107] The Ninth Circuit was influenced by references in an executive's corporate diary detailing product reliability problems. The court found a triable issue whether the technical problems with the printer did undermine the optimism of the company's public statements. To this extent, the decision is an affirmation of the Apple Computer analysis.

The most interesting aspect of Hanon is the Ninth Circuit's denial of the plaintiffs' request for class certification due to his unique background and factual situation as a professional plaintiff in securities fraud "strike suits." The court ruled that Mr. Hanon failed to establish Rule 23(a)'s typicality requirements, noting:

> Hanon's reliance on the integrity of the market would be subject to serious dispute as a result of his extensive experience in prior securities litigation, his relationship with his lawyers, his practice of buying a minimal number of shares of stock in various companies, and his uneconomical purchase of only 10 shares of stock in Dataproducts.

The Ninth Circuit's decision clearly represented an attempt to stem the tide of securities fraud class actions that has swamped the federal courts after the Supreme Court's adoption of the "fraud on the market" theory of reliance.

106/ Fed. Sec. L. Rep. (CCH) ¶97,021 (9th Cir. 1992).

107/ As authority for the proposition that projections and general expressions of optimism may be actionable under federal securities laws, the Ninth Circuit cited the U.S. Supreme Court's decision in Virginia Bankshares, Inc. v. Sandberg, 111 S. Ct. 2749 (1991) (knowingly false statements of reasons, opinions, or belief, even though conclusory in form, may be actionable as misstatements of material fact). The Ninth Circuit has held, however, that a prediction is not an "untrue" fact just because it subsequently proves wrong. See In re Lyondell Petrochemical Company Securities Litigation, Fed. Sec. L. Rep. (CCH) ¶97,335 (9th Cir. 1993) (internal projections are not inherently trustworthy and therefore, the mere possession of such projections does not make a contradictory public prediction false, unless such projections are based on undisclosed facts that contradict the prediction).

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3. In re Convergent Technologies Securities Litigation

The Ninth Circuit's decision of In re Convergent Technologies Securities Litigation,[108] proved that issuers can win summary dismissal on a duty not to mislead action. In Convergent, the Ninth Circuit affirmed the company's motion for summary judgment against claims that the company misled investors by recklessly overstating and projecting growth in demand for its existing line of computer workstations and also by concealing known production and profitability problems with two new product lines under development.

a. Overstated Demand for Existing Products

Convergent's March 1983 Prospectus stated that its largest customer for its existing workstation had accounted for 48% of total revenue in 1982 and that the company expected that "[this customer] may continue to account for a similar percentage of revenue in 1983." Convergent's May 1983 10-Q reported first quarter growth in revenues due to increases in shipments to its large customers. However, on August 5, 1983, Convergent disclosed in a press release that due to customer anticipation of Convergent's next generation of products, third quarter sales would be flat and that fourth quarter revenues could fall off. After this release the stock price dropped $6.60 per share, nearly 20%.

The Ninth Circuit found that Convergent's March revenue projections were accurate at the time made and did not overstate workstation demand. The court rejected the claim that the company's accurate report of past performance and specific limited predictions somehow implied that the company's growth would continue at the torrid rate of past performance. Furthermore, the court found that the market clearly understood that Convergent could not maintain its past growth rates and that demand for its existing products would decrease as its new products became available. Therefore, the court held that the plaintiffs could not maintain this omission claim in a fraud-on-the market case.[109]

108/ 948 F.2d 507 (9th Cir. 1991).

109/ The court cited with approval the district court's decision in In re Seagate Technology II Securities Litigation, Fed. Sec. L. Rep. (CCH) ¶94,502 (N.D. Cal. 1989) ("technical obsolescence of computer equipment in a field marked by rapid technological advances is information within the public domain"). See discussion infra note 68. See also In re Lyondell Petrochemical Company Securities Litigation, Fed. Sec. L. Rep. (CCH) ¶97,335 (9th Cir. 1993) (an issuer's truthful statements about its past performance did not imply a comparison between the rate of past and future growth).

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b. Production and Cost Problems of New Products

Convergent's March 1983 Prospectus also announced efforts to develop a new laptop computer named "Workslate." The Prospectus noted several specific risks with Workslate:

> The development of these products is anticipated to be complex and to require the development of proprietary technology; accordingly, product introduction may be subject to delay, which may adversely impact the Company's ability to market these products. There can be no assurance that the Company will successfully complete the development of its new products, or that it will be successful in manufacturing the new products in high volume or marketing the products in the face of intense competition.

Convergent did encounter problems with Workslate and had to sell certain of those products at a loss. In an August 1983 Prospectus, the company repeated the risks described in its March Prospectus and added a litany of additional risk factors. Various internal company memos and projections during the Fall of 1983 detailed the problems hampering the Workslate program. In February 1984, Convergent revealed to analysts that Workslate had been prematurely released, needed redesigning and had been sold at a loss. The company's stock price fell an additional 17% and the plaintiffs filed their class action shortly thereafter.

The Ninth Circuit rejected the claims that Convergent had concealed from the market the various cost and production problems with Workslate. The court denied that Convergent's risk disclosures were too general and misleading. The court acknowledged that Convergent had at its disposal more detailed internal Workslate projections of negative performance, but denied that the company was obligated to disclose these internal projections. The court noted:

> It is just good general business practice to make such projections for internal corporate use. There is no evidence, however, that the estimates were made with such reasonable certainty even to allow them to be disclosed to the public.

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4. In re Seagate Technology II Securities Litigation

Another high-tech California case, In re Seagate Technology II Securities Litigation,[110] demonstrated the difficulty in achieving bullet-proof disclosure. In this case, the plaintiffs alleged that defendants made several partially curative disclosures and thus artificially inflated the price of the stock. Seagate, a manufacturer of computer disk drives, dominated the 5 1/4" disk drive market throughout the 1980's. In 1988, due to industry conversion to 3 _" disk drives, Seagate faced obsolescence of a principal product and substantial costs to retool for the newer models. Nonetheless, instead of fully disclosing "the truth concerning its financial condition and business prospects," plaintiffs allege that, starting with a press release on July 18, 1988, defendants began to make a series of "grudging admissions of certain adverse facts--no one of which was fully curative."[111] Full disclosure of financial problems was delayed until October 5, 1988, when Seagate issued a press release announcing a loss for the quarter ended September 30 and the resignation of two sales executives. Seagate's stock dropped from $22 per share on April 13, 1988, to about $7 per share following Seagate's October 5 press release.

Plaintiffs sued under Rule 10b-5 alleging that Seagate's fraudulent nondisclosures and their "grudging" partial disclosures distorted, to varying degrees, the price of Seagate common over the period of from April 13, 1988, to October 5, 1988.[112] The court granted partial summary

[110] Fed. Sec. L. Rep. (CCH) ¶98,312 (N.D. Cal. 1994).

[111] Id. at 90,148.

[112] In the district court's decision, In re Seagate Technology II Securities Litigation, Fed. Sec. L. Rep. (CCH) ¶94,502 (N.D. Cal. 1989), the court determined that Seagate accurately disclosed existing information regarding the product transition and the potential expenditures needed to produce the new models. The company had no obligation to characterize the difficulties as "a major threat to the future," nor was the company required to publicly denigrate its products in the manner suggested by plaintiffs.

The court also noted that the dangers of obsolescence of computer disk drives "in a field marked by rapid technological change, information is within the public domain and does not exclusively lie with Seagate." Ironically, in Apple, the Ninth Circuit rejected similar arguments that the market understood the risks inherent in the new product development of Twiggy. In Seagate, however, the alleged omissions related to general industry-wide risks involved in product transition, whereas the alleged omissions in Apple related to specific risks involved in the development of Lisa and Twiggy, unique products.

Notwithstanding that Seagate made extensive disclosure regarding the product transition and its effects on earnings, the court found that Seagate may have misled investors about demand for its products. Seagate failed to disclose in its quarterly reports that it was reducing prices as a strategy to increase sales and market share. The court also allowed discovery to determine whether Seagate knew that it had overestimated demand for its products, resulting in severe excess production capacity, before it announced record sales and expansion plans.

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judgment for the defendants, finding that any claims based on alleged affirmative misstatements by defendants could not succeed.[113] However, the court found that defendants might have misled investors through material omissions.

Defendants' motion for summary judgment relied on, among other things, the contention that defendants had no duty to disclose the alleged material information to the investing public. In response to defendants' contention, plaintiffs alleged that Seagate made statements which were materially misleading due to omitted information. While defendants argued that the statements were not misleading because they were "literally true," the court stated that this argument "misses the point." Citing Convergent Technologies, the court stated that:

> [T]he disclosure required by securities laws is measured not by literal truth, but by the ability of the material to accurately inform rather than mislead prospective buyers.[114]

5. In re Gap Securities Litigation

In re Gap Securities Litigation[115] is one of the few cases that focuses on inadequate MD&A disclosure. Plaintiffs alleged that The Gap's 1986 annual report contained an overly optimistic forecast of future performance and misled investors by omitting to disclose developments which would adversely affect earnings, including: (1) an adverse build-up of inventory, and (2) a declining trend in merchandise margins due to rising wholesale costs of imported goods. The plaintiffs maintained that those omissions were aggravated by The Gap's statement in the annual report that, "we can control our own destiny," regarding wholesale costs. Finally, plaintiffs alleged that The Gap had a duty to disclose in the MD&A of subsequent 10-Q reports the continued inventory build-up and the causes and trends of this build-up.

In September of 1987, after The Gap announced a 33% decline in third quarter earnings over the prior period, The Gap stock plunged $40, from $77 to $37 per share. The plaintiffs contended that The Gap elected

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113/ The court relied on defendants' expert analysis which "conclusively shows that none of defendants' affirmative corporate disclosures caused a statistically significant variance in the price of Seagate stock." Seagate, Fed. Sec. L. Rep. (CCH) ¶98,312, at 90,167.

114/ Seagate, Fed. Sec. L. Rep. (CCH) ¶98,312, at 90,168, citing Convergent Technologies, supra note 66, at 512.

115/ Fed. Sec. L. Rep. (CCH) ¶94,724 (N.D. Cal. 1988), aff'd, 925 F.2d 1470 (9th Cir. 1991).

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not to disclose the negative trends in costs, sales and inventory in order to allow insiders to sell their stock at artificially-inflated prices.

a. Projections, Puffing and Explanations

The Gap had disclosed actual inventory levels in its 10-K and 10-Q filings. The court found that The Gap had adequately warned investors in its 10-K that "[if] inventory exceeds customer demand, . . . markdowns are employed to clear the merchandise. Such markdowns may have an adverse effect on earnings." The court also determined that the company had no further duty to make projections that the inventory build-up would continue or to specify that the higher levels of inventory did not mean higher sales. The court also declared that The Gap's "destiny" statement was mere "puffing," a vague expression of optimism as to future performance, and not actionable under the securities laws.

The district court also dismissed, but without prejudice, plaintiffs' claim that The Gap failed to disclose a deviation from its previously announced policy of marking down inventory when supply exceeded customer demands. The court noted that a failure to adequately explain any such deviation, delaying markdowns, may have artificially inflated second quarter earnings. Plaintiffs were granted leave to plead this claim with particularity.

b. Insider Trading

The district court also dismissed plaintiffs' insider trading claims against the individual Gap officers. The information on which the insiders allegedly traded was precisely the same information which plaintiffs claimed The Gap had a duty to disclose in its reports. Apparently, because The Gap had adequately disclosed this information, the individual defendants could not have traded on "inside" information. As for predictions of future performance, the court noted that "[a]n insider is no more required to predict future inventory levels or sales trends to prospective purchasers of Gap securities than is a corporation and its officers to the public."[116] The court never addressed whether the insiders may have improperly traded on the omitted information regarding the alleged deviation in markdown policy. Notwithstanding the dismissal of these claims, the existence of trading by insiders, even if innocent,

[116] Fed. Sec. L. Rep. (CCH) ¶94,724, at 93,911 (citing SEC v. Texas Gulf Sulphur, 401 F.2d 833, 848 (2d Cir. 1968)).

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probably colors the facts and subjects an issuer's statements to heightened scrutiny by the courts.[117]

6. Jaroslawicz v. Engelhard Corporation

Jaroslawicz v. Engelhard Corporation[118] illustrates that when an issuer does disclose adverse business developments, its discussion must be full and fair. Between 1982 to 1984, the Engelhard Corporation made several statements in annual and quarterly reports which, when compared to internal memorandum, painted a conflicting picture about the operational and economic health of two of its precious metals refineries (the Newark, New Jersey facility — also referred to as the "Delancy Street" operations — and the Sheffield facility, located in England). In April 1984, on the heels of its 1983 Annual Report, Engelhard announced a $36 million write-off with respect to the two refineries, sending the company's stock value down by 11%.

As for the materiality of the company's statements, the court first noted the importance Engelhard had attached to its refining operations. In its 1982 Annual Report, Engelhard had referred to refining as one of two "principal segments" of the company's operations. The court then undertook an examination of Engelhard's public disclosures in contrast to the company's internal memos regarding its refining business, summarized on the following pages as follows:

117/ Under the Reform Act, plaintiffs are alleging the existence of insider sales to support their scienter claims. See Section III.C.4.

118/ 704 F. Supp. 1296 (D.N.J. 1989).

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PUBLIC DISCLOSURES

1982:

First Quarter Interim Report to Shareholders:

The weakness in this quarter's results was the refinery business conducted in the Newark facility which has been operating at reduced levels because of the recession, particularly as compared to the first quarter of 1981 which benefited from business originating in 1980.

Second Quarter Interim Report to Shareholders:

During 1982's second quarter, we streamlined the operation of the Newark refinery to improve the efficiency of our refining business. Substantial reductions were made in the number of personnel at that facility as well as related service functions, and changes in processing techniques were implemented. The expenses associated with this program have, to a considerable extent been absorbed in this second quarter earnings, but the resulting profit improvements will become evident only in subsequent periods.

Annual Report to Shareholders:

INTERNAL MEMORANDUM

1982:

February—Study of Newark facility presented by Engelhard's CEO to the Board:

Describing that the Newark plant was in "a critical stage of deterioration" which "constituted an intolerable situation" and the almost $15 million anticipated loss for 1982 was caused by erroneous plant design, "inadequate" management, obsolete processes and technology, a lack of "commercial wisdom" regarding plant management and contracts, poor inventory control, environmental costs and "inexpert" staffing problems.

* * *

Citing a 1980 independent evaluation which stated at least $8.8 million would have to be spent to be an "absolute minimum for the efficient functioning of the refinery" and "for commercial viability under normal market conditions, further major capital expenditures would be called for."

* * *

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PUBLIC DISCLOSURES

. . . in response to the adverse impact of worldwide economic conditions . . . on the refining operations . . . a program to introduce cost-effective specialization and to streamline the organization of certain of our facilities was . . . substantially completed in 1982. The costs of this program have been partially offset by gains derived from the reduction of inventories as an integral of this effort.

1983:

A 10-A Report:

Solid earnings results were derived from the continuing strong performance of the Company's precious metal refining operations.

INTERNAL MEMORANDUM

Recommending that "certain operations" at Newark be terminated, reducing the number of employees from 410 to 225 by the end of 1982.

June 1982—REVISED REDEFINING OPERATING STRATEGY MEMORANDUM:

Setting out plans to reduce personnel to 60 by the end of 1982.

* * *

Noting "we must get relief!"

* * *

Containing plans to "phase out all refining operations . . . leaving only preparation and sampling" at the Newark facility.

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PUBLIC DISCLOSURES

Annual Report to Shareholders:

In response to . . . worldwide economic conditions on the refining operations . . . a program to introduce cost-effective specialization and to streamline the organization of certain of our facilities was . . . substantially completed in 1982. The costs of this program have been partially offset by gains derived from the reduction of inventories as an integral of this effort.

* * *

Earnings from the Company's . . . refining businesses increased substantially over 1982 levels. While cost reduction and better processing techniques were the principal causes of the earnings improvement, still more efficiencies must be obtained from both our U.S. and European refining operations.

* * *

INTERNAL MEMORANDUM

December—Memorandum written by Engelhard's assistant controller recording a meeting between their accountants and the Controller of Engelhard:

Determining that "the approximately $18 million of nonrecurring losses resulting from programs to streamline and introduce specialization at Newark and Sheffield" are to be offset by sales from inventory and concluding that nondisclosure of this measure was not "misleading with respect to ongoing operations."

* * *

Stating that "it was pointed out that disclosure of the magnitude of the refinery losses could lead to even more severe predatory practices by our competitors with adverse consequences for our stockholders" and "that it was decided . . . that it was appropriate to bring [illegible] the world-wide [illegible] of refining activity and the changes made by Engelhard to the attention of the annual report readers . . . ."

A letter from Engelhard's General Counsel:

Stating that the Company had decided to suspend one of Sheffield's "circuits" in late 1982 (one-third of the facilities operations).

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PUBLIC DISCLOSURES

Performance in 1983 benefited significantly from the cost reductions achieved through the restructuring of domestic refining operations in 1982. In 1983, the Company commenced a similar program at certain European refining operations, which should benefit future operating results beginning in 1984 . . . .

* * *

In addition, business conditions of our English precious metal chemical operations improved, although English and Italian metallurgical operations were adversely affected by weak local demand . . . .

* * *

INTERNAL MEMORANDUM

1983:

August—Memorandum by Coopers & Lybrand manager in charge of Engelhard's audit, regarding meeting with management relating that:

The meeting was held at Engelhard's request and related to the Company's proposed treatment of a write-down of certain P.P.&E. [Plant, Property & Equipment] at Delancy Street . . . .

* * *

We were informed by Isko that the Company intends to have an appraisal of the going concern value of the refining operations performed as a basis to recover a write-down of the P.P.&E.

We agreed that a write-down was appropriate . . ..

. . . Isko expressed his concern about the adverse impact of a Delancy Street write-down on the trend of earnings. He further stated that the write-down is a recognition of in appropriate decisions made by predecessor management . . . He requested our assistance to conceptualize a manner by which the impact of the write-down would not affect the earnings trends . . . .[119]

[119/] Despite the manager's repudiation of the contents of this memorandum at trial and other testimony contradicting the memorandum's conclusions, the Court used this evidence to hold that a jury could find that Engelhard pre-planned the April 1984 write-down. The Court denied summary judgment on this matter stating that the accuracy of this accountant's portrayal of the meeting was a triable issue of fact.

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PUBLIC DISCLOSURES

Profit from precious metal . . . operations and related refining in Europe grew over last year as these businesses posted increased sales.

INTERNAL MEMORANDUM

December—Internal Management Memorandum:

Stating that "at meetings on October 13th and 14th it was decided that we should close the Sheffield site in two phases."

* * *

Proposing a timetable to announce unemployable workers, a union settlement, clean-up of inactive equipment, and a reduction in the remaining two operating circuits; one circuit to reduce tonnage from 80 tons to zero, and the other to decrease from 47 tons to two.

Management Testimony:

By the end of 1983 the majority of the Newark operations had ceased.

* * *

Capital Expenditures at Newark went from $5.58 million in 1981 to $0.68 million in 1983 and capital expenditures at Sheffield had decreased from $1.81 million in 1981 to $0.94 million in 1982.

On the basis of the above, the court held that a reasonable jury could find Engelhard's behavior reckless and in violation of Rule 10b-5.

The Engelhard decision teaches two important lessons. First, Engelhard demonstrates an issuer's duty not to mislead. The inconsistency of the company's public disclosures with Engelhard's internal communications and actions taken by management clearly suggests that Engelhard's disclosures may not have reflected the reality of the situation at the refineries. The company's statements in its Annual and Interim Reports acknowledging difficulties with the refineries pointed investors in the wrong direction, suggesting that the company had successfully implemented corrective measures. The disclosures also blamed industry conditions for problems specific to Engelhard's operations.

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Second, Engelhard used standard boiler-plate language to describe its plants and other facilities in answer to Item 102 of Regulation S-K ("Description of Property"). Engelhard's 10-K Report for the period ending December 31, 1983 stated:

> The Company's processing and refining facilities, plants and mills are suitable and adequate and have sufficient capacity for its normal operations. Overall, these facilities were substantially fully utilized during the year, except for excess capacity in certain of the Company's refining facilities.

Engelhard made this exact same statement on March 31, 1984, only five days before they announced the write-down of the refineries. Too often issuers simply carry forward these types of statements from previous reports without examining them with an accurate eye. Issuers instead should compare these and other disclosures to the current state of affairs to insure that they provide investors an accurate impression of the company's business and financial condition.

The inconsistent internal document problem examined in the 1989 Jaroslawicz decision has continued to be an issue through the late 1990's. A 1998 decision reasoned that:

- Pre-merger disclosures concerning production problems that are inconsistent with a company's internal information, in addition to a motivation to conceal those problems in an attempt to make a merger attractive to another company, is sufficient to raise an inference of scienter.[120] (Emphasis added.)

C. Use Of Forward Looking Statement Information

Until the 1970's, the use of forward looking disclosure was essentially outlawed. Because of the importance of predictive information and its existence -- and indeed use in private placements -- it has gradually become not only allowable but encouraged.

But even with this more hospitable environment, except in self-dealing transactions, such as going private transactions, formal line-by-line projections are overwhelmingly not used in public disclosure or SEC filings.[121] This is primarily attributed to the wave of securities fraud class-action suits challenging even the slightest

[120]/ In Re Boeing Securities Litigation, Fed. Sec. L. Rep. (CCH) ¶90,285 (W.D.Wa. 1998).

[121]/ But see CUNO, Information Statement (Form 10), Sept. 6, 1996, pp 25-27.

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misstatement regarding predictive expression.[122] Prompted by the developments discussed below, however, softer forward looking information -- "The Company expects to exceed last year's record sales" -- is being used more often in non-Securities Act registered offerings.

1. Pre 1994 Decisions

A flood of cases challenging the propriety of certain projections and other generic expressions of optimism proved that, under the current disclosure regimen, issuers are "damned if they do and damned if they don't" make predictive statements.[123] The cases suggest that any optimistic statement by management may be construed as a present reaffirmation of formal projections previously supplied by the issuer. Unfortunately, management cannot simply ignore the future. As construed by the SEC, the MD&A requirements force issuers to look into the future on a quarterly basis and discuss known trends and uncertainties and other prospective information that management expects may impact the company. These cases illustrated that the securities markets and the plaintiffs' bar will concede no margin of error for these predictive statements.

a. Roots Partnership v. Land's End, Inc.

The case of The Roots Partnership v. Land's End, Inc.,[124] illustrates how critical it was that an issuer's public predictions comport perfectly with its internal projections. In Land's End, the plaintiffs challenged the propriety of a series of public statements and releases confirming that the company was "confident" it would achieve its goal of a 10% pretax return on sales in 1990, made at a time when the company's internal projections estimated a 9.9% pretax return. In December, 1989, after Land's End announced poor earnings for 1990 and a pretax return of as low as 8.3%, the company's stock price fell almost 50%.

122/ Christie Harlan, SEC Seeks To Beef Up "Safe Harbor" Provision, Wall St. J., May 17, 1994, noting that of 218 companies responding to a Journal Survey, more than one half indicated that the prospect of shareholder litigation affected the dissemination of forward-looking information.

123/ See Bruce A. Mann, Reexamining the Merits of Mandatory Quarterly Reporting, Insights, Apr. 1992, at 3, for a thought-provoking essay regarding the current regulatory scheme. See also John F. Olson and D. Jarrett Arp, Current Issues in the Use of Forward-Looking Information, Northwestern University School of Law, 22nd Annual Securities Regulation Institute (January 1995) for a detailed discussion of disclosure and forward-looking information.

124/ Fed. Sec. L. Rep. (CCH) ¶96,633 (7th Cir. 1992).

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The Seventh Circuit affirmed summary judgment for the defendants, ruling that the company's predictive statements fell within the safe harbor of Rule 175. The court noted that:

> The simple allegation that Land's End's internal earnings deviated slightly from its stated goals does not in itself suggest the goal fell outside the realm of reasonable probability and therefore lacked a reasonable basis.

The court also rejected the plaintiffs' claims that Land's End should have disclosed problems of slackening demand, obsolete inventory, low-margin liquidations and declining profit margins. Plaintiffs failed to establish that these alleged problems were so significant that they jeopardized the possibility of attaining the 1990 goal.

b. In re Sun Microsystems, Inc. Securities Litigation

In re Sun Microsystems, Inc. Securities Litigation[125] demonstrates the danger in confirming earnings forecasts if the company's internal reports discredit such forecasts. On May 1, 1989, Sun estimated fourth quarter earnings of 33¢ per share (identical to the previous year's fourth quarter). Sun also stated its "hope" that this figure could possibly increase. Sun's stock plummeted one month later, after the company announced a decline in net income for the fourth quarter and a possible loss for the year. The plaintiffs alleged that Sun failed to disclose the risks and financial impact of an MIS conversion program and new product introduction, and a decline in bookings during the third quarter. Sun also allegedly disregarded these problems when it made the fourth quarter projections. Plaintiffs produced evidence that at the time these statements were made, the company was supplying its banks different, more accurate information and a pessimistic earnings projection.

The court applied an analysis derived from the Apple Computer case, whereby projections are actionable only if any one of three implied factual assumptions is proven inaccurate: (1) that the projection is genuinely believed; (2) that there is a reasonable basis for that belief; and (3) that the speaker is not aware of any undisclosed facts tending to seriously undermine the accuracy of the statement. The court found that Sun had properly disclosed both the collapse of its computer system and the risks of the transition to new products. However, the court denied summary judgment for Sun because there was a triable issue whether

125/ Fed. Sec. L. Rep. (CCH) ¶95,504 (N.D. Cal. 1990).

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defendants knew that Sun would not meet its fourth quarter targets, and whether defendants were at least reckless in making the projections based on the available information.

c. Kirby v. Cullinet Software, Inc.

The decision in Kirby v. Cullinet Software, Inc.[126] illustrates the importance of fair disclosure when making voluntary statements about future performance. The court in Kirby found that Cullinet Software misled investors by affirming, in a press release and at a meeting with market analysts, prior positive projections regarding sales growth and operating margins which the company knew were unreliable. In a confused analysis, the court also implied that Cullinet had an independent duty to update the earlier projections once the company knew that it could not meet the forecasts.

i) Projections and PROJECTIONS

On May 30, 1985 Cullinet Software stated in a press release that, while it was too early to be sure, Cullinet expected growth of 30% to 40% in its first fiscal quarter for 1986 and that the company expected to meet its traditional operating margin of 20%. In a June 17 press release Cullinet announced 50% growth for fiscal 1985 and also expressed confidence it would "continue to exceed industry growth rates" in fiscal 1986. At the time Cullinet issued this second press release, the company's internal figures for the first half of the first quarter of 1986 revealed sales at about one tenth of those necessary to achieve the 30% growth rate projected in the May 30 release.

Cullinet's Chairman compounded his problems in a meeting with market analysts on July 18. Without mentioning the disappointing first quarter sales figures, he stated that although he was not making a forecast, he felt comfortable with 30% to 40% growth for the year. He also indicated that the traditional 20% operating margin was "sacred." On July 18, Cullinet needed $24 million in additional sales by month end to reach the 30% growth mark for the first quarter; $10 million in sales more than predicted for the entire month.

[126] 721 F. Supp. 1444 (D. Mass. 1989).

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After the company announced preliminary first quarter results on August 6, estimating an increase in revenues of only 4% and operating margins at 14%, the stock price fell from $24 to $18 per share. Plaintiffs sued alleging that Cullinet's May 30, June 17 and July 18 statements constituted a common course of fraudulent conduct designed to inflate the price of Cullinet's stock in violation of Rule 10b-5. Cullinet moved for summary judgment.

ii) Duty Not to Mislead

With respect to the May 30 release, the district court held that plaintiffs did not offer sufficient evidence to establish that the initial projections for the first quarter of 1986 lacked a reasonable basis or were reckless when made. The court granted summary judgment for Cullinet with regard to this claim.

The court, however, denied Cullinet's motion for summary judgment with regard to the June 17 and July 18 statements forecasting 30% to 40% growth and 20% margins for fiscal 1986. The court stated that the evidence was sufficient for a jury to infer:

> that by June 17, 1985, Cullinet knew or should have known that the projection [of 30% to 40% growth and 20% margins for the first quarter of 1986] would not be achieved, that Cullinet then had a duty to correct the projection or, in any event, had a duty not to make statements which while not literally false would convey the misleading impression that the recent promising prediction remained reliable.[127]

The court specifically determined that Cullinet had crafted its public statements to avoid any specific mention of the first quarter prospects thereby reinforcing the notion of short-term growth. To avoid misleading investors, the June 17 and July 18 statements should have discussed the adverse developments and the company's shortfall in sales for the first quarter of 1986.

iii) Duty to Update

[127] Id. at 1454.

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The district court persuasively reasoned that Cullinet may have violated the duty not to mislead. Unfortunately, the opinion also suggested that Cullinet had an independent duty to correct or update the May 30 projections once it understood that they had become unreliable. The court makes reference in the opinion, no less than six times, to an obligation to "update."

Cullinet's obligation to discuss the May 30 projection arose only from its subsequent statements which, according to the court, gave the misleading impression that the May 30 projection remained attainable. Had Cullinet not issued the June 17 and July 18 statements, the company would have had no duty to update the May 30 projection merely because subsequent developments proved it unreachable. Hence, a finding of a separate duty to update is inappropriate and arguably dicta. Hopefully, other courts and commentators will not interpret this case as imposing a continual duty to update material developments.[128]

2. SEC Efforts to Adopt a Stronger Safe-Harbor Rule

The SEC made an effort to promote more forward looking information through its emphasis on MD&A and its "Concepts Release on Safe Harbor for Forward-Looking Statements"[129] ("Concept Release") issued in 1994 designed to improve its 1979 safe-harbor rules -- Rules 175 and 3b-6. The Concept Release included eight alternative proposals to the safe-harbor rules and solicited comments on over 70 questions. Despite the large number of alternative proposals and widespread support for expanding the safe-harbor rules, during 1995 it became clear that the SEC would not act on this issue and legislative activity replaced the SEC initiative.

In the late 1970's, the SEC designed the safe-harbor rules to protect companies that voluntarily disclosed forward looking information from fraud claims unless the projections made were "without a reasonable basis or was disclosed other than in good faith."[130] Companies, however,

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128/ Unfortunately, the concept of a "duty to update" is still alive, but may disappear. For a more detailed discussion of the duty to update, see infra Section III.F.

129/ See Rel. Nos. 33-7101; 34-34831; 35-26141; 39-2324; IC-20613 (Oct. 13, 1994), 26 Sec. Reg. & Law Rep. 1405 (Oct. 21, 1994) (the "Concept Release").

130/ The safe harbor rules -- Rule 175 under the Exchange Act and Rule 3b-6 under the Securities Act -- are 17 C.F.R. §230.175 (1994) and 17 C.F.R. §240.3b-6 (1994) (the "Safe Harbor Rules").

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have found that the safe harbor "doesn't work in practice."[131] Companies have curtailed the information they provide about future performance because the safe harbor was not so safe.[132] Consequently, in 1994 the SEC issued the Concept Release soliciting comments on possible reforms to the safe harbor rules. The various reform proposals from both the private and public sector are discussed below. The primary issue to focus on when reading these proposals is whether they effectively balance the goal of encouraging broader dissemination of forward looking information to the investing public without compromising investor protection by sanctioning fraudulent or recklessly prepared forecasts.

The Concept Release is still worth reading even after adoption of the Reform Act since (i) many of the proposals were endorsed by the Reform Act, (ii) the Reform Act expressly encourages the SEC to adopt additional safe harbor rules and (iii) the last chapter on this subject has not been written. The Concept Release traces the history of the Commission's prohibition against the use of projections (pre-1970's), through the Wheat Commission and Advisory Committee on Corporate Disclosure Reports (1969 and 1976) to the adoption of the Safe Harbor Rules (1979). It also discusses the 1989 Interpretive Release, qualitative performance, the courts' approaches toward liability for forward looking statements, and the criticisms directed toward the Safe Harbor Rules because of their under-inclusiveness, lack of judicial support -- or even recognition --, failure to deal with whether a duty to correct or update exists and how they apply to disclosures to analysts, on roadshows, or otherwise. The Concept Release then describes eight alternative proposals that had been advanced, which are described below. It concluded by soliciting public comments in a series of approximately 70 questions and announced that public hearings would be held in February 1995.

a. The Alternative Proposals

The eight proposals submitted to the Commission were:

i) Commissioner Beese's Proposal: The Business Judgement Rule

[131] See Christi Harlan, SEC Seeks to Beef Up 'Safe Harbor' Provision, Wall St. J., May 17, 1994, at C1.

[132] According to the Wall Street Journal article, a recent survey by the American Stock Exchange showed that "more than half of the 218 companies responding said that the prospect of shareholder litigation affected the dissemination of forward-looking information." Harlan, supra note 92.

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Commissioner Beese gave two reasons why companies were unwilling to use the safe harbor rules. First, the safe harbor rules covered only written statements contained in documents filed with the Commission.[133] The safe harbor rules thus did not cover a company's conversations with analysts, where projections are most often communicated. Second, the safe harbor rules failed to keep the company out of extensive and expensive litigation once a plaintiff filed a suit and commenced discovery. No matter how good an issuer's defense, it was still cheaper to settle.

Commissioner Beese proposed that the SEC improve the safe harbor rules by adopting the business judgement rule to govern projections and other forward looking information provided by corporate officers. In addition, oral, as well as written, statements would be covered by the new rule.

The business judgement rule gives directors great latitude to oversee the corporation provided that they adopt courses of action which the directors, in good faith, honestly and reasonably believe will benefit the corporation. In the case of providing forward looking information voluntarily, Commissioner Beese proposed that the SEC allow corporate officers similar leeway to make good faith mistakes.

An integral of Commissioner Beese's proposal was to have issuers create a projection binder at the time of the preparation of its projections. This binder would "reflect the data underlying the projections, as well as the steps taken by management to analyze this data."[134] If the issuer was subsequently sued, the projection binder would be turned over to the plaintiffs, who would have the burden to prove why the projections lacked a proper basis at the time of disclosure.[135] Unless plaintiffs could show the judge that additional discovery was warranted, there would be no further discovery. The judge could allow the action to move forward only if plaintiffs could demonstrate that some potential deficiencies existed. Thus, judges could make an early disposition of the case before issuers faced the threat of extensive and costly discovery.

133/ Tools for Executive Survival Program, Luncheon Address by J. Carter Beese, Jr., Commissioner, Stanford University, Palo Alto, California, June 15, 1994.

134/ Id. at 17.

135/ Id.

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The business judgement safe harbor rule would cover projections and other forward looking information. Moreover, the rule would demand that officers gather and analyze sufficient information to justify their positions.

ii) The "Opt-In" Proposal

From the private sector, Harvey Pitt and Karl Groskaufmanis also proposed changes regarding the safe harbor.[136] Their proposal consisted of four components:

> First, companies planning to take advantage of the rule should be required to opt affirmatively for a so-called "safe-harbor regime." Companies making such an election would disclose their intention not only to make forward looking statements, but also to update those statements periodically. Once a company opted in, it would be obligated to continue to make projections for a minimum of four quarters.
>
> Second, any company opting to cease disclosing forward looking should be required to give notice thirty days before its next periodic filing with the Commission. In addition, these issuers would be required to detail the reasons for this change in policy (and would be precluded from opting back into the regime for another year) . . . A company's announcement of the reason or reasons for withdrawing from the program would not, of course, be subject to any Safe Harbor.
>
> Third, . . . projections [would be required to have] an adequate basis in fact, be issued in good faith, and be consistent with any similar forward looking information utilized by the company or supplied to its financial advisors, lenders, management or members of its board of directors. The SEC could bring an administrative cease-and-desist proceeding, or an injunctive action, for any projection found to have been issued in bad faith or without a reasonable basis in fact. The Commission could seek disgorgement, restitution and/or civil fines from issuers who

[136] See Harvey L. Pitt, Karl A. Groskaufmanis & M. Gilbey Strub, Toward a 'Real' Safe Harbor For Forward-Looking Statements: A Reassessment of SEC Rule 175, 866 PLI Corporate Law, 671 (November, 1994).

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do not meet that standard. Any company found by the Commission to have issued its projections without an adequate basis, or in bad faith, would be barred from re-opting into the Safe Harbor regime for a five-year period.

Fourth, for any company opting into the Safe Harbor regime, its projections could not constitute a false or misleading statement, or the omission of a material fact, for purposes of any private action, express or implied, under the federal securities laws . . . mean[ing] that, to the extent enforcement of the law occurs with respect to projections, it would occur solely at the behest of the Commission.[137]

iii) "Seasoned Issuer" Proposal

Under this proposal, an issuer would be precluded from private actions for oral and written forward looking statements with respect to securities quoted on Nasdaq or listed on a national securities exchange; and, if the issuer had filed all reports required under §§ 13, 15(d) of the Exchange Act within six months prior to the making of the statement. This proposal contained two exclusions from the safe harbor protection: (1) the inapplicability of the proposed safe harbor to penny stock issuers; and (2) the exclusion of issuers previously convicted of securities law violations or issuers subject to any securities-related injunction within the previous five years.

iv) "Heightened Definition" Proposal

Under this proposal, liability would be imposed only if a misstatement or omission was material, made or omitted with scienter and, for private plaintiffs, relied upon. There would be no attribution to the issuer of statements made by third parties unless the issuer expressly endorsed or approved of the statement. Furthermore, an issuer would not have a duty to update a forward looking statement unless it expressly undertook to do so at the time the statement was made. The proposed safe harbor would expressly extend to both qualitative and quantitative statements of management's plans and objectives for future operations.

137/ Id. at 678.

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v) "Bespeaks Caution" Proposal

This proposed safe harbor,[138] available to reporting companies (except penny-stock issuers), would protect a forward looking statement so long as it contained "clear and specific" cautionary language that was sufficient to inform a reasonable person of the approximate risk associated with the statement and its basis. Oral or written forward looking statements that had not been filed with the Commission would be protected only if it had been reaffirmed in a filed document or an annual report which was made publicly available within a reasonable time after the statement was first disseminated. The forward looking statement did not need to have a "reasonable basis" (as under existing Rules 175 and 3b-6). Finally, qualifying forward looking statements made in Exchange Act filings would be exempted from automatic incorporation by reference in Securities Act filings unless registrants affirmatively sought inclusion, in which case existing Rule 175 would remain available.

vi) "Fraudulent Intent" Proposal

A forward looking statement would be protected unless recklessly made or with an actual intent to deceive. To prove recklessness, the plaintiff would be required to prove that at the time the statement was made, the issuer was aware of facts that made it "highly unlikely" that the projections could be achieved.

vii) "Disimplication" Theory

Professor Joseph Grundfest proposed that the Commission redefine the elements of a private claim under Rule 10b-5 to afford projections greater protection. He suggested that Rule 10b-5 should be amended to require a showing of "knowing securities fraud," demonstrating "actual knowledge that the [projection] is false," as a precondition for private recovery in a Rule 10b-5 action complaining of a falsely optimistic projection.

viii) "Reasonable Basis In Fact" Proposal

Under this proposal, the safe harbor would protect oral or written forward looking statements, whether or not filed with the

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138/ This proposal, submitted by Professor John Coffee, would codify a variant of the "Bespeaks Caution" doctrine, discussed more fully supra Section III.E.

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Commission, unless the statement was made without a reasonable basis in fact, was seriously undermined by existing facts, was not genuinely believed or was made other than in good faith.

b. What Happened to the Concept Release?

Notwithstanding the large number of alternative proposals and the widespread support for expanding the Safe Harbor Rules, the SEC tabled the proposal. Observers indicated that the SEC's inaction during the eight months after the Concept Release was issued in October 1994 was the result of strong differences of opinion within the Commission on two primary issues: (1) whether a safe harbor should limit private remedies and (2) what type of information should be covered in a safe harbor.[139] Questions were also raised about the agency's authority in the area of forward looking information.[140]

3. Post 1994 Decisions

The courts have recently rendered decisions which help minimize exposure resulting from the use of forward looking statements. For example, in Herman v. Legent Corp., Thomas Herman, representative for a class of investors in Legent Corporation, brought a "fraud on the market" securities fraud class action, alleging that Legent made a series of fraudulent public statements about its future performance that inflated the value of Legent's stock over a six-month period. On appeal, the Fourth Circuit held that the statements of future performance were not fraudulent.[141]

On its face, the opinion seems to restrict the scope of securities fraud in actions pertaining to public predictions of future performance. The court proclaims that statements regarding projections of future performance are actionable under Section 10(b) and Rule 10b-5 only if they are supported by specific statements of fact or are worded as guarantees. The "specific statements of fact" would have to be extremely specific to qualify, such as statements referring to specific business projects. Otherwise, such "soft, puffing statements" involving optimistic opinions or predictions of future performance are not material, and thus

139/ SEC's Safe Harbor Initiative May Be Overtaken by Litigation Reform, 27 Securities Regulation & Law Report 939 (June 23, 1995).

140/ Id.

141/ Fed. Sec. L. Rep. (CCH) ¶98,650 (4th Cir. 1995).

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not actionable as a matter of law.[142] Companies are to be given freedom to prognosticate.

Other courts have relied on the "Bespeaks Caution" doctrine to dismiss claims based on faulty projections. In Saltzberg v. TM Sterling/Austin Assoc., Ltd., another Court of Appeals affirmed the grant of summary judgment to defendants under the "Bespeaks Caution" doctrine. The court noted that "when a offering documents' projections are accompanied by meaningful cautionary statements with specific warnings of the risks involved, that language may be sufficient to render the alleged omissions or misrepresentations immaterial as a matter of law."[143]

Many other recent decisions were unsympathetic to suits claiming the use of false or misleading forward looking information. Various reasons were used to support dismissals of such claims: the statements were too vague to be material[144]; the statements merely expressed general enthusiasm or non-actionable puffing[145]; the forward looking statements had a reasonable basis[146]. As is always the case, however, some courts have upheld complaints based on allegations similar to the ones which other courts have dismissed.[147]

4. The Private Securities Litigation Reform Act of 1995

December 1995 was a month of high drama for securities professionals. Congress passed the Reform Act and sent it to the White House. Most observers thought that President Clinton would sign the

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142/ See also San Leandro Emergency Medical Group Profit Sharing Plan v. Phillip Morris Companies, Inc., infra note 333 and accompanying text.

143/ 45 F.3d 399, 400 (11th Cir. 1995).

144/ Searls v. Glasser, Fed. Sec. L. Rep. (CCH) ¶98,867 (7th Cir. 1995); Siegel v. Lyons, Fed. Sec. L. Rep. (CCH) ¶99,227 (N.D.Cal. 1996).

145/ Fishbaum v. Liz Claiborne, Inc., Fed. Sec. L. Rep. (CCH) ¶90,676 (2nd Cir. 1999); Lasker v. New York State Electric & Gas Corp., Fed. Sec. L. Rep. (CCH) ¶99,231 (2nd Cir. 1996); Jakobe v. Rawlings Sporting Goods Co., Fed. Sec. L. Rep. (CCH) ¶99,406 (E.D. Mo. 1996); Robbins v. Moore Medical Corp., Fed. Sec. L. Rep. (CCH) ¶98,902 (S.D.N.Y. 1995).

146/ In re Healthcare Compare Corp. Securities Litigation, Fed. Sec. L. Rep. (CCH) ¶99,012 (7th Cir. 1996); In re Cyress Semiconductor Securities Litigation, Fed. Sec. L. Rep (CCH) ¶98,762 (N.D. Cal. 1995). See also Eisenberg, Securities Litigation - Courts Are Increasingly Willing to Dismiss Weak Claims, Insights, September 1994.

147/ E.g. In re Valence Technology Securities Litigation, Fed. Sec. L. Rep. (CCH) ¶98,793 (N.D. Cal. 1995); In re Clearly Canadian Securities Litigation, Fed. Sec. L. Rep. (CCH) ¶98,803 (N.D. Calif. 1995).

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legislation, but at the last minute he vetoed it.[148] Both Houses quickly overrode the veto and the Reform Act became law before the end of the year.[149] According to the Conference Report ("Report"), Congress sought to limit abusive, manipulative and frivolous securities litigation and "to protect investors, issuers and all those who are associated with our capital markets."[150] The Reform Act operates on a number of levels:

- Class action procedures, including the mechanics of settlement, have been significantly tightened.
- A system of proportional liability has in many instances replaced joint and several liability.
- Pleading standards have been raised, especially those regarding "state of mind allegations", i.e., scienter.
- In certain circumstances, discovery has been limited.
- Auditors are required to report illegal acts.
- The SEC -- but not private parties -- is expressly authorized to prosecute for aiding and abetting violations.
- More specific direction is provided regarding the calculation of damages and the necessity to prove loss causation.
- Except for when there has been a criminal conviction, "any conduct that would have been actionable as fraud in the purchase or sale of securities" cannot be the predicate for a violation of RICO.
- A safe-harbor has been added to both the 1933 and 1934 Acts for a "forward looking statement."

Our focus will be on the new safe-harbor provisions, although the other provisions of the Reform Act are extremely important and will change the landscape of securities litigation. It is still too early to tell, but I "forecast":

148/ President's veto message, Fed. Sec. L. Rep. (CCH) ¶85,714 (1995).

149/ The Reform Act does not affect or apply to any private securities action commenced and pending before the Act was adopted.

150/ Conference Report on HR 1058, 27 Securities Regulation and Law Report, 1881, 1890, November 1995 (the "Report").

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- It will take considerable litigation and many years to flush out the meaning of the new legislation. This remains true regarding the issue of pleading scienter.[151]

- It will most likely reduce frivolous litigation, but "serious" suits will be more costly to defend and more expensive to settle.

- Proportionate liability may turn out to be a double-edged sword. On the other hand, in what may be the first case to be decided by a jury under the Reform Act, the accounting firm BDO Seidman was exonerated. In a press release, it was reported that BDO took the risk of a trial because BDO believed that the proportionate liability provisions of the Reform Act would shield it from a verdict for the total loss.[152]

- While the contours of the safe-harbor provisions are not fully formed, they will in all probability reduce the number of suits filed based upon the use of forward looking information and be of considerable value in defending against such claims.[153]

The safe-harbor provisions are rather simple. They apply to both written and oral statements made by or on behalf of a reporting issuer.[154] To fall within the safe-harbor provisions, a forward looking statement must be:

(A) General - Written and Oral Statements

(B) The forward looking statement is

(i) "identified as a forward looking statement and

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[151] See Carney v. Cambridge Technology Partners, Inc., Fed. Sec. L. Rep. (CCH) ¶91,415 (Mass. Dst. Ct. March 30, 2001) (holding that the plaintiffs' vague fraud allegations did not meet the "factual particularity" pleading requirement for scienter under the Private Securities Litigation Reform Act).

[152/] Elizabeth MacDonald, *Federal Jury Exonerates BDO Seidman In Accounting Suit Over Audit of Firm*. Wall Street Journal (Oct. 28, 1999); Elizabeth MacDonald, *BDO Seidman Wins Overturn of Jury Verdict*. Wall Street Journal (Nov. 30, 1999).

[153] See Ehlert, et al. v. Singer, et al., Fed. Sec. L. Rep. (CCH) ¶91,407 (11th Cir. 2001) (ruling that a software maker's allegedly material misstatements in a registration statement and prospectus were protected by the PSLRA's safe harbor for forward-looking statements because the statements, accompanied by appropriate cautionary language, concerned forward-looking events).

[154/] The safe-harbor provisions apply to statements made by an issuer, a person acting on behalf of an issuer, an outside reviewer retained by the issuer or an underwriter. The term "person acting on behalf of an issuer" is further defined to mean an officer, director or employee of the issuer.

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accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward looking statement." **OR**

(ii) be immaterial

(C) The plaintiff fails to prove that the forward looking statement

(i) "if made by a natural person, was made with actual knowledge by that person that the statement was false or misleading;" **OR**

(ii) "if made by a business entity; was --

(I) made by or with the approval of an executive officer of that entity," **AND**

(II) "made or approved by such officer with actual knowledge by that officer that the statement was false or misleading."[155]

(2) Oral Forward Looking Statements Are Also Protected

(A) If the oral forward looking statement is accompanied by a cautionary statement indicating that the oral statement is forward looking **and** that actual results could differ materially from those projected in the forward looking statement; **and**

(B) If --

(i) "the oral forward looking statement is accompanied by an oral statement that additional information . . . is contained in a readily available written document,"[156]

(ii) the accompanying oral statement identifies where to locate the additional information; and

(iii) the additional information in the written document is in fact cautionary that satisfies the standards established in (1)(A) above.

155/ 27 Securities Regulation and Law Report at 1885.

156/ "Readily Available Information" means any "document filed with the Commission or generally disseminated." Id.

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Forward looking information is broadly defined to include:

- Projections of revenues, income, earnings per share, capital expenditures, dividends, capital structure or other financial items.
- Plans and objectives of management for future operations including future products or services.
- Future economic performance, including any statement contained in MD&A. The assumptions underlying any of the foregoing.
- A report issued by an outside reviewer to the extent that it assesses a forward looking statement made by the issuer.
- Statements containing projections that may be covered by specific rules of the SEC.

Very importantly, the Reform Act specifically provides that the safe-harbor provisions do not impose a duty to update forward looking statements. The SEC, moreover, is expressly granted authority to craft additional safe-harbors.

There are a number of specific and important exclusions from the safe-harbor:

- Forward looking statements by certain issuers are excluded:

  Those with a "bad boy" history.

  Forward looking statements made by a blank check company in connection with an offering of its securities.

  Penny stock issuers.

  An issuer who makes a forward looking statement in connection with a roll up transaction.

  An issuer who makes a forward looking statement in connection with a going private transaction.

- Forward looking statements made in certain SEC forms or in certain transactions are excluded:

  Statements made in certified financial statements.

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Statements made by investment companies.

Statements made in connection with a tender offer.

Statements made in connection with an IPO.

Statements made in connection with an offering by, or relating to the operation of, partnerships, limited liability companies or direct participation investment programs.

Statements made concerning beneficial ownership in Schedules 13D.

- Statements of present fact are not covered by the safe harbor.[157]

The Report emphasizes that of the rationale for adopting the safe-harbor is to encourage companies to disclose forward looking information. It also furnishes some helpful legislative history that will be useful in interpreting and applying the new safe-harbor provisions:

- Boilerplate warnings do not qualify as "meaningful cautionary statements" -- the cautionary statements must convey substantive information that realistically could cause results to differ from those projected.[158]

157/ This was true before the adoption of the safe harbor. See Jaroslawicz v. Engelhard, 704 F.Supp. 1296 (D.N.J. 1989) (statements regarding company's current production problems are statements of present fact). Since the adoption of the Reform Act, a number of courts have held the safe harbor inapplicable to historic statements of fact. For example, the District Court in Massachusetts held that the safe harbor for forward-looking statements did not protect press release comments concerning order volume and backlogged orders as a matter of law because they were statements of current conditions rather than projections. Geffen v. Micrion Corp., Fed. Sec. L. Rep. ¶90,307 (D.Mass 1998). See, also, In re Boeing Securities Litigation, Fed. Sec. L. Rep. (CCH) ¶90,285 (W.D. Wa. 1998); Wenger v. Lumisys, 2 F. Supp. 2d 1231 (N.D. Ca. 1998); Harris v. IVAX Corp., 998 F.Supp. 1449 (S.D. Fla. 1998), aff'd at Fed. Sec. L. Rep. ¶90.528 (1999).

On the other hand, in In re Stratoshphere Corp. Securities Litigation, the District Court in Nevada found that statements phrased in the past tense, but used to trumpet a future event, were predictive in nature, and protected by the safe harbor. In re Stratoshpere Corp. Securities Litigation, Fed. Sec. L. Rep. ¶90,669 (1999).

158/ The cases applying the "Bespeaks Caution" doctrine will clearly be useful in interpreting the term "meaningful cautionary statements." Indeed, the Report states that the Conference Committee does not intend that the safe-harbor provisions replace the "Bespeaks Caution" doctrine or to stop further development of that doctrine by the courts. 27 Securities Regulation and Law Report at 1894.

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- "Important factors" need to be identified, but not "all factors" or "the particular factor that ultimately causes the forward looking statement not to come true".[159]

- The courts, "where appropriate," are invited to decide motions to dismiss "without examining the state of mind of the defendant."[160]

- A second prong of the safe-harbor does focus on the state of the mind of the person making the forward looking statement: such person will not be liable in a private action "unless a plaintiff proves that person or business entity made a false or misleading forward looking statement with actual knowledge that it was false or misleading".[161]

- The Conference Committee has established the safe-harbor as a "starting point" and "fully expects" the SEC to continue rulemaking procedures in this area.

Client education concerning the Reform Act is essential. Emphasis should be on the development of "meaningful cautionary statements" and the adoption of procedures to implement the oral safe-harbor, i.e., including the magic language in the oral statement and identifying and publishing the "readily available written document."[162]

Many questions have been raised regarding the cautionary statements, including, what does it mean that a forward-looking statement must be "accompanied by" cautionary language, and which "important factors" must be included in the meaningful cautionary language?

159/ Id. and see also Rasheedi v. Cree Research Inc., Federal Securities Law Report (CCH) ¶ 99566 (1997) (court holds that forward look statements will be protected under the safe harbor even if the specific risk factor is not mentioned in the cautionary language; thus, the safe-harbor does not require "companies to make accompanying cautionary language that identif[ies] all important factors that could cause results to differ materially from projections"). See also Harris v. IVAX, supra fn 117. For the safe harbor legend in Harris, see Section III. C. 5 infra.

160/ Id.

161/ Id.

162/ For an excellent discussion of the Safe Harbor requirements, see Carl W. Schneider and Jay A. Dubow, Forward-Looking Information - Navigating in the Safe Harbor, 51 Bus. Law. 1071 (1996).

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- "Accompanied by" has not received much attention in case law, but cautionary language that is adjacent to or in close proximity to the forward-looking statement should be considered "accompanying" the statement. Cross-references should also be sufficient.[163]

- Since the courts in Rasheedi and Harris stated that not *all* important factors need be mentioned, it is up to each company to decipher which factors could have an impact upon a reasonable investor. Some statements, moreover, are mere puffery and not required to be identified in the cautionary language.[164]

It is important that clients understand that cautionary language must be used in cyberspace documents as well. The special risks involved in posting news bulletins or other information on a Web posting include the availability on the Web of stale and/or unreliable information (not updated perhaps, because the SEC does not mandate a duty to update).[165] In her article on Safe Harbors in Cyberspace, Lisa Klein Wager of Morgan, Lewis & Bockius LLP in New York, offered the following suggestions:

- Establish and enforce effective procedures for internal review of all public statements and Web postings.

- Explicitly identify written forward-looking statements in all contexts.

- Ensure that documents containing forward-looking statements enumerate the risks relevant to the specific subjects of the forward-looking statements.

- Take precautions when converting oral statements to a written medium or posting them on the Web.

- Disclaim a duty to update.

- Avoid entanglements with third parties and disclaim responsibility for content or updating of hyperlinked sites.

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[163] Thomas W. Kellerman, Anthony S. Wang and Felix Lee. Update on Forward-Looking Statements and the Reform Act Safe Harbor, Securities & Commodities Regulation, Vol. 32, No. 12 at 129 (June 23, 1999).

[164] See In re Stratosphere Corp. Sec. Litig., 1998 U.S. Dist. LEXIS 4759 (D. Nev. Apr. 7, 1998).

[165] "Securities Disclosure: Finding Safe Harbors in Cyberspace." Wager, Lisa Klein. *Insights*, Volume 12, Number 11, November 1998.

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- Segregate marketing and investor information, current and historic information on the corporate Web site.

- Regularly review and update investor pages of the corporate Web site.

5. The Safe Harbor Legend

Unfortunately, the safe harbor rules have not yet been litigated in any depth, so it is too early to predict precisely what language must be included, or even where and how often the language must appear in order to protect the issuer from liability.[166] In addition, the requirement of a "safe harbor legend" for forward looking statements, coupled with the enumeration of specific risk factors, raises certain practical considerations for issuers. CUNO provides a good example, in my opinion, of the type of "Safe Harbor Legend" required in an Annual Report, and Motorola has created what may become a model disclosure format for the future -- a combination risk factors/safe harbor legend section.

CUNO's 1996 Annual Report contains the following paragraph at the end of the MD&A section on a page by itself:

Forward Looking Information

Because CUNO wants to provide shareholders with more meaningful and useful information, this Annual Report contains certain statements which reflect the Company's current expectations regarding the future results of operations, performance and achievements of the Company. CUNO has tried, wherever possible, to identify these "forward looking" statements by using words such as "anticipate," "believe," "estimate," "expect" and

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166/ In Operating in the New World of Securities Regulation, Insights, October, 1996, Ronald L. Marmer and C. John Koch identify three common errors that issuers made in failing to comply fully with the requirements to bring their forward-looking statements within the safe harbor:

(1) failing to identify which statements are forward-looking;

(2) failing to accompany forward-looking statements with cautionary statements and important factors; and

(3) using boiler plate and generic important factors.

See, also, In Re Boeing Securities Litigation, Fed. Sec. L. Rep. ¶90,285 (W.D. WA. 1998) (Forward-looking statement given in a boiler plate, and not speaking to specific factors that could cause actual results to differ materially from those in the statement not given safe harbor protection because the Safe Harbor legend was insufficient).

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similar expressions. These statements reflect the Company's current beliefs and are based on information currently available to it. Accordingly, these statements are subject to risks and uncertainties which could cause the Company's actual results, performance or achievements to differ materially from those expressed in, or implied by these statements. These risks and uncertainties include the following: absence of history as a stand-alone company; volumes of shipments of the Company's products, changes in the Company's product mix and product pricing; costs of raw materials; the rate of economic and industry growth in the United States and the other countries in which the Company conducts its business; economic and political conditions in the foreign countries in which the Company conducts a substantial of its operations and other risks associated with international operations including taxation policies, exchange rate fluctuations and the risk of expropriation; the Company's ability to protect its technology, proprietary products and manufacturing techniques; changes in technology, changes in legislative, regulatory or industrial requirements and risks generally associated with new product introductions and applications; and domestic and international competition in the Company's global markets. The Company is not obligated to update or revise these 'forward looking' statements to reflect new events or circumstances.

In its Annual Report for the period ending December 31, 1999, Motorola "merged" the "safe harbor legend" with the risk factors at the end of the MD&A. Motorola's combined disclosure reads as follows:

Business Risk Factors

Except for historical matters, the matters discussed in this Form 10-K are forward-looking statements that involve risks and uncertainties. Forward-looking statements include, but are not limited to, statements under the following headings; (i) "Personal Communications Segment," about the allocation and regulation of frequencies, the impact from the loss of key customers, the expected component shortages during 2000, expected shipments during 2000, and the availability of supplies and labor, (ii) "Network Systems Segment," about the allocation and regulation of frequencies, the impact from the loss of key customers, expected shipments during 2000, and the availability of supplies and labor; (iii) "Commercial, Government and Industrial Solutions Segment," about the impact from the loss of key customers, the allocation and

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regulation of frequencies, expected shipments during 2000, and the availability of supplies; (iv) "Semiconductor Products Segment," about the impact from the loss of key customers, the impact of available capacity, cyclical customer demands, new product introductions and aggressive pricing, capital expenditures, expected shipments during 2000, backlog and the availability of supplies; (v) "Integrated Electronic Systems Sector," about the impact from the loss of key customers, expected shipments during 2000, and the availability of supplies ad software; (vi) "Internet and Networking Group," about the expected shipments during 2000, and the availability of supplies; (vii) "General," about expected shipments during 2000, seasonality of business, large system orders and competitiveness through research and development and utilization of technology; (viii) "Item 2: Properties," about the completion of facilities currently being constructed and plans to sell or shut down currently operating facilities; and (ix) "Item 3: Legal Proceedings," about the ultimate disposition of pending legal matters.

Motorola wishes to caution readers that in addition to the important factors described elsewhere in this Form 10-K, the following important factors, among others, sometimes have affected, and in the future could affect, Motorola's actual results and could cause Motorola's actual consolidated results during 2000, and beyond, to differ materially from those expressed in any forward-looking statements made by, or on behalf of, Motorola:

- Changes in Laws Affecting Frequency. The effects of, and changes in, laws and regulations and other activities of governments, agencies and similar organizations, including, but not limited to, those affecting frequency, use and availability of spectrum authorizations and licensing.

- Risks from Large System Contracts. Risks related to the trend towards increasingly large system contracts for infrastructure equipment and the resulting reliance on large customers, the technological risks of such contracts, especially when the contracts involve new technology, and financial risks to Motorola under these contracts, including the difficulty of projecting costs associated with large contracts.

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- Component Shortages. Motorola's ability to meet customer demands depends in part on our ability to obtain timely delivery of parts and components from our suppliers. Motorola has experienced component shortages in the past, including components for wireless telephones, that have adversely affected our operations. Although Motorola works closely with our suppliers to avoid these types of shortages, there can be no assurances that Motorola will not continue to encounter these problems in the future.

- Demand for Customer Financing. Increasing demand for customer financing of equipment sales, particularly infrastructure equipment, and the ability of Motorola to provide financing on competitive terms with other companies.

- Transition From Analog to Digital. The ability of Motorola's wireless telephone business to continue its transition to digital technologies and successfully compete in that business and retain or gain market share. Motorola faces intense competition in these markets from both established companies and new entrants. Product life cycles can be short and new products are expensive to develop and bring to market.

- Development of New Products and Technologies. The risks related to Motorola's significant investment in developing and introducing new products such as digital wireless telephone, two-way and voice paging, CDMA and other technologies for third-generation (3G) wireless, products for transmission of telephony and high-speed data over hybrid fiber coaxial cable systems, integrated digital radios, and semiconductor products. These risks include: difficulties and delays in the development, production, testing and marketing of products; customer acceptance of products, particularly as Motorola's focus on the consumer market increases; the development of industry standards; the significant amount of resources Motorola must devote to the development of new technology; and the ability of Motorola to differentiate its products and compete with other companies in the same market.

- Demand for Wireless Communications Equipment. The need for continued significant demand for wireless communications equipment, including equipment of the type Motorola manufactures or is developing.

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- Ability to Compete in Semiconductor Market. The ability of Motorola's semiconductor market. Factors that could adversely affect Motorola's ability to compete include: production inefficiencies and higher costs related to underutilized facilities, including both wholly-owned and joint venture facilities; shortage of manufacturing capacity for some products; competitive factors, such as rival chip architectures, mix of products, acceptance of new products and price pressures; risk of inventory obsolescence due to shifts in market demand; the continued growth of embedded technologies and systems and Motorola's ability to competing that market; and the effect of orders from Motorola's equipment businesses.

- Success and Impact of Increased Use of Foundry Manufacturing Capacity. The ability of Motorola's semiconductor business to increase its utilization of foundry manufacturing capacity and the impact of such efforts on capital expenditures, product costs and the ability to satisfy delivery requirements.

- Risks Related to the Iridium System. Unfavorable outcomes to any currently pending or future litigation involving the Iridium project.

  Difficulties, delays and unexpected liabilities or expenses encountered in connection with the implementation of Iridium's liquidation proceedings, including those encountered in finalizing and implementing the deorbiting process and in resolving any remaining obligations Motorola has under its agreements related to the Iridium project.

  Difficulties, delays and unexpected liabilities or expenses incurred in effectively reallocating resources that were previously dedicated to the Iridium project.

- Outcome of Litigation. The outcome of pending and future litigation and the protection and validity of patents and other intellectual property rights. Patent and other intellectual property rights of Motorola were important competitive tools and many generate income under license agreements. There can be no assurances as to the favorable outcome of litigation or that intellectual property rights will not be challenged, invalidated or circumvented in one or more countries.

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- Outcome of Litigation. The outcome of pending and future litigation and the protection and validity of patents and other intellectual property rights. Patent and other intellectual property rights of the Company are important competitive tools and many generate income under license agreements. There can be no assurances as to the favorable outcome of litigation or that intellectual property rights will not be challenged, invalidated or circumvented in one or more countries.

- Integration of New Businesses. The ability of Motorola to integrate its newly acquired businesses, and to achieve strategic objectives, cost savings and other benefits.

- Recruitment and Retention of Employees. The ability of Motorola to recruit and retain engineers and other highly skilled personnel needed to compete in an intensely competitive market and develop successful new products.

- Development of Acquired Technologies. During 1998 and 1999, Motorola acquired controlling and non-controlling interests in several businesses that had technology that was not fully developed. If the technology is not fully developed in a timely manner, Motorola's investments in such companies could be materially adversely impacted.

- Strategic Alliances. Motorola's success in partnering with other industry leaders to meet customer product and service requirements, particularly in its communications businesses.

- Euro Conversion. Risks related to the introduction of the euro currency in Europe, including the ability of Motorola to successfully compete in Europe.

The Appellate Court of the Eleventh Circuit stated that the following cautionary language issued in connection with a press release was sufficient under the safe harbor. In its August 1996 Press Release, the Chairman and CEO of IVAX Corporation stated that while a disappointing quarter had just passed, the outlook for the pharmaceutical industry, and for IVAX in particular, was much better than it might appear at first glance. The cautionary language reprinted below was found to be adequate even though it did not identify the specific factor that caused the results to differ from those predicted, namely the write-off of goodwill. The press release was followed by the following warning in italics.

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> *Statements made in this press release, including those relating to expectations of increased reorders, receipt of a credit facility waiver, earnings distribution, and the generic drug industry, are forward looking and are made pursuant to the safe harbor provisions of the Securities Reform Act of 1995. Such statements involve risks and uncertainties which may cause results to differ materially from those set forth in those statements. Among other things, additional competition from existing and new competitors will impact reorders; the credit facility waiver is subject to the discretion of the bank syndicate; and IVAX's ability to distribute earnings more evenly over future quarters is subject to industry practices and purchasing decisions by existing and potential customers. In addition, the U.S. generic drug industry is highly price competitive, with pricing determined by many factors, including the number and timing of product introductions. Although the price of generic product generally declines over time as competitors introduce additional versions of the product, the actual degree and timing of price competition is not predictable. In addition to the factors set forth in this release, the economic, competitive, governmental, technological and other factors identified in IVAX's filing with the Securities and Exchange Commission, could affect the forward looking statements contained in this press release.*[167]

6. Initial Results of the Reform Act

Although it is 2001, it is still too early to make definitive conclusions regarding the effect of the Reform Act, some recent studies indicate that the impact has been far from positive.

a. The Grundfest Study

Former SEC Commissioner Joseph Grundfest issued a study on February 27, 1997, that compares patterns of class action securities fraud litigation in federal and state courts filed before and after the Reform Act's

[167/] Harris v. IVAX Corporation, 998 F.Supp. at 1450, aff'd at Fed. Sec. L. Rep. ¶90,528 (1999).

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effective date.[168] The study highlights the increase in securities fraud suits filed in state courts where plaintiffs seek to avoid the provisions of the Reform Act. Significantly, Grundfest's preliminary findings include the following:[169]

Overall litigation rates have changed little.

About 26% of litigation activity has moved from federal to state court.

Allegations of accounting irregularities or trading by insiders now explain the lion's share of federal class action litigation.

Pure "false forecast" cases explain a relatively small percentage of pending Reform Act claims.

Litigation typically follows larger price declines than observed prior to the Reform Act.

Federal claims are now rarely filed against the largest issuers.

High technology issuers continue to be the most frequent targets of class action litigation.

The dominant plaintiffs' class action law firm, Milberg Weiss Bershad Hynes & Lerach, appears to have increased its significance nationally and in California in particular. Judges appear to be resolving legal questions regarding the interpretation of the "strong inference" requirement in favor of plaintiffs

The growth of parallel state and federal litigation, with concomitant disputes over discovery stays and other matters, suggests that attention to federal preemption issues is warranted.

168/ Joseph A. Grundfest and Michael A. Perin, Securities Litigation Reform: The First Year's Experience, http://securities.stanford.edu/report (Working Paper Series, February 27, 1997).

169/ Id.

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b. Forward-Looking Statements and Cautionary Language After the 1995 Reform Act: An Empirical Study.[170]

This study, conducted by attorneys at seven law firms, found that in general, forward-looking disclosure has not expanded or become more detailed since the passing of the Reform Act. The study had the following observations:

- The Safe Harbor has had little effect on the written disclosure of forward-looking information.
- The study determined that only with federal preemption of state law claims would issuers alter their disclosure practices.[171]

c. The SEC's Report to the President and the Congress

In its "Report to the President and the Congress on the First Year of Practice under the Private Securities Litigation Reform Act of 1995,"[172] the SEC echoes some concerns raised in the Grundfest Study. After noting that "it is too soon to draw definitive conclusions," the SEC made the following preliminary observations about the impact of the Reform Act on the effectiveness of the securities laws and on investor protection:[173]

- The number of companies sued in securities class actions in federal court is down for the twelve months following passage of the Reform Act.
- Most securities class action complaints filed in federal court post-Reform Act appear to contain detailed allegations specific to the action.
- The race to the courthouse has slowed somewhat.
- Secondary defendants, such as accountants and lawyers,

170/ This study was conducted by Gerald S. Backman, Karl A. Groskaufmanis, Richard A. Rosen, and Stephen J. Schulte. Copyright 1997.

171/ On October 13, 1998, Congress passed the Securities Litigation Uniform Standards Act of 1998, preempting state securities fraud class actions relating to covered securities. The Act became law when it was signed by the President on November 3, 1998 (Pub. Law 105-353).

172/ Fed. Sec. L. Rep (CCH) ¶85,931 (1997).

173/ Id. at 89,475.

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are being named much less frequently in securities class actions.

- The discovery stay imposed by the Act during the pendency of a motion to dismiss, coupled with the heightened pleading standards required by the Act, has made it more difficult for plaintiffs to bring and prosecute securities class action lawsuits.

- Plaintiff's law firms continue to control securities class actions; institutional investors have not actively sought to become involved in such suits.

- The number of state filings reportedly has increased.

- While the allegations contained in state court complaints are generally similar to those of the federal complaints, state complaints having no parallel federal action are more likely to be based solely on forecasts which have not materialized and less likely to include insider trading allegations.

- Companies have been reluctant to provide significantly more forward looking disclosure beyond what they provided prior to enactment of the safe harbor.

The SEC noted that it was too soon to draw any definitive conclusions about the effect of the Reform Act in light of the fact that no federal appellate court had an opportunity to interpret the provisions of the Act. The SEC thus did not recommend any legislative changes in its Report although other Bills have been subsequently introduced to close loopholes, as discussed below.

d. NERA's "Recent Trends in Shareholder Class Actions" Study

This study is the most recent compilation of data through June 1999, and it is arguably one of the most influential studies in this area. The National Economic Research Associates ("NERA") have studied the impact of the PSLRA since its enactment in 1995. Moreover, NERA has

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compiled data relating to securities class action filings since January 1991. The recent study's findings include the following:[174]

- The number of accounting fraud cases has increased dramatically since the passage of the PSLRA, and the number with more serious accounting allegations have been increasing at an even faster rate.

- The number of dismissals is also up because of the more stringent pleading requirements, especially on scienter, although often there is the potential for repleading.

- Post-PSLRA average settlement values have been higher -reflecting the growth in the stock market.

- The number of filings in 1998 set an all-time record and the filing rate during the first five months of 1999 was even greater than in 1998. But since July 1999, shareholder class action filings were lower by almost eight per month than they were in the first half of the year.

7. Reform Act Cases

a. Pleading

The Act requires plaintiffs to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.[175] Plaintiffs have generally used a pattern of sales by insiders as evidence of scienter, and the courts have found that evidence of insider trading is often enough to find a strong inference of scienter.[176] However, to prove scienter, one bears the burden of showing that sales by insiders

[174] See Todd S. Foster, Denise N. Martin, Vinita M. Juneja, Frederick C. Dunbar and Lucy P. Allen, National Economic Research Associates, "Trends in Securities Litigation and the Impact of the PSLRA," American Bar Association, 1999.

[175/] 15 U.S.C. § 78 u-4(b)(2).

[176/] See Bryan v. Apple South, Inc., Fed. Sec. L. Rep. (CCH) ¶90,275 (MD Ga. 1998) (unusual insider trading during the class period can support a strong inference of scienter); In re Employee Solutions Securities Litigation, Fed. Sec. L. Rep. (CCH) ¶90,293 (D. Az. 1998) (motion to dismiss denied where the CEO used offshore entities to conceal his stock transactions while selling over a million shares of stock because of strong inference of scienter).

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were in fact unusual or suspicious in amount or timing.[177] The interpretation of this standard has been the subject of considerable disagreement among district and appellate courts. The debate focuses on whether the Reform Act simply adopts the "reckless" Second Circuit standard, or requires more. Several cases have held that the Reform Act adopted the Second Circuit pleadings standard,[178] while other cases have found that the Reform Act standard goes beyond the Second Circuit standard.[179]

Despite varying language used by the courts, one commentator has concluded that actual results reached in the district courts are generally consistent.[180] Accordingly, it is uncertain if, in the long run, courts will adopt the Second Circuit standard or move to the stricter standard of Silicon Graphics. The higher the standard set, the more difficult it will become for plaintiffs to withstand motions to dismiss, and thus, potentially lowering the volume of litigation in the federal courts.

The appellate courts that have reviewed the pleading standard under the Reform Act have reflected a lack of uniformity, making it likely

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177/ Lirette v. Shiva Corp., 1998 WL 812696 (D. Mass. 1998).

178/ The district courts are in disagreement about what the pleading requirement is. In Marksman Partners, L.P. v. Chantal Pharmaceutical Corp., 927 F. Supp. 1297 (C.D. Cal. 1996), the court held that the two tests established by the Second Circuit should be employed. In In re Baesa Securities Litigation, Fed. Sec. L. Rep. (CCH) ¶97,633 (S.D. NY 1997), the court held that the Reform Act did not change the requirement for liability in a private securities fraud action by raising the scienter higher than recklessness. Also, the mere pleading of opportunity and motive did not suffice in raising the inference of fraudulent scienter. Other cases have followed the Second Circuit tests. See, e.g., Zeid v. Kimberley, 930 F. Supp. 431 (N.D. Cal. 1996); STI Classic Funds v. Bollinger Industries, Inc., No. 3-96-CV-823-R (N.D. Tex. Nov. 12, 1996); Fischler v. AmSouth Bancorporation, 1996 U.S. Dist. LEXIS 17670 (N.D. Fla. Nov. 14, 1996); Rehm v. Eagle Finance Corp., 954 F. Supp. 1246 (N.D. Ill. 1997).

179/ See e.g., In re Silicon Graphics, 970 F. Supp. 746 (N.D. Cal. 1997) (plaintiff must create a "strong inference of knowing or intentional misconduct."); Friedberg v. Discreet Logic, 959 F. Supp. 42, 48 (D. Mass. 1997) (holding that the pleading standard was intended to be stronger than the existing Second Circuit standard); Norwood Venture Corp. v. Converse, 959 F. Supp. 205, 208 (S.D.N.Y. 1997) (holding that Congress sought to raise the pleading standard beyond the Second Circuit standard); and Voit v. Wonderware Corp., et al., Fed. Sec. L. Rep. (CCH) ¶99,541 (E.D. Pa. 1997).

180/ Rosenfeld, Pleading Scienter Under the Private Securities Litigation Reform Act of 1995, 31 rev. of sec. & com. reg. 25 (1998). The Second Circuit is plainly wedded to its pre-Reform Act interpretation. See Stevelman v. Alias Research, Inc., Fed. Sec. L. Rep. (CCH) ¶90,455 (2d Cir. 1999) where the court cited all pre-Reform Act cases in analyzing the fraud and scienter pleading standards. The court also relied upon the sale of "large portions" of the defendants' stock to support a "strong inference of fraudulent intent", i.e. motive and opportunity. Id. at 92,110. See also Press v. Chemical Investment Services Corp., Fed. Sec. L. Rep. (CCH) ¶90,415 (2d Cir. 1999); Maldonado v. Dominquez, Fed. Sec. L. Rep. (CCH) ¶90,159 (1st Cir. 1998).

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that the Supreme Court will have to decide this issue, and put an end to the pleading requirement conjecture.[181]

Ninth Circuit The Silicon Graphics court, in the first appellate opinion on this issue, and also the most stringent, wrote that mere recklessness "may provide some inference of intent," but did not satisfy the strong inference requirement of the Reform Act. "A heightened form of recklessness, i.e., deliberate or conscious recklessness, at a minimum" is required.[182] The court went on to say that had Congress intended to simply codify the Second Circuit standard, it would have done so, instead of numerous times stating an intent to raise the bar on the standard. The Silicon Graphics case is discussed in more detail below.

Second Circuit The Second Circuit held that plaintiffs may meet the "strong inference" standard by setting forth specific facts either (1) showing motive to commit fraud and an opportunity to do so, or (2) constituting circumstantial evidence of either reckless or conscious misconduct.[183]

Third Circuit The Third Circuit declined to come to terms with conflicting legislative history, and opted for a plain-language analysis, determining that the Reform Act language was "virtually identical" to the pleading requirement set forth by the Second Circuit, and therefore must be interpreted in an identical manner.[184] Unlike the Second Circuit, however, the Third Circuit also ruled that the Reform Act's "additional requirement that the plaintiffs state facts 'with particularity' represents a heightening of the

181/ The Appellate Court of the Eleventh Circuit reviewed the district court's decision in Harris v. IVAX Corp., but specifically did not address the question of "what exactly a 'strong inference' of the appropriate scienter is." Harris v. IVAX Corp., Fed. Sec. L. Rep. (CCH) ¶90,528 (11th Cir. 1999). The court did, however, reiterate that cautionary statements need not mention *all* possible factors, that could cause, or the particular factor that did cause, actual results to differ materially from those in the forward-looking statement. The Fourth Circuit also acknowledged the disagreement among the circuits, and did not find reason to visit the issue, as the stockholders had not pleaded sufficient facts to meet even the most lax of standards. Phillips v. LCI International, Inc., Fed. Sec. L. Rep. (CCH) ¶90,645 (4th Cir. 1999).

182/ In re Silicon Graphics Securities Litigation, 970 F. Supp. 746 (N.D.Cal. 1997), aff'd at In re Silicon Graphics Inc. Securities Litigation, Fed. Sec. L. Rep. (CCH) ¶90,512 (9th Cir. 1999).

183/ Press v. Chemical Inv. Serv. Corp., No. 98-7123, 1999 U.S. App. LEXIS 1494 (2d Cir. 1999), cited in In re Silicon Graphics at 92,503.

184/ In re Advanta Corp. Securities Litigation, 180 F.3d 525 (3d Cir. 1999).

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standard."[185]

Fourth Circuit The Fourth Circuit also disagreed with the Second Circuit's approach and appears to require intentional or deliberate conduct to state a claim under 10(b) and 10b-5.[186]

Sixth Circuit The Sixth Circuit took issue with the Second Circuit and stated that plaintiffs may show a strong inference of recklessness, but alleging facts merely establishing that a defendant had the motive and opportunity to commit securities fraud would not be sufficient. If motive and opportunity simultaneously establish that the defendant acted recklessly or knowingly, or with the requisite state of mind, the Sixth Circuit's middle of the road test would be met.[187]

Eleventh Circuit This circuit agreed with the Sixth Circuit, refusing to accept the proposition that allegations of motive and opportunity to commit fraud were sufficient to plead scienter, unless the facts demonstrate the required state of mind, namely that the defendant acted recklessly or knowingly.[188]

The district courts have reflected the same disharmony as the appellate courts. In In re Silicon Graphics Securities Litigation, the district court ruled on the pleading standard under the Reform Act.[189] According to the court, to adequately plead scienter under the Reform Act, plaintiffs must establish a strong inference of knowledgeable or intentional misconduct. The court stated further that "[m]otive, opportunity and non-deliberate recklessness may provide some evidence of intentional wrongdoing . . . but are not alone sufficient to support scienter unless the totality of the evidence creates a strong inference of fraud."[190] The appellate court then stated that "Congress intended to elevate the pleading

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185 See id. See also Paul J. Collins, "Pleading Fraud Allegations Under the Private Securities Litigation Reform Act," Newsletter of the Federal Regulation of Securities Committee of the Business Law Section of the ABA, Volume 5, Issue 1 (Spring 2000).

186 See Phillips v. LCI Int'l, Inc., 190 F.3d 609 (4th Cir. 1999). See also Paul J. Collins, "Pleading Fraud Allegations Under the Private Securities Litigation Reform Act," Newsletter of the Federal Regulation of Securities Committee of the Business Law Section of the ABA, Volume 5, Issue 1 (Spring 2000).

187/ In re Comshare Inc. Securities Litigation, Fed. Sec. L. Rep. (CCH) ¶90,513 (6th Cir. 1999).

188/ Bryant v. Avado Brands, Inc., Fed. Sec. L. Rep. (CCH) ¶90,636 (11th Cir. 1999).

189/ In re Silicon Graphics Securities Litigation, 970 F. Supp. 746 (N.D.Cal. 1997).

190/ Id. at 757.

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requirement above the Second Circuit standard."[191] This standard takes issue with a more liberal standard articulated in older Second Circuit cases that allow for unqualified allegations of recklessness to establish scienter.[192]

Plaintiffs alleged in Silicon Graphics insider trading and false and misleading statements. The district court stated that, in evaluating scienter, the Reform Act required the court to consider each defendant's stock sales separately, as well as the amount and timing of the sales. The court held that plaintiffs artificially inflated the level of defendants' trading activities by failing to consider available options in evaluating stock sales. The court then stated that as to two senior officials whose sales represented a high portion of their holdings, the stock sales may be considered as evidence of fraud if plaintiffs could substantiate their claims regarding negative internal reports.[193]

It is unclear how courts will interpret the "all facts" pleading requirement.[194] In Silicon Graphics, the court granted a motion to dismiss plaintiffs' amended complaint. In interpreting the "all facts" pleading requirement, the court observed that the provision was the subject of specific debate in Congress. Concerns were raised that the provision would require disclosure in the complaint of specific names and other potentially confidential information.[195] The court reasoned that if Congress enacted the requirement despite these concerns, plaintiffs were obligated to plead "all facts". Plaintiffs did not meet this burden and the court dismissed the complaint.

The other case which has interpreted the "all facts" requirement is Zeid v. Kimberley, a class action involving Firefox Communications, Inc.[196]

191/ In re Silicon Graphics Inc. Securities Litigation, Fed. Sec. L. Rep. (CCH) ¶90,512 (9th Cir. 1999).

192/ Id. at 755-756.

193/ Id. at 767, citing Acito v. Imcera Group, Inc., 47 F.3d 47 (2nd Cir. 1995) (stock trading will support a strong inference of fraud when the sales are unusual or suspicious). See also San Leandro Emergency Medical Group Profit Sharing Plan v. Phillip Morris Companies, Inc., infra, note 333 where the Second Circuit, in reviewing plaintiffs attempt to plead scienter via insider stock sales, concluded that "[i]n the context of this case.l..the sale of stock by ne company executive does not give rise to a strong inference of the company's fraudulent intent; the fact that other defendants did not sell their shares during the relevant class period sufficiently undermines plaintiffs' claims regarding motive." Id. at 93,984.

194 See Zeid, et al. v. Kimberley, et al., Fed. Sec. L. Rep. (CCH) ¶91,410 (9th Cir. 2001) (holding that the complaint did not state with particularity all facts which form the belief that an omission is misleading).

195/ Id. at 763.

196/ No. 96-20136 SW at 8-9 (N.D. Cal. May 6, 1997).

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In Zeid, the court held that when a complaint is based on "investigation of counsel" rather than "information and belief", plaintiffs are not required to state with particularity all facts. In such circumstances, however, the court held that plaintiffs must meet the other strict pleading requirements of the Reform Act. "Plaintiffs cannot rely on conclusory allegations or tenuous inferences but instead, must allege with particularity: (1) each statement, (2) why each statement is false, and (3) as to each statement, facts giving rise to a strong inference that Defendants acted with scienter."[197] The court found that plaintiffs' complaint failed to satisfy this standard, and it was dismissed with prejudice.[198]

If other courts follow either the Silicon Graphics or Zeid holdings, it is reasonable to expect an increase in the percentage of defendants that prevail on motions to dismiss. The interpretation of the "all facts" pleading requirement is a major uncertainty regarding the Act. With all of these conflicting opinion leading to severely differing results in federal securities litigation, the Supreme Court will have to take a stand and determine the pleading requirement under the Reform Act.[199] And when the Ninth circuit refused in October 1999 to rehear In re Silicon Graphics, it paved the way for the Supreme Court to do just that.

[197/] Id. at 9.

[198/] See also Harris v. IVAX Corporation, 998 F.Supp. at 1450 (cautionary language in a press release was found to be adequate even though it did not identify the specific factor that caused the results to differ from those predicted), aff'd at Fed. Sec. L. Rep. ¶90.528 (1999); Wenger, et al. v. Lumisys, et al., 2 F. Supp.2d 1231 (N.D. California 1998) (Defendants not required to couple each forward-looking statement with a particular warning); Friedberg v. Discreet Logic Inc., Fed. Sec. L. Rep. (CCH) ¶99,491 (D. Mass. 1997) (Four separate statements made by the company and its officers were pleaded particularly enough to constitute claims under the heightened standard of the Reform Act.); Schwartz v. Celestial Seasonings, Inc. et al., Fed. Sec. L. Rep. (CCH) ¶99,538 (10th Cir. 1997) (A securities fraud claim stated with sufficient particularity by incorporating by reference to press releases, prospectuses, and reports. Plaintiff need not have matched individual statements with particular sources or individuals; annual reports and prospectuses presumably involved the collective effort of the company.); and Rasheed, et al. v. Cree Research, Inc., et al., Fed. Sec. L.Rep. (CCH ¶99,566 (D.N.Carolina 1997) (plaintiff must specifically allege to which defendants certain statements are attributable in order to trigger the group-published information presumption.)

[199/] For a thorough analysis of each case and outlook on the possible Supreme Court decision, see James E. Day and Ivan B. Knauer, Four Appeals Courts Cannot Agree on Post-Reform Act Standard for Pleading Scienter, Insights, Sept. 1999, at 4.

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b. Historical v. Forward Looking Statements

A number of courts have found the safe harbor to be inapplicable to what they consider historical facts rather than forward looking statements.[200]

c. Is the Safe Harbor Broad Enough?

The safe harbor has been interpreted to allow companies decipher which factors could have an impact upon a reasonable investor.[201] Even if a specific risk factor is not mentioned in the cautionary language, and that factor results in a material impact upon an investor, a company can still be protected by the safe harbor; thus, the safe-harbor does not require "companies to make accompanying cautionary language that identif[ies] all important factors that could cause results to differ materially from projections."[202] Since some statements are mere puffery, and not required to be included in the cautionary language,[203] and others are actionable, the decision does not promise to be an easy one.

8. New Securities Litigation Reform Bills After the Reform Act

Some members of Congress could not wait for more precise interpretations of the Reform Act. Soon after the SEC's report hit the press, two Bills were introduced to close the perceived loophole in the Reform Act that had resulted in an increased amount of securities actions filed in the state courts and, as combined, were made into law on November 3, 1998.

Representatives Anna Eshoo (D-Calif.) and Rick White (R-Wash.) proposed the "Securities Litigation Uniform Standards Act," (H.R.1689) on May 21, 1997. This bill proposed to amend the 1993 Securities Act and the 1934 Securities Exchange Act and supplement the Reform Act of 1995. The White-Eshoo Bill proposed to require securities class actions against nationally traded securities to be litigated in federal court under a uniform federal law. The bill would thus insure that the remedies available to purchasers and sellers of nationally traded securities would not vary based on the state in which the purchasers or sellers reside.

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[200] See, supra, note 116 and accompanying text (discussion of safe harbor cases).

[201] Rasheedi v. Cree Research Inc., Federal Securities Law Report (CCH) ¶ 99566 (1997).

[202] Id.

[203] See In re Stratosphere Corp. Sec. Litig., 1998 U.S. Dist. LEXIS 4759 (D. Nev. Apr. 7, 1998).

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Subsequently on October 7, 1997, a bill entitled the "Securities Litigation Uniform Standards Act of 1997" (S.1260) was introduced in the Senate by Senators Phil Gramm, Pete Dominici, and Chris Dodd.[204] The "Senate Bill" was substantially similar to the White-Eshoo Bill, except with respect to its definition of a covered security. The White-Eshoo Bill tied preemption to an issuer that has covered securities while the Senate Bill applied only to the covered securities themselves. In addition, the White-Eshoo Bill adopted the definition of covered security contained in section 18(b)(1) of the Securities Act of 1933 while the Senate Bill looked to sections 18(b)(1) and (b)(2).

On May 13, 1998, the Senate passed S.1260 by a vote of 79-21. Shortly before S.1260 was reported to the Senate by the Senate Banking Committee, the Securities and Exchange Commission and the White House endorsed the legislation.

On June 10, 1998, the House Commerce Finance and Hazardous Materials Subcommittee voted 21-4 to report to the full Committee an amended version of the White-Eshoo Bill. The amended bill generally aligns the operative provisions of the White-Eshoo Bill with those of S.1260. Specifically, the amendments did the following:

- Narrowed the White-Eshoo Bill's definition of covered securities to the definition in the 1996 National Securities Markets Improvement Act (so that only suits involving nationally traded securities, rather than suits involving any security of a nationally traded company, are covered);

- Inserted language from S.1260 to preserve state court authority over certain corporate governance questions; and

- Provided that state and municipal pension funds may bring class action suits in state court, so long as those in the class are named plaintiffs and the pension fund has authorized the action.

President Clinton signed the Securities Litigation Uniform Standards Act of 1998 into law on November 3, 1998 ("SLUSA").[205] SLUSA made federal courts the exclusive venue for most securities class action suits. The highlights of SLUSA are:

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[204] 143 Cong. Rec. S10475 (daily ed. Oct. 7, 1997).

[205] Securities Litigation Uniform Standards Act of 1998 (Pub. Law 105-353), as reported in Fed. Sec. L. Rep (CCH), November 11, 1998.

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- State courts are barred from hearing class actions alleging fraud in connection with the purchase or sale of nationally-traded securities, such as those listed by the NYSE or Nasdaq, as well as securities issued by registered investment companies (privately placed debt securities do not fall within SLUSA).

- A federal court is permitted to stay discovery proceedings in any state court action in order to deny class action plaintiffs the ability to circumvent the Reform Act's stay of discovery pending a motion to dismiss by conducting state court discovery.

- State court jurisdiction is preserved over a number of actions, including certain actions based on the law of the subject issuer's state of incorporation, as well as certain other actions.

- Shareholder derivative actions are not considered class actions within SLUSA.

Before the passage of SLUSA, there was concern over whether changes to the Reform Act were premature. The focus of the dispute was over the potential pre-emption of investor protection at the state level through private securities actions. However, according to Michael Perino of Stanford:

> Neither bill [White-Eshoo or the Senate Bill] is intended to limit the scope of any state's authority to bring lawsuits alleging violations of state law. Nor are they intended to intrude upon the dominant corporate law causes of action that are traditionally the province of the states. Such a provision would be wholly consistent with the structure of the Reform Act itself, which is intended to regulate only private litigation. It would also be a straightforward matter to add language assuring that uniform securities fraud litigation standards do not intrude on traditional corporate law causes of action.[206]

On the other hand, Rep. Edward J. Markey attacked the Bills' underlying assumptions at their core, arguing that there has been "no showing" of an increase of securities class actions in state courts. He asserted that in 1997, only 44 securities class action suits were filed in

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[206] What We Know and Don't Know About the Private Securities Litigation Reform Act of 1995. Written Testimony of Michael A. Perino, Stanford Law School, before the Subcommittee on Finance and Hazardous Materials of the Committee on Commerce, United States House of Representatives on October 21, 1997.

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state courts. Most of the suits were in California, Markey pointed out, and stated that if anyone needs to address the issues at hand, it is the California legislature. In 1994, prior to the 1995 Reform Act, 67 securities class actions were filed in state courts, and in 1996, the year following the Reform Act's enactment, 66 such cases were filed.[207]

It is too soon to tell if the passage of such "uniform standards legislation" will make it increasingly difficult for plaintiffs to circumvent the stringent requirements of the Reform Act.

D. Risk Factors

Risk factors have become a common section in many prospectuses, even for seasoned companies. The risk factor section helps in establishing a company's "Bespeaks Caution" compliance and is also useful in ensuring an issuer's disclosure is complete. There is generally some discussion as to whether the risk factor section should be drafted prior to the rest of the prospectus or only after all other items in the prospectus have been drafted. I generally advise preparing the risk factor section after everything else is complete to ensure that specific risks associated with a particular issuer are identified.

The growing concern involving the risk factor section of prospectuses is that companies are so concerned about liability that they bombard the prospective investor with many irrelevant and impractical risks. There is an ever present tension between the underwriters' counsel, who wants to avoid potential liability through the disclosure of as much information as possible, and the company, who wants to disclose fewer risk factors to remain an attractive investment to potential investors. Often, the result is a risk factor section filled with a list of boiler plate risks that could apply to any offering or risks unlikely to occur. Consequently, the SEC has proposed that issuers draft the risk factor section to avoid overwhelming investors with irrelevant and improbable risks. In an effort to facilitate complete disclosure, the SEC has proposed (i) writing the risk factors in Plain English, (ii) listing the risk factors in the order of their importance, and (iii) removing "boiler plate" risks entirely from the risk factor section.[208] In addition, the SEC has also considered limiting the total number of risk factors. The likely result of such proposals is the substantial reduction in size of the risk factor section of a prospectus. We would see a scaled down list of generic offering risks associated with the particular company.

[207/] Rachel Witner, House Panel Reports Securities Litigation Standards Bill to Full Commerce Committee, 30 Sec. Reg. L. Rep. 883 (1998).

[208/] SEC Release No. 34-38164, (Jan. 14, 1997).

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1. **Plain English**

The SEC wants the risk factor section of a prospectus written in plain English. While there have not been many objections to the use of plain English in the risk factors section, some opponents fear that simpler writing will expose companies to greater liability. Opponents fear that plain English will prevent them from adequately warning prospective investors of potential risks. The SEC counters that the substance of the risk factors section will not change, only the way the risks are presented.[209] See Section VII for a more complete discussion of the Plain English requirement.

2. **Order of Importance**

The SEC's proposal to require issuers to list risk factors in the order of their importance has been met with some objections. The New York State Bar Association's Committee on Securities Regulation (the "Committee") argues that this proposed requirement is impractical and unwise. The Committee argues that the order of importance of risk factors is impossible to determine, and the process of ranking such factors will make issuers vulnerable to claims that they attempted to downplay certain risks by listing them last.[210] The Capital Markets Committee of the Securities Industry Association (the "SIA") also believes that such ranking of risk factors is inappropriate. According to the SIA, "such a requirement would not only expose companies to greater liability, but also result in investors being misled and encouraged to consider less than all the material risks."[211]

3. **Prohibition of "Boiler Plate" Risks**

The purpose of the proposal to eliminate boiler plate risks is to remove the unnecessary general risks that can overwhelm an investor and that potentially provides no meaningful information to the investor. The SEC wants disclosure that communicates to the potential investor. As the amount of information given to an investor increases, so does the

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209/ See Bureau of National Affairs, Conference Report: PLI's Annual Institute on Securities Regulation, Securities Regulation & Law Report, Nov. 14, 1997, p. 1591 and Section VII, infra.

210/ New York State Bar Prefers Staff Guidance on Plain English Disclosure, Corporate Secretary's Guide, May 6, 1997, p. 68.

211/ SIA Committee Urges SEC "Plain English" Initiative Should be Voluntary, BNA's Securities Regulation and Law Report, May 2, 1997, p. 610 and See Nov. 14, 1997 BNA SRLR at 1591 (final Plain English rule may allow greater flexibility) and Section VII, infra.

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likelihood that he or she will choose to ignore some of that information. Often, if an investor sees boiler plate language, he or she might assume it is not important and will skip over that passage. The SEC believes that if the risks disclosed are tailored to a particular company and are industry specific, the investor will make a more informed decision concerning his or her investment versus facing a myriad of general risks that could apply to any offering.

4. Limiting the Number of Risks

Concerned that plain English alone will not address the problem of describing too many meaningless risk factors, the SEC considered limiting disclosure to a specific number of risk factors (such as eight), or alternatively, limiting the length of the risk factor section to two pages. While this may help to ferret out the impractical general risks that an investor may already be aware of, some fear that this is a step in the wrong direction because the SEC is equating fewer disclosures with better disclosure. While encouraging the listing of industry specific risks is a good goal, the mechanics of numerically limiting risks is dangerous. Some industries are more speculative in nature and may require more risk disclosure, while others require less. With regard to placing a numerical limit on risk factors, the Committee stated that "[n]o issuer should be put in a position of choosing among significant material risks in order to satisfy a numerical limitation."[212] Likewise, the page limitation for the Risk Factor section may place a burden upon the issuer to eliminate some key risks in light of the Plain English initiative.[213] Plain English, moreover, suggests using dual columns, lists, or open white space, which would significantly subtract from the amount of space the issuer has to list the risks associated with the investment.[214]

5. What Should the Risk Factors Section Look Like?

I believe that a combination section merging the safe harbor legend with a broader description of risk factors will become more prevalent and may eventually become a model for securities law disclosure. An example

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[212] New York Bar Prefers Staff Guidance on Plain English Disclosure, BNA's Corporate Secretary's Guide, May 6, 1997, at 68.

[213] See Nov. 14, 1997 BNA SRLR at 1591 (final Plain English rule may allow greater flexibility) and Section VII, infra.

[214] The SEC plans on providing more guidance through the final Plain English rule to "rein in the excess" of risk factors. See Nov. 14, 1997 BNA SRLR at 1592.

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of such a blended disclosure section, from Motorola's 1999 Annual Report, is included in Section III.C.5. above.

Additionally, risk factors are not only found in a company's prospectus, but also in other SEC filings such as Form 8-Ks, Form 10-Qs and Form 10-Ks. The inclusions of risk factors in such other filings can often times be beneficial in a company's defense. For example, in Geffon v. Micrion Corp., the defendant company's inclusion of a risk factor section in its Form 8-K ultimately defeated appellants' claims that the company made materially misleading statements regarding its sales.[215] In Geffon, the court ruled that summary judgment should be granted in the defendant company's favor because the appellants failed to introduce evidence that the company had the requisite scienter at the time the misleading statements were made.[216] In this case, the company disclosed that it "booked an order" worth $50 million, however, the company did not simultaneously reveal the fact that the purchaser had the right to cancel the order.[217] The court reasoned that the company did not act with the intent to deceive investors because it attempted to provide investors with adequate warnings of the possibility that not all of the units would be purchased under the agreement.[218] Moreover, in its press releases and conference calls, the company referred to the risk factor stated in the company's Form 8-K which warned that the order could be cancelled or terminated at any time.[219] Accordingly, the reference to the risk factor defeated any inference that the company had the requisite scienter to support a claim that it violated the Securities Exchange Act.[220]

E. "Bespeaks Caution" Doctrine

A recurrent theme of cases attacking forward looking information is the claim that the issuer reaffirmed prior projections through general expressions of optimism or by confirming its goals at a time when it knew or should have known that identified problems with products or operations threatened its ability to achieve the earlier projections. These allegations often are commingled with a sundry of other counts constituting a Rule 10b-5 action. Defendants have a difficult burden dismissing these claims when internal memorandum, statements to third parties or other "smoking guns" contradict the issuer's public statements. Issuers should beware that virtually any public expression of optimism can be construed as a reaffirmation of prior forward looking statements.

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[215] See Geffon v. Micrion Corp., Fed. Sec. L. Rep. (CCH) ¶91,419 (1st Cir. 2001).

[216] See Id. at pg. 96,402.

[217] See Id. at pg. 96,399.

[218] See Id. at pg. 96,403.

[219] See Id.

[220] See Id.

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A number of other cases, however, hold that issuers can avoid liability for projections and other predictive information when the information is accompanied by specific risk disclosure. This "Bespeaks Caution" doctrine holds that when precise cautionary language that directly addresses itself to future projections, estimates or forecasts is used, such projections, estimates or forecasts cannot be misleading as a matter of law.[221] This doctrine does not apply, however, when the speaker knows he is making untrue statements.[222] Regardless of the "matter of law" rhetoric used when speaking of this doctrine, as illustrated by the cases below, and in light of certain statements made by the Supreme Court in Virginia Bankshares Inc. v. Sandberg[223], the application of the "Bespeaks Caution" doctrine is indeed a case-by-case factual analysis.

The following cases demonstrate that, regardless of any safe harbor or disclosure of risk factors and underlying factual assumptions, forward looking statements will be subject to a plaintiff's 20/20 hindsight and may be actionable under the federal securities laws, although this trend appears to be shifting. On the brighter side, the Ninth Circuit's adoption of the "Bespeaks Caution" doctrine in Worlds of Wonder shows that issuers may indeed find protection when cautionary language is specific and not generic -- but, as emphasized by the Ninth Circuit in Fecht, the cautionary language must be specific.[224]

In the recently enacted Reform Act, Congress provided for a statutory safe-harbor for many "forward looking statements" based in upon the "Bespeaks Caution" doctrine.

221/ The rationale for some courts in applying this doctrine is that where there is enough cautionary language attached to optimistic statements, investors have no right to rely on only the optimistic statements. See e.g., Donald C. Langevoort, Disclosures that "Bespeak Caution", 49 Bus. Law. 481 (1994), for a more detailed discussion of the "Bespeaks Caution" doctrine. It has been argued, however, that "even caution-laden

(continued . . .)

(continued . . .)

disclosures may have the propensity to mislead" because the "presence of cautionary language actually may make the projections more influential." Id. at 497-98. Thus, it can be argued that courts which assume that cautionary language automatically negates optimistic statements would be erroneously applying the doctrine. Id. at 497. See also Rubenstein v. Collins, discussed infra notes 180-186. The other rationale expressed by the courts is that the cautionary language so dilutes the disclosure that no reasonable person would find an optimistic message. See Id. at 487.

222/ But see the district court's decision in In re Donald J. Trump Casino Sec. Litig., 793 F. Supp. 543, 553 (D.N.J. 1992), aff'd, 7 F.3d 357 (3d Cir. 1993), where the court stated: "The 'Bespeaks Caution' analysis subsumes the misrepresentation analysis. No reasonable inference can be drawn in favor of a plaintiff that a . . . statement which bespeaks caution as to future forecasts contains actionable misrepresentations." See also Langevoort, supra note 170, at 488.

223/ 111 S. Ct. 2749 (1991). In Virginia Bankshares, the Supreme Court held that statements by management of reasons, opinions or beliefs - even though conclusory in form - may be material facts that could give rise to misstatement liability under the federal securities laws.

224/ See also Parnes, et al. v. Gateway 2000, Inc., Fed. Sec. L. Rep. (CCH) ¶99,509 (8th Cir. 1997).

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1. In re Donald Trump Casino Securities Litigation

In In re Donald Trump Casino Securities Litigation,[225] investors who purchased bonds to provide financing for the Taj Mahal alleged that the prospectus which accompanied the bond offering contained materially misleading statements and omissions regarding, among other matters, defendant's belief that operation of the Taj Mahal would generate enough money to cover its debt service. The language from the Management Discussion and Analysis section stated:

> The Partnership believes that funds generated from the operation of the Taj Mahal will be sufficient to cover all of its debt service (interest and principal).

However, the above statement was followed by a warning:

> No assurances can be given, however, that the actual operating results will meet the Partnerships' expectations. See "Special Considerations -- Ability of the Partnership to Service Debt."

The subsection, "Ability of the Partnership to Service Debt" listed several specific risk factors and scenarios under which the contemplated adverse effects would materialize.

The district court dismissed the action, applying the "Bespeaks Caution" doctrine and stating that the prospectus "virtually bristle[d] with warnings" concerning the "extremely risky nature of the investment."[226] The Third Circuit subsequently affirmed the lower court's ruling, concluding that in light of the disclaimers contained in the prospectus, "no reasonable investor could believe anything but that the Taj Mahal bonds represented a rather risky, speculative investment."[227] The court stated that:

> . . . when an offering document's forecasts, opinions or projections are accompanied by meaningful cautionary statements, the forward looking statements will not form the basis for a securities fraud claim if those statements did not affect the "total mix" of information the document provided investors. In other words, cautionary language, if sufficient,

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[225] 793 F.Supp. 543 (D.N.J. 1992), aff'd, 7 F.3d 357 (3d Cir. 1993).

[226] 793 F.Supp. at 555.

[227] 7 F.3d at 369.

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renders the alleged omissions or misrepresentations immaterial as a matter of law.[228]

On March 7, 1994, the U.S. Supreme Court allowed the federal appeals court's decision to stand.

2. Sinay and Mayer

In Sinay v. Lamson & Sessions Co.[229], the Sixth Circuit held that the issuer's optimistic statements regarding its performance and confirmation of an analyst's earnings estimates were not misleading where the predictions bespoke sufficient caution. The Court also found that the issuer also could not predict a decline in the construction market nor a devastating labor strike any better than the public.

But in Mayer v. Mylod,[230] the Sixth Circuit backed down from the "Bespeaks Caution" doctrine in light of the Supreme Court's statements in Virginia Bankshares that, while publishing accurate facts may render misleading statements too unimportant to create liability, not every mixture of the truth will neutralize the deceptive. In Mayer, the Sixth Circuit overturned the district court's application of Sinay to several statements of "opinion" made by a Michigan bank, holding that Virginia Bankshares required a weighing of the true with the untrue and thus, cautionary statements cannot "as a matter of law" render optimistic statements unactionable.

3. Rubinstein v. Collins

In Rubenstein v. Collins,[231] the Fifth Circuit stated that "cautionary language is not necessarily sufficient, in and of itself, to render predictive

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[228] Id. at 371. See also Gasner v. Board of Supervisors, Fed. Sec. L. Rep (CCH) ¶99,379 (4th Cir. 1996). The
Court applied the "total mix" standard from Trump and dismissed plaintiff's complaint concluding that cautionary statements in offering materials for municipal bonds for a new solid waste facility were sufficient to warn investors of the high risks at stake. Plaintiffs alleged that the issuer had additional information as to the viability of the facility. The Court held, however, that the risks that materialized were the same as those outlined in the issuers cautionary statements such that the "total mix" of information was not misleading. Specifically, the offering statement disclosed that repayment of the bonds depended on the commercial success of the facility.

[229] 948 F.2d 1037 (6th Cir. 1991).

[230] Fed. Sec. L. Rep. (CCH) ¶97,379 (6th Cir. 1993).

[231] 20 F.3d 160 (5th Cir. 1994).

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statements immaterial as a matter of law."[232] Thus, while "[i]nclusion of cautionary language along with disclosure of any firm-specific adverse facts or assumptions is, of course, relevant to the materiality inquiry . . . cautionary language as such is not per se dispositive of this inquiry."[233]

In Rubenstein, Plains Resources, Inc. ("Plains"), one of the defendants to the suit, announced on August 19, 1991, that it had made a significant natural gas discovery which was characterized as "substantial." Initial tests of the discovery were conducted, and analysts subsequently gave optimistic opinions about high yields from the discovery. On October 23, 1991, Plains' CFO reportedly characterized as "realistic" an analyst's opinion that, among other things, the asset value of Plains was between $66 to $100 per share. In November 1991, Plains filed a registration statement for a proposed secondary public offering which reiterated the initial test results and contained the following assertion:

> Although there is insufficient production history and other data available to definitely quantify the proved reserves attributable to this discovery, the Company believes . . . that [the] well is a significant discovery that, when fully evaluated, could add substantially to the Company's oil and natural gas reserves. There can be no assurance, however, that subsequent production, drilling and other data will not cause the Company to reevaluate its assessment of the significance of this discovery.[234]

Similar statements were made in the prospectus that accompanied the offering.

The plaintiffs alleged that the registration statement and the October 23rd statement were misleading because the defendants knew that the discovery testing conducted up to that time "was not sufficient to provide a reasonable basis for these statements, and failed to disclose the declines in flow-tube and shut-in pressures."[235] On December 4, 1991, the defendants began to disclose some of the adverse information regarding the discovery. Five days later, however, Plains' CEO announced that the discovery was up and running and was producing gas and condensate at levels seen before the recent sharp drop in flow-tube pressure. On January 24, 1992, the planned public offering took place. Plains filed its

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[232] Id. at 167.

[233] Id. at 168.

[234] Id. at 163-64.

[235] Id. at 164.

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10-K report on March 20, 1992, in which it reiterated the favorable October test results. Finally, on April 13, 1992, an analyst publicly reported that the well's reserves were worth less than $2 million, which was insufficient to cover the actual cost of the well.

The plaintiffs alleged, among other things, that defendants violated § 10(b) and § 20(a) of the Exchange Act, as well as Rule 10b-5. The district court dismissed these claims holding that the statements by defendants "were made in good faith, suggested reliability and bespoke caution."[236] According to the district court, "positive economic forecasts and predictions such as those made by defendants may not form the basis of a securities fraud action when such statements are couched in cautionary language."[237]

The Fifth Circuit subsequently overturned the district court's decision, stating that the district court had applied the "Bespeaks Caution" doctrine too broadly.[238] In its decision, the Fifth Circuit declined to follow Sinay and instead cited Mayer favorably. Thus, it appears that some courts will continue to back down from the "Bespeaks Caution" doctrine, as Mayer and Rubenstein reveal, and instead find that statements couched in cautionary language are merely of the "total mix of information" that courts look to in determining liability. Conversely, the "Bespeaks Caution" doctrine has gained support in other courts, as Worlds of Wonder, discussed below, illustrates.

4. In re Worlds of Wonder Securities Litigation

In In re Worlds of Wonder Securities Litigation,[239] the Ninth Circuit adopted the "Bespeaks Caution" doctrine and affirmed the district court's summary judgment in favor of the defendants regarding the textual of a Debenture Prospectus.

Worlds of Wonder ("WOW") was formed in 1985 and quickly achieved huge success with its two lines of toys: Teddy Ruxpin and Lazer Tag. To fund further expansion, WOW conducted a debenture offering in

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236/ Id. at 165.

237/ Id.

238/ See also In re Prudential Securities, Fed. Sec. L. Rep. (CCH) ¶99,253, 95,430 (S.D.N.Y. 1996) (cautionary language does not protect material misrepresentations or omissions when registrant knows they are false when made).

239/ Fed. Sec. L. Rep. (CCH) ¶98,393 (9th Cir. 1994).

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June of 1987, raising $80 million. This additional infusion of capital was inadequate to sustain WOW's uncontrolled growth and, in addition to sluggish sales in the 1987 Christmas season, lead to WOW filing for bankruptcy on December 21, 1987. Several purchasers of WOW debentures subsequently filed this class action, alleging that the prospectus accompanying the offering was false and misleading in violations of sections 11 and 12(2) of the 1933 Act and section 10(b) of the 1934 Act.

The district court held that where a prospectus contains extensive discussions of the specific risks inherent in investing in a start-up toy company, optimistic statements about such investment are not misleading as a matter of law.[240] According to the district court:

> It does not matter if the optimistic statements are later found to have been inaccurate or based on erroneous statements when made, provided that the risk disclosure was conspicuous, specific, and adequately disclosed the assumptions upon which the optimistic language was based . . . [241]

On appeal, the Ninth Circuit considered the issue whether the district court erred by adopting and applying the "Bespeaks Caution" doctrine. The Ninth Circuit began its discussion of the doctrine by noting that at least six circuits have adopted some form of the "Bespeaks Caution" doctrine. The court further stated that " . . . the doctrine, when properly construed, merely represents the pragmatic application of two fundamental concepts in the law of securities fraud: materiality and reliance."[242] The Ninth Circuit then found that the district court had applied the doctrine narrowly and thus affirmed the district court's summary judgment in favor of defendants. To prevent overboard application of the doctrine, the Court stated that:

[240/] 814 F. Supp. 850 (N.D. Cal. 1993).

[241/] Id. at 858-59.

[242/] Fed. Sec. L. Rep. at 90,681.

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> the "Bespeaks Caution" doctrine applies only to precise cautionary language which directly addresses itself to future projections, estimates or forecasts in a prospectus. By contrast, blanket warnings that securities involve a high degree of risk [are] insufficient to ward against a federal securities fraud claim.[243]

5. Harden v. Raffensperger

In Harden v. Raffensperger,[244] plaintiffs alleged that Raffensperger, as underwriter, was liable for, among other things, misstatements concerning the issuer's ability to secure insurance and its plans to restore company profitability. Raffensperger argued that the statements were couched in sufficient cautionary language creating a viable "Bespeaks Caution" defense.

In rejecting Raffensperger's arguments, the Court noted:

> Essentially, Raffensperger contends that the word 'plans' used in this statement means 'future efforts' rather than existing methods, ideas or means of achieving some goal. We cannot agree . . . Contrary to Raffensperger's attempt to portray the 'plans to restore [profitability] statement' as containing solely 'soft information,' the statement constitutes a present assertion of fact . . . [245]

And again, with respect to the issuers cautionary statement regarding its efforts to secure insurance the court found that:

> [The company] knew, prior to the issuance of the registration statement, that there was in fact no possibility of such approval and omitted to disclose this fact. The information . . . does not concern subjective or 'soft information,' but rather 'hard facts.' The "Bespeaks Caution" doctrine does not, as a matter of law, offset the materiality of such information. [246]

243/ Id. at 90,681, citing In re Worlds of Wonder Sec. Litig., 814 F. Supp. at 858. See also In re Prudential Securities Inc. Limited Partnerships Litigation, Fed. Sec. L. Rep. (CCH) at ¶95,430) (cautionary language must precisely address the substance of the specific statement or omission that is challenged).

244/ Fed. Sec. L. Rep. (CCH) ¶98,869 (7th Cir. 1995).

245/ Id. at 93,224.

246/ Id.

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The court's distinction between "hard" and "soft" information has lead some commentators to suggest that the decision cuts back on the "Bespeaks Caution" defense. However, the court's emphasis on the language used by defendant in preparing the registration statement suggests that more concise drafting by issuer and underwriter may preserve a "Bespeaks Caution" argument even if the cautionary language concerns "hard facts."

6. Fecht v. The Price Company

The Ninth Circuit signaled that it will carefully review dismissals of securities fraud claims based upon the "Bespeaks Caution" Doctrine.[247] The court quoted its ruling in In re Worlds of Wonder Securities Litigation, but went on to state:

> The "Bespeaks Caution" doctrine is thus wholly consistent with our analysis that whether a statement in a public document is misleading may be determined as a matter of law only when reasonable minds could not disagree as to whether the mix of information in the document is misleading. Inclusion of some cautionary language is not enough to support a determination as a matter of law that defendants' statements were not misleading.

In early 1996, the Ninth Circuit made clear that it considered Fecht to be the controlling case for reviewing dismissals based on the "Bespeaks Caution" doctrine. In Warshaw v. Xoma,[248] the court applied the Fecht standard to dismiss a plaintiff's complaint, concluding that effective cautionary language must be so obvious that reasonable minds could not differ as to its meaning. The court concluded: "The complaint asserts that the defendants knew that the facts contravened their 'optimistic' statements that E5 was safe, effective, and would be approved by the FDA. In this case, we easily conclude that the complaint satisfied Rule 9(b) requirements."[249]

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[247] Fecht v. The Price Company, Fed. Sec. L. Rep. (CCH) ¶98,946 (9th Cir. 1995).

[248] Warshaw, et al. v. Xoma Corp., et al., Fed. Sec. L. Rep. (CCH) ¶99,013 (9th Cir. 1996).

[249] Warshaw, 74 F.3d, 955, 960. For a more recent example of stringent application of the bespeaks caution doctrine, see In re Westinghouse, Fed. Sec. L. Rep (CCH) ¶99,271 (3rd Cir. 1996). In Westinghouse, Plaintiffs alleged that the company misrepresented the adequacy of its loan loss reserves in its 1991 Registration Statements. Westinghouse's Registration Statement contained cautionary language regarding "future economic developments" that may cause losses in the company's marketable securities portfolio. In holding these cautionary statements insufficient to warrant dismissal of defendant's complaint, the court stated:

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7. Pozzi v. Smith

In Pozzi v. Smith,[250] an electronics and software company, Quad Systems Corp., could not successfully invoke the "Bespeaks Caution" doctrine because the company's use of cautionary language was qualified. Quad disclosed certain problems it was having with its software, but qualified the disclosures by saying that the problems were not unusual and could be satisfactorily resolved. The court concluded: "Thus, even though Quad made certain cautionary statements about software limitations and bugs (which it soft-pedaled by describing them as not unusual), it was simultaneously hiding the effect of those problems on the Company's business."[251]

8. Saslaw v. Al Asakari

In Saslaw v. Al Askari,[252] a garment manufacturer, Plaid Clothing Group, successfully invoked the Bespeaks Caution doctrine and defeated investors' claims that the company made false representations in its registration statement. The registration statement detailed the past, present and future turmoil in the clothing industry as well as a "panoply" of risks facing the company and its recent acquisitions. The company disclosed as a risk factor that its margin would decline as sales shifted from higher-priced specialty stores to value-priced retailers, and that problems with its information systems led to poor inventory control. The court concluded that these risk factors were clearly delineated and were not "buried in a mass of trivial information."[253]

> "In our view, a reasonable investor would be very interested in knowing, not merely that future economic developments might cause further losses, but that (as plaintiffs allege) current reserves were known to be insufficient under current economic conditions. A reasonable investor might well be willing to take some chances with regard to the future of the economy, but might be quite unwilling to invest in a company that knew that its reserves were insufficient under current conditions and knew it would be taking another major write-down in the near future (as plaintiffs allege)."

Id. at 95,582.

[250] Pozzi v. Smith, Fed. Sec. L. Rep. (CCH) ¶98,967 (E.D.Pa. 1995).

[251] Id. and See also Voit v. Wonderware Corp., et al., Fed. Sec. L. Rep. (CCH) ¶99,541 (E.D.Pa. 1997). In Voit, the bespeaks caution doctrine could not be invoked by executives who allegedly omitted present facts.

[252] Fed. Sec. L. Rep. (CCH) ¶99,461 (S.D.N.Y. 1997).

[253] See also Brogen v. Pohlad, Fed. Sec. L. Rep. (CCH) ¶99,462 LD. Minn. 1997). In Brogen, the risks of a recently acquired chain of beauty salons were sufficiently warned of through a variety of cautions and warnings to render defendants' optimism only part of total mix of information available.

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9. In re International Business Machines Corp. Securities Litigation

The Second Circuit upheld the lower court in dismissing a suit against IBM for fraudulent representations of fact concerning future payment of dividends.[254] The court held that an officer's statement to the press that there was "no plan, no desire" to cut the dividend, followed by a cut of the dividend first by $0.67 and then again by $0.29 were opinions concerning an uncertain future event, and not actionable as such.[255] Because the statements were opinions and not guarantees and since the power to declare dividends is clearly vested in the Board of Directors and not in the management or person making the statements, the court upheld the dismissal.[256] Additionally, the court relied upon the bespeaks caution doctrine and held that the statements of opinion were followed by appropriate cautionary language, making it unreasonable for an investor to rely on the statements as long-term guarantees.[257]

10. Rissman v. Rissman

The Northern District of Illinois held in Rissman v. Rissman that a shareholder in a closely-held corporation could not claim reliance on allegedly misleading oral statements when deciding to sell his shares to a majority shareholder.[258] Plaintiff Arnold Rissman sold his one-third ownership in Tiger Corporation ("Tiger") for $17,000,000, and at that time signed a Buy-Out settlement agreement (the "Agreement"). The Agreement stated, among other things, a full release, and a statement that Arnold Rissman had received no promises or inducements to sell. Additionally, Arnold Rissman was informed in the Agreement that a potential future sale to a third party or to the public in an initial public offering could be for a price substantially more than the purchase price in the Agreement.

254/ In re International Business Machines Corp. Securities Litigation, Fed. Sec. L. Rep. (CCH) ¶90, 328 (2d Cir. 1998).

255/ Note that some statements of opinions or predictions are actionable. See Time Warner, 9 F.3d at 266; In re Apple Securities Litigation, 886 F.2d 1109, 1113 (9th Cir. 1989). Those opinions that are actionable are so because they are worded as guarantees, or if the speaker does not genuinely believe them.

256/ International Business Machines, at ¶91, 599.

257/ International Business Machines at ¶91,560. See, also, San Leandro Emergency Med. Group Profit Sharing Plan v. Philip Morris, 75 F.3d 801 (2d Cir. 1996) ("[l]iability may not be imposed based on statements that, considered in their entirety, clearly 'bespeak caution.'").

258/ Rissman v. Rissman, et al., Fed. Sec. L. Rep. (CCH) ¶90,630 (N. Dist. Ill. 1999).

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Arnold Rissman, however, claimed that he had been told that under no circumstances would Tiger be sold to a large company who could then take Tiger public (and, presumably, garner major fortunes for shareholders), and because this was not a possibility, he chose to sell. Less than a month after he sold his shares, Tiger was sold to Hasbro for a price that far exceeded the price per share Arnold Rissman received.

Citing Teamsters Local 282 Pension Trust Fund v. Angelos,[259] the court stated that "an investor cannot close his eyes to a known risk."[260] "No reliance is reasonably made upon antecedent declarations that Tiger would never be sold. Here, the plain language of corporate opportunity to sell or merge or consolidate Tiger bleeds upon the Agreement."[261] The court stated in no uncertain terms that a shareholder with perhaps less than all available information can still be held to have had enough information to reasonably sell his shares.

F. Duty to Update

It was hoped that the Reform Act would clarify the question of whether issuers have a "duty to update" statements which were accurate when made, but which become inaccurate due to subsequent developments. Although nothing in the Reform Act's safe harbor imposes such a duty, the statutory language does not eliminate the duty to update which may arise under current case law.[262] According to Carl Schneider, "in effect, the Reform Act does not change the law, whatever it may be, relating to the duty to update.[263]

The cases discussed below, including the well-publicized Polaroid case, suggest that issuers have a "duty to update." These cases often confuse the duty to correct and the duty not to mislead. If an issuer makes a statement that is inaccurate or is misleading based on the facts and circumstances existing at the time of such statement, then the issuer has a duty to correct such misstatements. That is not to say that an issuer has a duty to update statements which were accurate when made, but later became inaccurate or misleading due to a change of facts and circumstances. There is virtually no precedent for the proposition that either the duty to correct or the duty not to mislead requires that issuers update prior, accurate statements. Such decisions would impose upon issuers a

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259/ Teamsters Local 282 Pension Trust Fund v. Angelos, 762 F.2d 522, 530 (7th Cir. 1985).

260/ Rissman, at ¶90,874.

261/ Id.

262/ Carl W. Schneider and Jay A. Dubow, Forward-Looking Information--Navigating in the Safe Harbor, 51 Business Lawyer 1071, 1077 (1996).

263/ Id.

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continuous obligation to disclose all material information during periods between SEC reports.

In fact, these cases are misconstrued duty not to mislead claims. The "duty to update" theory is a misnomer which threatens to negate the established principle that an independent trigger of a duty to disclose is a distinct element of a Rule 10b-5 action. Although a narrower duty to update only "so-called forward looking" statements appears more palatable, in practice it would be an unworkable and dangerous precedent. Such a duty to update prior disclosures would discourage issuers from making disclosure in the first place, and therefore is counterproductive to a system which encourages timely voluntary disclosure of material information.[264] Nevertheless, there was a trend to require such a duty, as some of the earlier cases such as Time Warner illustrated. Fortunately, recent cases such as Cummins Engine and Centel Corp. indicate that this trend to require a duty to update may be reversing.

1. Backman v. Polaroid Corporation

If bad facts make bad law, then the opinion by a panel of the First Circuit in Backman v. Polaroid Corporation[265] shows that unique circumstances also can produce bad law. The panel's opinion would have imposed upon Polaroid a broad duty to disclose material adverse developments concerning its new instant movie system called "Polavision" solely to update prior, accurate statements which were rendered inaccurate by subsequent adverse developments. The panel would have imposed this interim period disclosure obligation even though it was unable to conclude that Polaroid was either trading its own securities or making statements which, without an update, would have been otherwise misleading.

Fortunately, the court's opinion was withdrawn, and the judgment vacated. After a rehearing en banc the First Circuit held that Polaroid's statements could not have been considered misleading when made, nor did they become misleading in light of subsequent events.[266] Nevertheless, because the full court did not completely reject the notion that certain "forward looking" statements could require further disclosure, the Polaroid

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264/ See e.g., Carl Schneider, Update on the Duty to Update: Did Polaroid Produce the Instant Movie After All?, 23 Rev. Sec. & Comm. Reg. 83 (1990); Carl Schneider, The Uncertain Duty to Update -- Polaroid II Brings a Welcome Limitation, Insights, Oct. 1990, at 2; Carl Schneider, The Duty to Update: Time Requires a Reevaluation of Basics, Insights, Apr. 1994, at 2.

265/ Fed. Sec. L. Rep. (CCH) ¶94,899 (1st Cir.), opinion withdrawn, judgment of the court of appeals vacated, opinion en banc, 910 F.2d 10 (1st Cir. 1990).

266/ 910 F.2d 10 (1st Cir. 1990) (en banc).

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case merits close attention to prevent the so-called “duty to update” from receiving further credibility.

a. Unique Circumstances: The Third Quarter Report, Polavision Problems and The Foundation Stock Sale

Polaroid introduced its much-heralded Polavision with a massive ad campaign in the Spring of 1978, projecting sales of 200,000 units for the year. By October, the company had adjusted projected sales to 100,000 units and ordered its supplier to decrease production. Polaroid temporarily ceased all production of Polavision in November to deplete excess inventory. On both occasions, Polaroid requested secrecy from its supplier concerning the cutbacks. In early December, 1978 Polaroid circulated among upper management a forecast estimating 1978 sales of Polavision at 97,000 units.

Polaroid’s Third Quarter Report to Stockholders issued on November 5, 1978, emphasized increased earnings, booming sales and record manufacturing output for the company as a whole. These representations were true and correct in every respect. The Report made only the following direct reference to Polavision:

> [The President] noted also that earnings continue to reflect substantial expenses associated with Polavision, Polaroid’s new system of instant movies.[267]

The Report also attributed a major of the company’s increase in the ratio of cost of sales to net sales for the first nine months of the year and the third quarter, to “substantial expenses associated with Polavision.” These statements also were true.

On January 9, 1979, the Rowland Foundation, a charitable organization run by Dr. Edwin Land, Polaroid’s founder, Chairman and CEO, issued a press release through Polaroid’s public relations department announcing its intent to sell 300,000 Polaroid shares. The press release had been reviewed by Polaroid’s in-house counsel and the Foundation’s attorney, a vice-president and director of Polaroid. The press release cited the Foundations’ desire to diversify as its reasons for the sale and mentioned Dr. Land’s impending retirement as Chairman and CEO of Polaroid. The release made no reference to Polavision. The stock was sold on January 11, 1979 for $52 per share.

267/ Fed. Sec. L. Rep. (CCH) ¶94,899, at 94,956.

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On January 15, 1979, Polaroid circulated to management an internal report estimating fourth quarter earnings slightly lower than anticipated, and recommending a reserve for additional Polavision expenditures. Polaroid booked a reserve of $6.8 million for Polavision losses on February 1. At the close of the market on February 22, 1979, Polaroid issued a press release announcing a 26% increase in earnings for fiscal year 1978 and earnings per share of $1.32 for the fourth quarter. The release further disclosed that Polavision had incurred manufacturing and marketing expenses "substantially in excess of revenues" and that the project would continue to make such demands on cash and earnings in 1979. Polaroid's stock fell from almost $50 on February 22 to $43 on February 23, stabilizing at about $40 by March 1.

Plaintiffs sued, alleging that Polaroid misled investors by intentionally de-emphasizing the Polavision difficulties when it announced record earnings for the third quarter. The plaintiffs alleged that Polaroid had a duty to disclose the subsequent Polavision production cuts and the December and January internal reports to prevent the Third Quarter Report from "becoming misleading." Finally, the plaintiffs asserted that the press release announcing the Foundation stock sale was misleading because it did not discuss the adverse developments in the Polavision project.

After a bifurcated trial, the jury returned a verdict for the plaintiffs and awarded an aggregate of $9.75 per share in damages to all the class participants. Polaroid appealed the verdict, arguing that it never uttered any misleading statements or engaged in any conduct that would trigger a duty to disclose. Polaroid also challenged the jury instructions regarding materiality and the duty to disclose.

b. Duty to Disclose — No Misstatements

The First Circuit panel in Polaroid held that the trial judge's instructions to the jury regarding Rule 10b-5 improperly equated the duty to disclose with materiality and failed to specify the events that would trigger a duty to disclose.[268] Writing for the panel, Judge Bowne properly stated the circumstances that would trigger an obligation to disclose material information:

(1) when a "corporate insider trades on confidential information,"

[268] The panel also found that the trial judge failed to specifically instruct the jury with respect to the good-faith defense to scienter. The Rule 10b-5 scienter requirement is beyond the scope of this article.

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(2) when a corporation has made "inaccurate, incomplete, or misleading prior disclosures," and

(3) when a statute or regulation requires disclosure.[269]

The panel also determined that the Third Quarter Report was accurate and not misleading at the time of its issuance. Due to its significant involvement in the Rowland Foundation press release, the panel found that Polaroid was responsible for its content. Judge Bowne expressed significant reservations, however, that the release, standing alone, would provide an adequate basis to impose liability on Polaroid for the alleged omissions.

c. Bad Law: The Duty to Update

Notwithstanding that the Third Quarter Report was accurate and not misleading when made, the panel held that a reasonable jury could conclude that the Report "became misleading" once Polaroid ordered the November production halts and had assembled earnings estimates showing poor fourth quarter performance. The panel asserted that even though the statements were accurate when made, "a duty to disclose can arise if a company possesses material facts that must be released in order to render prior statements not misleading."[270] Therefore, rather than overturn the jury verdict, the First Circuit panel ordered a new trial.

d. Dubious Relief: The En Banc Opinion

In the opinion en banc, the First Circuit reasserted that a duty to disclose would arise only if the issuer: traded in its own securities; made prior inaccurate statements; or was required by a specific statute or regulation. The full court also concluded that Polaroid's statements in the Third Quarter Report about Polavision's negative effect on earnings were complete and accurate when made, and remained true and correct at all times thereafter. The court ruled that Polaroid had satisfied its obligations by disclosing that Polavision was being sold below cost. The court rejected the claim that Polaroid misled investors by electing not to say how much below cost. The court stated that the duty not to mislead:

269/ Fed. Sec. L. Rep. (CCH) ¶94,899, at 94,942 (citing Roeder v. Alpha Industries, Inc., 814 F.2d 22 (1st Cir. 1987)).

270/ Fed. Sec. L. Rep. (CCH) ¶94,899, at 94,944 (citing Greenfield v. Heublein, Inc., 742 F.2d 751, 758 (3d Cir. 1984)).

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> does not mean that by revealing one fact about a product, one must reveal all others that, too, would be interesting, market-wise, but means only such others, if any, that are needed so that what was revealed would not be "so incomplete as to mislead."[271]

Finding no evidence in the record to suggest that Polaroid knew by November that Polavision was a commercial failure, the court refused to consider the Polavision statements misleading simply because the Third Quarter Report omitted to mention exact sales figures.

The court also confirmed that if the Polavision statements had been misleading when made, Polaroid would have had a duty to correct them. Because the Polavision statements remained true and correct at all times after their utterance, no duty to correct ever arose. As for the so-called "duty to update," the full court stated that:

> in special circumstances, a statement, correct at the time, may have a forward intent and connotation upon which parties may be expected to rely. If this is a clear meaning, and there is a change, correction, more exactly, further disclosure, may be called for.[272]

The court acknowledged that it need not face that question, however, because even if the Polavision statements were forward looking, they remained precisely correct after their release. Hence, the court's statements as to the duty to update are dicta.[273]

e. A Bad Precedent

Although the First Circuit's rejection of a broad "duty to update" is a welcome relief, the dicta language suggesting that certain forward looking statements require further disclosure is very troubling. To distinguish statements of present fact from purely speculative and forward looking disclosure is practically impossible. Issuers also have no

[271] 910 F.2d at 16 (citing SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 862 (2d Cir. 1968)).

[272] Id. at 17.

[273] Ironically, Judge Bowne's dissent to the opinion en banc provides a better discussion of the disclosure issue than that given in the majority opinion. Judge Bowne admits that the language in the panel opinion could be construed as creating an overly broad "duty to update" past accurate statements of historical fact and that no such "duty to update" should exist. Unfortunately, Judge Bowne also stated that the duty to correct should apply to forward-looking statements which remain "alive" and become inaccurate due to events that occur while the statement is still viable in the marketplace.

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reasonable guidance as to the duration of viability of such statements in the market. Because of the compliance difficulties it presents, acceptance of even a limited duty to update would eviscerate the traditional rule that issuers have no general duty to disclose.

Various commentators and the SEC have long recognized the peculiar problems raised by forward looking statements, speculative analysis and projections.[274] The SEC has historically accepted a modicum of "touting" as an acceptable business practice and has adopted Rule 175 as a safe harbor to encourage issuers to provide projections of future performance, estimates and forecasts.[275] A duty to continually update all material statements, including forward looking statements, would discourage voluntary disclosure and undermine the SEC's efforts in this regard.

To undermine the doctrine of timely disclosure in this manner appears particularly short-sighted given the development of the MD&A as a quarterly disclosure vehicle, requiring issuers to disclose all material changes or subsequent developments in their 10-Q reports. Because virtually all such material changes relating to forward looking statements would be encompassed in the MD&A, courts should refuse to eliminate the flexibility and business judgment afforded management under the current regulatory scheme.

2. In re Time Warner Inc. Securities Litigation

After the takeover by Time of Warner, the resulting company faced a substantial debt. Time-Warner embarked on a highly publicized campaign to find international "strategic partners" to infuse billions of dollars of capital to the company. The plan failed, and Time-Warner resorted to a stock offering that diluted the rights of the existing

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274/ In his article, Update on the Duty to Update: Did Polaroid Produce the Instant Movie After All?, Carl Schneider describes statements which could possibly warrant a "duty to update" because of an "implied representation and/or reasonable expectation of continuity." See Schneider, supra note 213. Schneider states that if a company announces a long-term contract award which would double its sales, and loses that contract months later, the company should have to disclose the loss of that contract, solely because of its prior disclosure. Management should be entitled, however, to exercise its business judgment and delay disclosure of this information to assess the impact on the business and develop strategies to counter any losses. See supra note 1. Regardless, the company's next MD&A would require disclosure of the contract, loss if the company's liquidity or capital resources would be affected, or if the cancellation would cause the historical financial data in the report not to be indicative of future operating results or financial condition.

275/ Rule 175 generally provides a safe harbor for projections that are made with a reasonable basis and in good faith. See 17 C.F.R. § 230.175. For a discussion regarding the "enhanced" safe harbor rule under the Private Securities Litigation Reform Act of 1995, see infra parts III.C.4-5.

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shareholders, and a lawsuit followed. The plaintiffs alleged that Time-Warner and certain executives misled the investing public by making certain statements and omissions that were generally optimistic about the progress of the "strategic partnerships" and never indicated the actual difficulties.

The district court considered two categories of misstatements: (i) press releases and public statements from the individual defendants, and (ii) unofficial statements from unnamed sources given to analysts and the press. With regard to the first category, the court found that the statements indicating that talks were ongoing were accurate when made, and that later attempts did not give rise to a duty to correct or update the statements. As to the second category, the court concluded that the defendants could not be held responsible for any of the unattributed statements, and that the statements were not actionable for the same reasons as category one. The district court then dismissed the complaint for failure to adequately plead either material misrepresentations or omissions attributable to the defendants, and for failure to plead scienter adequately.

The Court of Appeals, however, reversed and partially granted the defendant's motion to dismiss. The court discussed, among other matters, two updating issues with regard to the attributed statements and corporate press releases: (i) failure to disclose problems in the strategic alliance negotiations, and (ii) failure to disclose the active consideration of an alternate method of raising capital.

With regard to the first issue, the plaintiffs' theory was that the defendants' statements promoting strategic alliances gave rise to a duty to disclose problems in the alliance negotiations as problems developed. The court found, however, that the attributed public statements "lack the sort of definitive positive projections that might require later correction." Thus these statements "did not become materially misleading when the talks did not proceed well."[276]

[276/] The court added in a footnote:

> Although the statements are generally open-ended, there is one sense in which they have a solid core. The statements represent as fact that serious talks with multiple parties were ongoing. If this factual assertion ceased to be true, defendants would have had an obligation to update the earlier statements. But the complaint does not allege that the talks ever stopped or ceased to be 'serious,' just that they eventually went poorly.

Fed. Sec. L. Rep. (CCH) ¶97,824 at 98,156-157, fn.4. Carl Schneider argues that this footnote should be interpreted to require at most "terminal" disclosures, i.e., when either an agreement is reached or the

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Addressing the second issue of the failure to disclose alternative methods of raising capital, the Court of Appeals found that the information about the consideration of the stock offering alternative material because the offering could have a negative effect on the market price for the company's stock. The court then considered whether there was a duty to disclose the omitted fact. The court stated that:

> Time Warner's public statements could have been understood by reasonable investors to mean that the company hoped to solve the *entire* debt problem through strategic alliances. Having publicly hyped strategic alliances, Time Warner may have come under a duty to disclose facts that would place the statements concerning strategic alliances in a materially different light.[277]

The court concluded that "when a corporation is pursuing a specific business goal and announces that goal as well as an intended approach for reaching it, it may come under an obligation to disclose other approaches to reaching the goal when those approaches are under active and serious consideration."[278]

3. Good v. Zenith Electronics Corporation

Unfortunately, the duty to update refuses to die a rational death. In Good v. Zenith Electronics Corporation,[279] the district court suggested that Zenith may have violated a duty to update certain earnings projections which were accurate and reasonable when made, but subsequently proved unattainable. Zenith's 1988 Annual Report stated that the company "expected further profit improvements in 1989." On April 25, 1989 Zenith reported a $4 million first quarter loss. The release stated that the company's initial forecasts had anticipated the loss and confirmed that the company still expected profit improvement for the full year. On July 21, 1989, Zenith reported a $13 million loss for the second

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"serious" negotiations end with no agreement. Carl Schneider, The Duty to Update: *Time* Requires a Reevaluation of *Basics*, Insights, Apr. 1994, at 4. Thus, updating disclosures during the course of ongoing negotiations should not be required. Further, it is unclear whether the duty to update would arise if the terms being negotiated were announced but were subsequently changed materially during the course of negotiations. Id.

277/ Fed. Sec. L. Rep. (CCH) ¶97,824 at 98,157.

278/ Fed. Sec. L. Rep. (CCH) ¶97,824 at 98,157-158. In a subsequent decision, the Second Circuit acknowledged the duty to update, but narrowed its application considerably. See note 219 and accompanying text.

279/ Fed. Sec. L. Rep. (CCH) ¶96,142 (N.D. Ill. 1990).

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quarter. The price of Zenith stock fell significantly. The plaintiffs alleged that Zenith's April statements confirming the initial projections and projecting profit improvement constituted securities fraud.

In denying the defendant's motion for summary judgment, Judge Bua held that Zenith may have violated Rule 10b-5 by confirming the prior earnings projections at a time that the company may have been in possession of information which undermined the accuracy of such projections. It is unclear from the opinion whether Zenith actually had actual knowledge of facts contradicting the initial projections because materials relating to this charge were submitted under seal. Any voluntary confirmatory statements, if made at a time when the company had reason to believe that the initial projections were no longer accurate, would likely violate the duty not to mislead.

Unfortunately, Judge Bua went on to state that Zenith also may have had a "duty to update" the initial projections, which were accurate when made, "if additional information became known to the parties that changed the meaning of the statement." Because Zenith's April statements apparently were inaccurate, Judge Bua need not have attributed his ruling to an independent duty to update the initial projections and his statements in this regard are dicta.[280]

4. Stransky v. Cummins Engine Co., Inc.

Although the debate is far from over, the Seventh Circuit repaired some of the damage in Stransky v. Cummins Engine Co., Inc.[281] In Stransky, Cummins Engine Co. issued optimistic press releases regarding its newly redesigned engines, and later discovered because of faulty design problems that warranty costs were skyrocketing. Alan Stransky filed a

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[280/] Another case where the court applied the "duty to update" is In re Kulicke & Soffa Indust., Inc. Securities Litig., 747 F. Supp. 1130 (E.D. Pa. 1990), where the jury responded in special interrogatories that an issuer had a duty to disclose material information which rendered a prior projected sales forecast misleading, even though defendants made no statements supporting the projections once the projections became unattainable. However, both the jury and the court found that defendants lacked scienter in their failure to correct the forecast immediately. The court in In re Meridian Securities Litig., 772 F. Supp. 223 (E.D. Pa. 1991), suggested that an issuer had a duty to correct and update between periodic reports its optimistic

(continued . . .)

(continued . . .)

statements regarding certain successful business operations after difficulties arose. However, in Capri Optics Profit Sharing v. Digital Equip., 760 F. Supp. 227 (D. Mass. 1991), the court cited Backman and rejected the claim that an issuer had a duty to disclose "additional information" regarding expected company performance.

[281/] Fed. Sec. L. Rep. (CCH) ¶98,668 (7th Cir. 1995).

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class action suit for securities fraud, and based the case (at least partially) on a duty to update. The Court noted that some legal scholars have argued that a duty to update arises when a company makes a forward looking statement (i.e., a projection) that, because of subsequent events, becomes untrue. The Court emphatically stated, however, that "This court has never embraced such a theory, and we decline to do so now."[282]

The Seventh Circuit explained that Rule 10b-5 implicitly precludes liability in circumstances that arise after the speaker makes the statement. It commented that "the securities laws typically do not act as a Monday Morning Quarterback," and it noted that the securities laws approach matters from an ex ante perspective. Consequently, forward looking statements can lead to liability only if they are unreasonable in light of the facts known at the time.[283]

5. Eisenstadt v. Centel Corp.: The Death of the Duty to Update?

In this decision, handed down May 12, 1997, Judge Posner, *in dicta*, followed the Stransky precedent that no duty to update exists in the Seventh Circuit and suggested further that the Reform Act eliminated the duty in all Circuits.[284] Eisenstadt involved a claim by Centel stockholders that Centel exaggerated the prospects of a planned auction for the company, thus inflating the company's stock price. According to the Court, Centel made "repeated claims that the auction process was going well, implying that lots of firms were interested in making attractive bids."[285] Ultimately, the auction failed. Only seven bids were submitted and Centel accepted none of them. Centel then quickly negotiated a sale of the entire company to Sprint at a price equivalent to $33.50 per share,

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282/ Id. at 92,105.

283/ The 7th Circuit applied the same reasoning in Grassi v. Information Resources, Inc., 63 F.3d 596 (7th Cir. 1995) in upholding the District Court's denial of plaintiffs post-trial motion for judgment as a matter of law. In Grassi, plaintiffs alleged, among other things, that Information Resources made fraudulent misrepresentations regarding projected earnings for 1989. Citing Stansky, the Court held that the projection was not fraudulent absent evidence that "management did not genuinely believe the projection or that the projection lacked any reasonable basis at the time it was made." Id. at 599.

284/ Eisenstadt v. Centel Corp., Fed. Sec. L. Rep. (CCH) ¶99,458 (7th Cir. 1997). *Compare* Elliot Assocs. v. Covance, Inc. Fed. Sec. L. Rep. (CCH) ¶91,269 (S. Dist. N.Y. 2000) (reasoning that a duty to update may exist when a statement, reasonable at the time it is made, becomes misleading in light of later events, however, there is no duty to update a vague or optimistic expression of opinion).

285/ Id. at 97,022.

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which was $9 below the then-current market price and 10% below the market price before the auction was first intimated.[286]

In upholding the District Court's dismissal, Judge Posner first noted that Centel's statements were not an attempt to cover up a "disaster" since Centel is entitled to "put a rosy face on an inherently uncertain process."[287] Furthermore, the auction process itself was uninterrupted although the results were disappointing. The Court then noted that even if Centel "had made a public prediction of [a more valuable result], it would have had no legal duty, in this Circuit anyway and perhaps in no Circuit after the Private Securities Litigation Reform Act of 1995, [*cite omitted*] to make a public revision of the prediction when it became clear that no such bonanza was in store."[288] The Court stated further that "Centel cannot be faulted for having failed to tell the stock market that there would be only seven bidders and their bids would be no good. Had it known this from the start, it wouldn't have announced an auction. Hindsight is not the test for securities fraud."[289]

6. Weiner v. Quaker Oats Co.: Duty to Update Resuscitated?

This case, decided on November 11, 1997, reverses a district court's dismissal of plaintiffs' claims that Quaker owed a duty to update projected debt-to-total capitalization ratios.[290] Quaker involves the claims of shareholders that Quaker knowingly made disclosures of projections on debt-capital ratios and earnings growth when such projections could not be achieved because of its impending merger with Snapple Beverage Corp.

The Third Circuit affirmed the dismissal of the projected earnings claim, focusing on the language of Quaker's 10-K which discussed the earnings growth figure as a goal "over time." This phrase insulating Quaker from claims of fraud as no "reasonable finder of fact could conclude that the projection influenced prudent investors."[291]

286/ Id. at 97,020.

287/ Id. at 97,024.

288/ Id. at 97,023.

289/ Id.

290/ Weiner v. Quaker Oats Co., Fed. Sec. L. Rep. (CCH) ¶99,563.

291/ Id. at *10.

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However, the court reversed the dismissal of the debt-capitalization claim. The court found that, given the 1993 and 1994 projected guidelines to keep the debt ratio under 70%, a potential investor "would have no ground for anticipating that the . . . ratio would rise as significantly as it did in fiscal 1995."[292] The merger took place one month after the 1994 annual statement was released. The court agreed that a trier of fact could find that "the merger would compel Quaker to take on sufficient additional debt to raise [the ratio beyond the purported guideline.]."[293]

Though the Court acknowledged that the terms of the merger were not set by the time the 1994 annual state was released, the probability that Quaker would have known of the costs and effect of the impending merger created a basis which a reasonable fact finder could determine that Quaker had a duty to update its projections when they became unreliable.

The significance of Quaker is somewhat questionable for several reasons. First, the fact pattern of the case is quite unusual - each of the three periodic reports relied upon by the plaintiffs (two annual reports and one quarterly report on Form 10-Q) stressed the debt/equity ratio goal frequently and prominently. The prominence placed on this projected ratio in all three publications essentially invited the court to apply a duty to update. Secondly, defendants relied upon the rather weak defense that updating the debt/equity ratio forecasts could indirectly disclose the impending merger with Snapple. The court, however, was not impressed and explained that the ratio goals could have been revised (and in fact had been in the past prior to other Quaker acquisition) without disclosing the Snapple merger.[294] Lastly, the court relied upon the language of In re Burlington Coat Factory Securities Litigation[295] and ignored the Seventh Circuit cases of Stransky v. Cummins Engine[296] and Eisenstadt v. Centel,[297] arguably undermining the strength of the opinion.

On remand, a federal district court in Illinois declined to follow the Seventh Circuit law on the "duty to update" but instead followed the "law

[292] Id. at *7.

[293] Id.

[294] Id.

[295] 114 F.3d 1410 (3rd Cir. 1997).

[296] Discussed supra at Section III.F.4.

[297] Discussed supra at Section III.F.5.

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of the case" doctrine and deferred to the Third Circuit.[298] The court ruled against defendant's motion for summary judgment. In so holding, the court interpreted Third Circuit law as requiring updating for forward looking statements that "could *fundamentally* change the natures of the companies involved" as contrasted with "run of the mill" forward looking statements for which updating is unnecessary. (Emphasis added.)[299]

7. In re International Business Machines Corp. Securities Litigation

The Second Circuit issued a decision indicating that the Time Warner duty to update is still alive in deciding whether IBM had a duty to update an officer's statements that he did not anticipate a cut in dividends.[300] The court narrowed that duty, however, by stating that "there is no duty to update vague statements of optimism or expressions of opinion... There is also no need to update when the original statement was not forward looking and does not contain some factual representation that remains 'alive' in the minds of investors as a continuing representation...or if the original statements are not material." (Omitted citations).[301]

8. Oran v. Stafford

The Third Circuit recently issued a decision which also indicates that the Time Warner duty to update is still an issue in deciding whether a drug manufacturer's failure to disclose potential safety problems with new weight-loss drugs was material.[302] In this case, the plaintiffs alleged that the manufacturer, American Home Products Corp., (AHP), knew that taking the weight-loss drug resulted in serious health problems, however, AHP did not disclose this knowledge until after obtaining statistical evidence that its product was linked to the health problem months later.[303] In finding that the district court properly granted a motion for summary judgment in favor of AHP, the court determined that the defendant had no

[298] See Weiner v. The Quaker Oats Co., Fed. Sec. L. Rep. (CCH) ¶91,266 (N. D. Ill. 2000).

[299] Weiner v. The Quaker Oats Co., Fed. Sec. L. Rep. (CCH) ¶91,266 (N. D. Ill. 2000). See also the discussion of this case at II. B. 2. c. *supra*.

[300] In re International Business Machines Corp. Securities Litigation, Fed. Sec. L. Rep. (CCH) ¶90,328 (2d Cir. 1998).

[301] Id. at ¶91,561. See, also, San Leandro, infra note 333 and accompanying text.

[302] See Oran v. Stafford, Fed. Sec. L. Rep. (CCH) ¶ 91,205 (3d Cir. 2000).

[303] Id. See also In re Carter-Wallace, Fed. Sec. L. Rep. (CCH) ¶ 91,039 (2nd Cir. 2000).

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duty to update its prior statement that it was merely investigating any potential health risk related to its drug.[304] The court reasoned that the manufacturer never made any prior statement regarding the time it learned of or received notice of the potential health problems.[305] In making this determination, the court made these statements:

> Moreover, AHO had no legal duty to correct or update even following…its receipt of the FDA report. The duty to correct exists "when a company makes a historical statement that, at the time made, the company believed to be true, but as revealed by subsequently discovered information actually was not." Here, because AHP never made any prior statement regarding when it learned of the heart-valve data, there can be no legal duty to correct.
>
> The duty to update, in contrast, "concerns statements that, although reasonable at the time made, become misleading when viewed in the context of subsequent events." ….In this case, AHP never made any factual representation – implicit or explicit – regarding when it was first placed on notice about potential heart-valve problems.

Accordingly, the court held that because there was no misleading prior factual representation, which "remained alive in the minds of investors as a continuing representation," AHP had no duty to update.[306]

Though the duty to update is at least apparently eliminated in the Seventh Circuit, the greater question now is whether other courts will follow the lead and reasoning of Stransky and Eisenstadt or Quaker, Oran and Time Warner.[307] The duty to update thus continues to be a widely

[304] Id.

[305] Id.

[306] Id.

[307/] Such a trend may be developing in some jurisdictions. The opinion in In re Cypress Semiconductor Securities Litigation, Fed. Sec. L. Rep. (CCH) ¶98,762 (N.D. Cal. 1995), echoes the Seventh Circuit distaste for the duty to update: "All of Cypress forward-looking statements had a reasonable basis at the time they were made, which is the only time that matters as far as the securities laws are concerned." Id. at 92,639. Similarly, in In re Symbol Technologies Class Action Litigation, Fed. Sec. L. Rep. (CCH)

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interpreted and conflicted issue. In my opinion, courts will continue to recognize a duty to update, however, similar to the Second Circuit in In re International Business Machines Corp., the courts will narrow the duty to update and distinguish the facts of cases before them so that ultimately the duty to update will not apply.

G. Suggested Guidelines for Counseling Disclosure

As a means to better protect themselves, corporate personnel responsible for drafting reports and press releases, and counsel who review them, should have in their possession and review all prior reports, releases and internal and external projections, if any, investment banker studies and analysts' reports to ensure that they understand the total context and environment in which the issuer speaks. These documents should be compared with the company's business plan and latest operations reports to ensure that information in the marketplace is consistent with the issuer's internal views and memoranda. Those executives charged with speaking on behalf of the issuer must be advised of the risks and sensitivities of their task. Under the safe harbor provisions of the Reform Act, all formal and informal projections and predictive statements, including materials promoting new products directed to the financial markets, should include specific and tailored "Cautionary Warnings" regarding their limitations, assumptions, and uncertainties, and should state clearly that they will not be updated or revised.

A significant number of current cases allow some degree of corporate puffing, but practitioners and corporate personnel should be aware that this trend may change with the growth of information services and news media. Off-the-cuff remarks made by personnel, calls to analysts, and annual meeting releases are now regularly reported and made public through the various news services or the internet. The growing accessibility

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¶99,412, 96,686 (E.D.N.Y. 1997), the court stated that "[d]efendants cannot be held liable for statements that were true when made; there is no fraud by hindsight." This optimism must be tempered, however, given the holding in Quaker. Also, in In re Burlington Coat Factory Securities Litigation, 114 F.3d 1410 (3rd Cir. 1997), the 3rd Circuit, prior to Quaker, examined the application of the duty to update for the first time. The court recognized that the duty to update might exist under certain circumstances based on Time Warner, but declined to do so on the facts before the court. Here, plaintiff argued a duty to update on one erroneous earnings forecast. The Court declined to hold that a "single, ordinary disclosure [could] produce such an expansive set of disclosure obligations." Id. at 1432. Similarly in Grossman v. Novell, Inc., 120 F.3d 1112 (10th Cir. 1997), the court did not rule out the possibility of holding a defendant to a duty to update, but chose not to do so on the facts of the case before it. Relying on Time Warner, the court declined to impose a duty to update for a "vague, optimistic statement that . . . was not a 'definite positive projection'." Id. at 1125, citing Time-Warner 9 F.3d at 267.

For a detailed analysis of the duty to update doctrine and the cases, see Jeffrey A. Brill, The Status of the Duty to Update, Cornell Journal of Law and Public Policy, Winter 1998 ("As a result of inter-circuit inconsistency and the SEC's and Congress's failure to provide clarification, the precise contours of the duty to update remain uncertain."); this article was cited twice by the district court in the Quaker case on remand, Fed. Sec. L. Rep. (CCH) ¶91,266 (N. D. Ill. 2000).

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to off-the-cuff or formerly unreportable statements through the development of the media may cause courts to take a more serious look at puffing statements.[308]

Although issuers are not responsible for and have no duty to correct third party statements, a continuous monitoring of these extra-corporate materials is important because it reveals the information that the market views as important. If management fails to scrutinize these public statements and perceptions, and does not anticipate the market's reaction to information regarding positive or adverse corporate developments, its disclosure will be subject to attack by investors suing with the benefit of hindsight.

It is becoming more difficult to defend the issuer on the ground that omitted information was not required to be disclosed under traditional concepts of materiality and timely disclosure. Management may believe in good faith that the success or failure of a new product, or the effect of a potentially negative business development, will not have a significant impact on the company's financial condition or operations. Plaintiffs and often courts, however, will look instead to the reaction of the market to positive or negative news regarding the product or development in determining its materiality. The purposes of the recommended exercises described above are to enable management to gauge investors and anticipate those developments and occurrences which, when disclosed, might have a significant impact on the market.

Finally, disclosure practitioners should educate their clients regarding the perils of MD&A and train them to prepare the MD&A with a view to anticipating the almost inevitable attack. In addition, counsel should learn to cross-examine vigorously the issuer's statements from the perspective of plaintiff's counsel suing with the benefit of hindsight. One must ask, has the issuer accurately depicted in the MD&A those trends and uncertainties which may affect its business and results of operations and which the market may perceive as significant? A process which includes a review of prior periodic reports, press releases, analysts' reports and the company's business plan and projections should provide counsel a sense of the company in motion, thereby providing more safety in disclosure. Knowing what the last 10-Q disclosed and anticipating what the next disclosure document will include is also a useful exercise. Moreover, perfunctory mark-ups of prior disclosure documents should be avoided.

In summary, as earlier stated, issuers should focus on the following key questions:

- Does the market understand the risks inherent in new product development, the continued viability of old products, or the condition of property, plants and equipment?

[308/] See Quaker, supra at Section III.F.6, discussing the significance of publicly reported puffing statements made by the CEO and the potential for liability for such statements.

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- Has the company identified any specific problems or difficulties--or has the company experienced similar difficulties in the past--which could diminish the prospects of the product or business development in general?

- Do the press releases and statements identify such potential risks and difficulties?

- Are the statements consistent with the internal memorandum and reports on the product or development?

- Do all statements reflect the new, somewhat blurred, definition of "materiality?"

- Is the statement complete enough or does it need more substance to minimize market reaction?

If the answer to any one of these questions is "no," then those persons responsible for corporate disclosure should reassess the company's promotional statements to assure that they are accurate and not misleading in the totality of the circumstances.

H. Disclosure on Web sites

Just as management can be held liable for statements made in financial statements, press releases, or earnings estimates, it can be held liable for items included on a company's Web site. Because there is no paper involved, companies may tend to forget, for example, to file advertisements with the NASD, or to monitor statements for accuracy and timeliness. As internet usage continues to grow, and reliance on the internet as a primary information resource deepens, companies are responding by prominently displaying all that they can on their Web sites. However, companies are still not using disclaimers as often or as effectively as they should, as "only half the Fortune 100 companies have a ... link on their home page linking to a set of disclaimers," only 30% use safe-harbor disclaimers for their investor relations page, and only a third disclaim a duty to update their Web site content.[309] Companies that choose to utilize the highly effective internet method of communication must become aware of the potential for securities law liability that stems from such activities. The SEC stated that "Issuers are responsible for the accuracy of their statements that reasonably can be expected to reach investors or the securities markets regardless of the medium through which the statements are made,

[309/] See Broc Romanek, Corporate Web Disclaimers: To Disclaim or Not to Disclaim, It Should Not Be A Question, *Wallstreetlawyer.com*, Vol. 3, No. 3, pp 9-13.

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including the Internet.[310] Potential causes for liability that companies need to be concerned about include:[311]

- Companies will be held just as liable for a statement on the Web site as for one in an SEC disclosure form.

- The duty to update statements introduces special problems for Web sites. Statements can be deemed as "republished" every time that someone logs onto the Web site.

- The SEC has opined that providing hyperlinks on a Web site offering is akin to including the contents of the second site in the same delivery envelope as the prospectus.[312] Whether or not the company in question has "adopted" the information on a third-party Web site depends on three factors: 1.) The context in which the hyperlink is offered; 2.) the risk of an investor's confusion as to the source of the information; and 3.) the presentation.[313] First, when determining whether information on a third-party's Web site is attributable to the issuer, the SEC will take into account the context in which the issuer places the hyperlink. Does the issuer say anything about the hyperlink on the Web page? Second, the SEC will consider whether there is a likelihood of investor confusion about the source of information, the issuer or the third party? Did the issuer make it clear that the browser is leaving its Web site before linking to the third-party site is complete? Lastly, the SEC will consider the presentation of the hyperlink on the issuer's Web page. For example, does the issuer promote the link by increasing its size or differentiating its color to attract Web browsers?[314]

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310 SEC Release No. 33-7856 (May 4, 2000).

311/ See Mary Lou Peters, Avoiding Securities Law Liability for a Company's Web site, Insights, April 1999, at 16. Also See Section III. C. 4 of this article for a discussion on cyberspace documents and the Private Securities Litigation Reform Act.

312/ Release No. 33-7233, Example 16.

313 Release No. 33-7856. See also Brown &Wood, LLP, "Memorandum to Clients Re: Use of Electronic Media", May 19, 2000; Gibson, Dunn & Crutcher, LLP, "SEC Approves New Internet Release", May 12, 2000; Paul, Weiss, Rifkind, Wharton & Garrison, "SEC Issues Guidance on the Use of Electronic Media", May 2000; and Proskauer Rose LLP, Client Alert - "SEC Interpretations on the Use of Electronic Media", May 2000.

314 Release No. 33-7856. See also Brown &Wood, LLP, "Memorandum to Clients Re: Use of Electronic Media", May 19, 2000; Gibson, Dunn & Crutcher, LLP, "SEC Approves New Internet Release", May 12, 2000; Paul, Weiss, Rifkind, Wharton & Garrison, "SEC Issues Guidance on the Use of Electronic Media", May 2000; and Proskauer Rose LLP, Client Alert - "SEC Interpretations on the Use of Electronic Media", May 2000.

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- Just as statements about research and developments printed and disseminated in scientific journals can be used to support a claim for 10b-5 liability,[315] so can marketing statements posted on a Web site be used.

- Not all investors have access to the internet, and as such, disclosure on a Web site may not yet be considered full disclosure. Other, more traditional, means should still be used until the law catches up to the reality of the internet.[316]

Companies can act to limit their liability. The following suggestions come from Nora M. Jordan, a partner with the New York firm of Davis Polk & Wardwell.[317]

- Pretend the Web site is paper, and review statements of fact for accuracy and completeness before posting them on the Web site, just as would be done with a mailing.

- Do not give control of the Web site to the marketing department. All items on the site should be reviewed and approved by the appropriate business people.

- Date all statements on the site, and disclaim any duty to update them. There is no way to know how much time has passed since the document was posted before it is read. This will help visitors to the Web site decipher which information is current, and which is stale.

- Be wary of hyperlinks. Always alert a Web site visitor to the fact that they are leaving your site to enter another, drawing a distinct line between your statements, and those of other companies.

- Keep security over the Web site tight. Be aware that even if someone else posts a statement, if it made it onto your Web site, you may be held liable.

315/ See, e.g., In re Carter-Wallace Sec. Litig., 150 F.3d 153 (2d Cir. 1998), aff. in In re Carter-Wallace Sec. Litig., Fed. Sec. L. Rep. (CCH) ¶ 91,039 (2000) (holding that complaint failed to plead scienter with particularity because at the time of defendant drug company's alleged misstatements in product ads there was no statistical link between defendant's product and any adverse side effects in patients).

316 The SEC reiterated its belief that the reality of the situation does not yet indicate that everyone has access to the Internet in Release No. 33-7856 when it stated, "Under the ["access-equals-delivery" model], investors would be assumed to have access to the Internet, thereby allowing delivery to be accomplished solely by an issuer posting a document on the issuer's or a third-party's Web site. We believe that the time for an "access-equals-delivery" model has not arrived yet."

317/ Practical Advice for Reviewing Corporate Web sites, The SEC Today Vol. 99-195 (Oct. 8, 1999).

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There are additional concerns when a company is in the midst of a registration process. The communications a company makes are restricted during the "waiting period," and the only written material issuers may send to investors is a preliminary prospectus. Companies, therefore, must be aware of the content on the Web site so that it cannot be deemed improper pre-filing communications that condition the market for the offering. Alan Berkeley and John McDonald note that companies may continue to advertise their products and services, but counsel should insure that the Web site has no product or market forecasts, nor links to third-party Web sites that might contain prohibited information.[318] The SEC also defined permissible ordinary-course business information during the "in registration" period to include:

- advertising materials regarding products and services;
- Exchange Act reports filed with the SEC;
- proxy statements, annual reports or dividend notices; and
- press materials regarding financial or business developments.[319]

I. Electronic Delivery

Electronic means of communication are typically faster, less expensive and easier than traditional methods involving paper delivery. Electronic media includes audiotapes, videotapes, facsimiles, CD-ROM, electronic mail, bulletin boards, Internet Web sites and computer networks. In order to provide investors with the same protections offered with paper delivery, the SEC has instituted certain rules regarding the use of electronic delivery of SEC required documents. In order to utilize electronic delivery, a company must 1) give timely notice to its investors of the opportunity and the risks associated with it, 2) be able to assure access to the information and 3) be in the position to evidence delivery of the documents. The following items help to clarify the SEC's position relating to electronic delivery and disclosure.[320]

318/ Alan Berkeley and John McDonald, Observations on Corporate Web sites and the Federal Securities Laws, *Securities Reporter*, Vol. 4, No. 2, pp. 2-9.

319 See Marilyn Mooney, The Challenge of Electronic Media: Interim Guidance from the SEC, Insights, June 2000, at 5.

320 SEC Release No. 33-7856. See also Wilmer, Cutler & Pickering, *SEC Issues New Release On Use of Electronic Media (Part 1 of 2)*, Securities Law Developments (May 3, 2000). See also Linda C. Quinn and Ottilie L. Jarmel, *Securities Regulation and the Use of Electronic Media*. Northwestern University 27th Annual Securities Regulation Institute.

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- Telephonic Consent – While investors can continue to give informed consent by written or electronic means, the SEC has now authorized the receipt of telephonic consent, so long as the consent is informed and a record of that consent is retained. In discussing examples of ways to assure authenticity of the telephonic consent, the SEC allowed its receipt if the investor was known to the individual receiving the consent, or if a password or personal identification number was used.

- Global Consent – An investor may give global consent to electronic delivery relating to all documents of any issuer, so long as the consent is informed. This particular consent requires that the investor be informed explicitly that he or she is consenting to a broad scope of electronic delivery, and that he or she has the right to revoke the consent at any time.

- Portable Document Format – The Release clarifies that, while Portable Document Format ("PDF") may be a special software that is not necessarily owned or used by each investor, PDR may be used for electronic delivery, so long as investors are fully informed as to the requirements necessary to download PDF and investors are provided with any necessary software and technical assistance at no cost.

- Envelope Theory – Because certain SEC documents are required to be delivered simultaneously, meaning traditionally delivered in the same envelope, there has been some question as to what is deemed to be delivered in the "same envelope" when documents are delivered via a company's Web site. This Release clarifies some of the ambiguity in stating that if an issuer includes a hyperlink within a Section 10 prospectus, the hyperlinked information becomes a part of the prospectus, and must then be filed as part of the prospectus in the effective registration statement.[321] Conversely, a hyperlink from an external document into the Section 10 prospectus does not constitute inclusion of the external document in the prospectus.

J. Online Offerings

The Securities Act Release on electronic media also addressed the issue of online registered and private offerings.[322] The release stressed the view that online offerings of securities must comply with the general rule that until the registration statement is

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[321] Note, also, that a consent of the third party must also be obtained and filed with the SEC in textual format. See Marilyn Mooney, The Challenge of Electronic Media: Interim Guidance from the SEC, Insights, June 2000, at 1.

[322] *Use of Electronic Media*, Securities Act Release No. 33-7856.

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effective, no sale may occur and no part of the purchase price may be received by the seller of the securities.[323] Accordingly, the best approach to understanding the release is to first determine whether a public or private online offering is at issue.

- **Online Public Offerings**: The SEC reserved the right to continue to analyze issues presented by online public offerings in the context of emerging technology. As a result, the release provides little guidance in this area.[324]

- **Online Private Offerings under Regulation D**: On the other hand, the release examined issues presented by private online offerings. The SEC focused on whether Web site operators, who are not registered brokers or dealers, violate the registration requirements of the 1933 Act if they engage in general solicitations.[325] When may a service provider solicit information from investors to determine if they meet the "sophisticated" or "accredited" requirement under Regulation D? Must the Web site operator register as a broker or dealer? The SEC has not yet addressed this issue. The SEC's comment simply stated that such determinations will be made based on the facts and circumstances of the solicitation. Generally, where there is a "pre-existing, substantive relationship" between the issuer or broker and the offeree, the inference will be that the solicitation was not "general". Accordingly, the solicitation would not be prohibited by the Securities Act.[326]

K. ABA Letter Responding to the SEC Release Re: Use of Electronic Media

On August 3, 2000, the American Bar Association commented on the SEC's May 4, 2000 release regarding the use of electronic media.[327] The comment reflected the belief that the SEC release failed to promote the use of electronic media for both public and private offerings and the dissemination of information.[328] The ABA Committee first

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[323] See Marilyn Mooney, The Challenge of Electronic Media: Interim Guidance from the SEC, Insights, June 2000, at 6.

[324] See Wilmer, Cutler & Pickering, "Securities Law Developments," May 3, 2000.

[325] See Marilyn Mooney, The Challenge of Electronic Media: Interim Guidance from the SEC, Insights, June 2000, at 6.

[326] See Marilyn Mooney, The Challenge of Electronic Media: Interim Guidance from the SEC, Insights, June 2000, at 6. See also Wilmer, Cutler & Pickering, Securities Law Developments, May 3, 2000.

[327] Stanley Keller, Chair, Committee on Federal Regulation of Securities of the Business Law Section of the American Bar Association, Final Comment Letter Re: Use of Electronic Media (File No. S7-11-00), August 3, 2000.

[328] Id. at 1.

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proposed that the Commission "rework the existing framework of notice, access and evidence of delivery to eliminate any functional distinction between traditional delivery (in paper form) and electronic delivery."[329] Accordingly, the ABA sought a more simplified framework for electronic delivery based on the principles of informed consent.[330]

In response to the SEC's comments concerning Web site content, the ABA critiqued the use of the "entanglement" and "adoption" theories as the analytical framework for assessing liability for hyperlinked information.[331] The ABA sought to encourage the SEC to implement "safe-harbor" standards where certain clear policies and procedures will promote issuers and intermediaries to establish easy access to third-party Web sites through hyperlinks.[332] Furthermore, the ABA urged the SEC to require that clear exit notices be posted when browsers jump from one Web site to another via the hyperlinks. Such exit notices would reduce investor confusion relating to issuer or intermediary endorsement of hyperlinked information.[333] Accordingly, the ABA's letter sought to encourage the Commission to accept advanced technology in the securities industry, while it constructively criticized the rigid interpretations regarding the use of electronic media set forth in the SEC's May 2000 release.

L. Future Electronic Media Issues

- **Message Boards and Internet Chat Rooms:** Online message boards and chat rooms are a popular way for investors and employees of issuers to anonymously communicate about the market.[334] Employees often share information about their issuer-employer's securities and as a result, issuer companies may be liable for the message posted by an employee if it is construed as selective or misleading disclosure.[335] To avoid having employee postings attributed to them in violation of securities laws, employers should institute insider trading policies regarding message boards and implement employee education through training and programs which create an awareness

[329] Id. at 3.

[330] Id. at 5.

[331] Id. at 10.

[332] Id.

[333] Id.

[334] See Broc Romanek, "Understanding the 'Undernet': Message Boards Can Be Tricky for Employers," Insights, Volume 14, Number 5, (May 2000).

[335] Id.

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of corporate and legal policy.[336] Moreover, companies are also advised to develop "Electronic and Telephonic Communications Systems Policies" so that employees realize that unless they are designated speakers on behalf of the company, sharing information about their employer may be detrimental to the company.[337]

- **Corporate Web Disclaimers**: Companies are just realizing the legal ramifications of their online investor relations activities.[338] The "post now, review later" philosophy may lead companies straight into court as there is an increased level of potential corporate liability for investor communications on Web sites. Accordingly, a way to mitigate this exposure to litigation is to use disclaimers which "warn investors that their legal rights are restricted."[339] Though prominently implementing disclaimers in "plain English" on Web sites does not completely insulate an issuer from liability, it is a proactive step in this technologically advanced society. Nevertheless, corporate Web disclaimers remain quite rare and this legal issue will no doubt become very interesting as our society becomes more electronically advanced.[340]

IV. DEVELOPMENTS IN MANAGEMENT'S DISCUSSION AND ANALYSIS (the "MD&A")

One of the most noteworthy developments since the Supreme Court's decision in Basic is the Securities and Exchange Commission's 1989 Interpretive Release regarding Management's Discussion and Analysis ("MD&A" Release), heralded as a major policy statement on compliance with MD&A disclosure requirements.[341] The MD&A requires issuers to provide information on financial conditions with an emphasis on liquidity, capital resources and the

[336] Id.

[337] See Louis M. Thompson, Jr., "A Suggested Electronic and Telephonic Communications System Policy," Insights, Volume 14, Number 1, (January 2000). For a sample policy, the Thompson article contains a model drafted by Maryann Waryjas, a partner at Katten Muchin Zavis in Chicago.

[338] See Broc Romanek, "Corporate Web Disclaimers: To Disclaim or Not To Disclaim, It Should Not Be a question", Vol. 3 No.3, wallstreetlawyer.com.

[339] Id.

[340] Id.

[341/] Exch. Act. Rel. No. 26831 (May 18, 1989). For several years, the SEC warned issuers regarding the sufficiency of MD&A disclosures. In 1987, the SEC sought comments on the adequacy of MD&A disclosure rules, including proposals submitted to the SEC by the accounting profession to expand MD&A disclosures and subject the MD&A to auditing procedures. See Sec. Act. Rel. No. 6711 (Apr. 17, 1987). In November 1987, Linda Quinn, the director of the SEC Division of Corporation Finance, announced that the division's accounting staff would routinely review more 10-K's for MD&A compliance. See 19 Sec. Reg. & L. Rep. (BNA) ¶1725 (Nov. 13, 1987).

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results of operations. Registrants are required to discuss in the MD&A known trends, material changes and uncertainties, including inflation, that would cause the historical financial data disclosed therein not to be necessarily indicative of future operating results or future financial conditions.[342] According to the SEC, the MD&A is intended to provide investors "an opportunity to see the company through the eyes of management."

The SEC's actions against Caterpillar, Inc., Bank of Boston and Sony illustrate the SEC's continued focus on the adequacy of MD&A disclosures and serves as a warning to issuers that the SEC will not tolerate boiler-plate MD&A disclosures. Even more ominous is the trend for private litigants to include allegations of inadequate MD&A in their securities fraud claims.

The 1989 MD&A Release specifically provides that issuers need not disclose merger negotiations in the MD&A, even if such discussions are material. The MD&A Release indicates that where disclosure is not otherwise required, and has not otherwise been made, registrants need not discuss the impact of merger negotiations where, in the registrant's view, inclusion of such information would jeopardize completion of the transaction.

The MD&A Release also rejects the probability/magnitude test for materiality in Basic as inappropriate for determining whether forward looking information (other than merger discussions) must be disclosed in Item 303 of MD&A. Instead, the SEC adopted a "reasonably likely to have a material effect" standard for MD&A disclosure. This separate standard of materiality for MD&A purposes arguably is less stringent than the standard adopted by the Supreme Court in Basic for Rule 10b-5 purposes.

A. Pre-1989 Interpretive Release: American Savings and Loan Association of Florida

Prior to the 1989 MD&A Release, the SEC bolstered the notion of a general quarterly MD&A disclosure obligation in In the Matter of American Savings and Loan Association of Florida,[343] an enforcement release arising out of the well-publicized collapse of E.S.M. Government Securities, Inc. ("E.S.M."). In a consent order, the SEC ruled that American Savings and Loan Associations of Florida ("ASLA") failed to adequately disclose in its MD&A an unusually large securities repurchase transaction with E.S.M., which resulted in a $69 million write-off when E.S.M. failed.

342/ For a detailed discussion of the MD&A requirements, see Ronald M. Loeb et al., The Focus on MD&A, C859 ALI-ABA 343 (1993); Thomas Gilroy & Mary Elizabeth Pratt, Preparing the Management's Discussion and Analysis, 835 PLI/Corp. 9 (1994).

343/ Exch. Act Rel. No. 25788 (June 8, 1988). The SEC now mandates that financial institutions disclose in the MD&A the effects of federal assistance programs, especially the potential loss of such assistance, on financial condition and operations. See Exch. Act. Rel. No. 26831 (May 18, 1989). For a discussion of the unique disclosure problems facing these financial institutions, see Gary Lynch et al., Application of the Securities Laws to Financial Institutions, 414 P.L.I. Comm. 69 (1987).

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Several egregious circumstances made this case particularly vulnerable to SEC attack. E.S.M. was controlled by a director of ASLA. In addition, the $1 billion U.S. Treasury Bill repurchase transaction was enormous compared to any previously undertaken by ASLA, had an unusually long one-year term and was over-collateralized such that ASLA was exposed to an unsecured position of nearly $100 million. Nonetheless, prior to E.S.M.'s demise, ASLA's MD&A in its 10-Q report had not specifically mentioned the repurchase transaction and its 10-K reports mentioned the repurchase transaction only in brief reference to the corresponding increase in assets, liabilities and investments. The SEC criticized ASLA's failure to analyze the risks attendant to the repurchase transaction in the MD&A as follows:

> Mere overviews or limited, cursory financial footnote disclosures do not provide shareholders with the required perspective on the financial condition and results of operations of an institution. A complete discussion by management of the insured institution's operations and the risks attendant thereto is the type of full disclosure mandated by the federal securities laws.[344]

The SEC elaborated that Texas Gulf Sulphur and its progeny required that ASLA disclose in its MD&A the factors considered by management in undertaking the transaction and also "explain the reasoning behind an assessment by management that an eventual loss was unlikely to occur."[345] There is no practical difference between requiring disclosure of particular information and forcing management to disclose thoughts as to why they believe the information is not material and need not be disclosed. The latter enables investors to substitute their own risk-analysis for the business judgment of management. Such analysis ignores the business judgment rule and undermines the concept of materiality as a limitation on the SEC's power to mandate disclosure.

The SEC eventually determined that the repurchase transaction was material under Texas Gulf Sulphur, concluding that the magnitude of the potential loss was so great that even a remote risk of default required detailed disclosure in the MD&A. The SEC's analysis is rather disturbing and suggests that any contingent event of substantial magnitude must be disclosed in the MD&A no matter how remote the likelihood of its occurrence. It would appear that the rejection of a probability/magnitude test and the elaboration of a "more likely than not" threshold of probability for determining MD&A

344/ Exch. Act Rel. No. 25788, at 84. The SEC reinforced this view in its action against Bank of New England Corporation ("BNEC"), alleging that BNEC's MD&A was deficient for its failure to discuss adverse trends indicating a deterioration in the New England real estate market which were likely to adversely affect BNEC's loan portfolio and net income. SEC v. Bank of New England Corporation, Lit. Rel. No. 12743 (Dec. 21, 1990). There exists a tension between these cases and those confirming that issuers need not disclose simple mismanagement or breach of duty. For cases involving nondisclosure of mismanagement and misleading disclosures of sound management, see infra Section IX.

345/ Exch. Act Rel. No. 25788, at n.37.

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materiality in the 1989 MD&A Release, described below, recants the position taken by the SEC in this case. Under the new SEC MD&A materiality standard, ASLA arguably would not have to discuss risks attendant to the repurchase transaction if management could determine that the default was not likely to occur.[346] However, all of this optimism must be tempered by the thought of the SEC Staff Accounting Bulletin on Materiality, discussed at length above in Section II.D., which has the potential to change the definition of "material" in innumerable ways.

B. The 1989 Interpretive Release

The 1989 Interpretive Release summarizes the results of the SEC's review of MD&A sections in reports filed by registrants in selected industries in 1988.[347] The MD&A Release purports to provide issuers guidance for MD&A preparation through specific examples of disclosures and observations on the disclosure of various corporate events, including merger negotiations, participation in highly leveraged transactions or non-investment grade loans, and the effects of federal financial assistance upon the operations of financial institutions. The MD&A Release also addresses disclosure issues regarding prospective information, long and short-term liquidity and capital resources, material changes in financial statement line-items and segment basis analysis.

The MD&A Release confirms that the SEC views the MD&A as a quarterly disclosure vehicle for distressed companies. The MD&A Release emphasizes that issuers must update the MD&A on a quarterly basis to include a discussion of all the MD&A items, except the impact of inflation and changing prices on operations for interim periods.

1. Materiality Standard for Known Contingencies

An interesting aspect of the MD&A Release is the SEC advocacy of a separate standard of materiality for prospective information to be reported in the MD&A. The Release requires that registrants describe periodically in the MD&A "known trends, demands, commitments, events or uncertainties" that are "reasonably likely to have a material effect" on an issuer's financial condition or results of operations. The MD&A Release sought to distinguish between forward looking information that registrants

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[346] The interpretive guidelines in the 1989 MD&A Release now require full disclosure of the risks associated with participation in high yield financings, highly leveraged transactions and non-investment grade loans and investments. Query: whether the SEC would have characterized ASLA's repurchase transaction as such a high risk venture?

[347] Exch. Act. Rel. No. 26831 (May 18, 1989). The 1989 MD&A Release states that only 14 of the 359 companies reviewed passed the SEC's standards; 125 of the remaining companies filed amendments in response to SEC comments. Six registrants were referred to the Division of Enforcement, mainly due to accounting problems which affected the MD&A disclosures.

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are encouraged, but not required, to disclose and "presently known data which will impact upon future operating results," that must be discussed.[348] The MD&A Release suggests that management make two assessments to determine whether prospective information must be disclosed:

(1) Is the known trend, demand, commitment, event or uncertainty likely to come to fruition? If management determines that it is not reasonably likely to occur, no disclosure is required.

(2) If management cannot determine the likelihood of occurrence, it must evaluate objectively the consequences of the known trend, demand, commitment, event or uncertainty, on the assumption that it will come to fruition. Disclosure is then required unless management determines that a material effect on the registrant's financial condition or results of operations is not reasonably likely to occur.[349]

The SEC explicitly states in a footnote that the "reasonably likely to have a material effect" standard for MD&A disclosure is separate and distinct from the probability/magnitude materiality analysis originally articulated by the Second Circuit in Texas Gulf Sulphur and adopted by the Supreme Court in Basic for Rule 10b-5 purposes. This rejection of the probability/magnitude balancing test for determining the materiality of MD&A disclosure contradicts a prior SEC Enforcement Release[350] and a 1988 SEC Interpretive Release regarding disclosure of government inquiries, both of which specifically apply the Texas Gulf Sulphur probability/magnitude balancing analysis to MD&A materiality.[351]

Strangely, the SEC elected to deviate from Basic and the Commission's own past statements outside of a rulemaking context, which would have afforded an opportunity for notice and comment. Issuers may find, however, that the "reasonably likely to occur" probability threshold makes the MD&A standard less burdensome than the Rule 10b-5 probability/magnitude balancing standard. Specifically, the SEC's prior

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348/ See Carl Schneider, MD&A Disclosure, 22 Rev. Sec & Comm. Reg. 14 (1989), for an in-depth analysis of this issue.

349/ See Exch. Act. Rel. No. 26831, n.27 and accompanying text.

350/ In the Matter of American Savings and Loan Association of Florida, Exch. Act. Rel. No. 25788 (June 8, 1988), discussed at pages 126-127 supra.

351/ Exch. Act. Rel. No. 25951 (Aug. 2, 1988), discussed infra Section IX.A.

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application of the probability/magnitude balancing test suggested that, in certain instances, where the magnitude of the contingent event was so great, the event must be disclosed even though the probability of occurrence was slight or at least less than "more likely than not." The SEC's new articulation of MD&A materiality suggests that no matter how great the magnitude of the contingent event, it need not be disclosed unless management believes that the probability of occurrence is "more likely than not," i.e., greater than 50%.[352]

The 1989 MD&A Release also raises the question whether it is wise to establish separate materiality analyses for MD&A and for Rule 10b-5 purposes. If the SEC desires to treat certain developments differently for MD&A disclosure, it could create specific exceptions to disclosure requirements, much like the Commission did for MD&A disclosure of merger negotiations. On balance, the standard for assessing materiality, however, should remain constant throughout the federal securities laws.

2. Exception for Merger Negotiations

The MD&A Release specifically excludes preliminary merger negotiations from the MD&A requirement to disclose "known events or uncertainties reasonably likely to have material effects" on future financial condition or results of operations. The SEC determined as a matter of policy that the risk of endangering sensitive negotiations through premature disclosure was greater than the immediate informational needs of investors. Hence, where management has a business purpose for maintaining confidentiality, the MD&A will not impose an independent duty to disclose merger negotiations.[353] The SEC also indicated that issuers need not disclose involving major asset acquisitions or dispositions not in the ordinary course of business in the MD&A.

The original purpose of the MD&A was to provide a meaningful discussion of management's views of their business to aid investors in their assessment of line-item changes from year-to-year that might impact the registrant's future financial condition and results of operations. The

[352] Former SEC Commissioner Fleischman has stated his belief that "reasonably likely to occur" means a 40% or more probability of occurrence. See Fleischman Addresses MD&A Issues Before Southern Securities Institute, The SEC Today Vol. 91-51 (Mar. 15, 1991).

[353] The Supreme Court in Basic rejected this argument as support for the agreement-in-principle standard of materiality for merger negotiations, stating that "a need for secrecy" public policy rationale was inapposite to the definition of materiality. The Court explicitly left the issue open, however, for consideration under the rubric of the duty to disclose. See Wander & Pallesen, supra note 15, at 115.

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MD&A was simply not intended to require disclosure of all fundamental business prospects, such as potential mergers. The SEC's analysis of MD&A disclosure of merger negotiations demonstrates how far the SEC's policy has strayed from the original purpose of the MD&A. Apparently the SEC now will require that issuers analyze anticipated fundamental corporate events in the MD&A unless management reasonably believes that disclosure may disrupt the transaction or otherwise harm the issuer's business advantage. Query: whether the SEC's decision to exempt merger negotiations in the MD&A Release signals a retreat by the SEC from its more recent interpretation of the MD&A as a quarterly disclosure vehicle for all material contingencies? We doubt it.

3. Other Items

As noted above, the MD&A Release provides guidance on a number of disclosure topics, including capital expenditures and financing to maintain sales growth and for new products, expiration of government contracts, designation as a potentially responsible party under "Superfund,"[354] changes in revenues and deficiencies in liquidity, and participation in highly-leveraged transactions. The MD&A Release provides detailed examples of suggested disclosure for these various developments and hypothetical scenarios. Those responsible for MD&A preparation should read the MD&A Release in its entirety.

C. Caterpillar, Inc.

In the Matter of Caterpillar, Inc.[355] provides a textbook example of the application of Item 303 and the 1989 MD&A Release to MD&A disclosure issues involving segment reporting, results of operations and known material uncertainties. In the Caterpillar consent order, the SEC found that the MD&A in Caterpillar's Form 10-K for the year ended December 31, 1989 and Form 10-Q for the first quarter of 1990 was deficient due to Caterpillar's failure to discuss the magnitude of Caterpillar's Brazilian subsidiary's contribution to consolidated earnings, the non-operating items which accounted for a greater than usual profit for this subsidiary in 1989, and the uncertainty of maintaining this level of profit for the subsidiary in 1990 due to volatility in the Brazilian economic and political environment.

1. CBSA Impact on 1989 Consolidated Earnings and Uncertainty in

[354] Given the ramifications of "Superfund" liability and the increased attention being paid to accounting for hazardous waste treatment costs, environmental problems may become the next "hot" MD&A disclosure issue. For further discussion of environmental disclosure obligations, see infra Section XI.

[355] Exch. Act Rel. No. 30532 (Mar. 31, 1992).

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Brazil

CBSA, Caterpillar's Brazilian subsidiary, accounted for approximately 23% of Caterpillar's $497 million net profit for 1989. Several non-operating gains, including Brazilian tax loss carry-forwards, export subsidies and interest income due to hyperinflation in Brazil and dollar-cruzado exchange rates, contributed to CBSA's bottom line profits. At least two weeks before the filing of the 1989 Form 10-K, Caterpillar's top management expressed "substantial uncertainty" about CBSA's ability to repeat its 1989 performance and began to separate the impact of the Brazilian operations in their presentation of 1990 projections to the board. This separate analysis of CBSA's results of operations, which continued throughout 1990, represented a departure from management's usual practice of analyzing the company as a whole.

In April 1990, after a new government had come to power in Brazil proposing sweeping economic reforms, Caterpillar's board discussed the uncertainty of the situation and management's belief that CBSA's profits would be substantially lower in 1990 than in 1989. On June 25, 1990, Caterpillar voluntarily issued a press release explaining that 1990 results would be lower than expected and in a telephone conference with analysts that afternoon, revealed CBSA's impact on 1989 consolidated earnings. The next day the trading price of Caterpillar's stock fell 18%.

2. **Preparation of the MD&A**

Caterpillar was not required to separately report business segments. Therefore, the company's financial statements and accompanying notes did not disclose the disproportionate effect of CBSA's earnings on the consolidated entity. Caterpillar's MD&A did not reveal the substantial impact of CBSA's profits on the company's consolidated results of operations, nor did the MD&A discuss the source of CBSA's profits and the substantial risk that these profits could not be repeated in 1990. Caterpillar's MD&A had been reviewed by the company's top officers and by the legal, economic and public relations departments of the company. The board of directors had even obtained an opinion from Caterpillar's General Counsel that the 1989 Form 10-K complied with all SEC rules and regulations. Despite this extensive review process, Caterpillar's MD&A contained only boiler-plate references to the Brazilian operations.

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3. Deficient MD&A

The SEC ruled that:

> Caterpillar's failure to include required information about CBSA in the MD&A left investors with an incomplete picture of Caterpillar's financial condition and results of operations and denied them an opportunity to see the company "through the eyes of management."[356]

The SEC concluded that disclosure of the magnitude of CBSA's contribution to Caterpillar's overall earnings and the various items included in CBSA's profits was necessary to give a reader of Caterpillar's financial statements an understanding of Caterpillar's results of operations. Furthermore, the SEC concluded that management could not have concluded that lower earnings from CBSA were not "reasonably likely to occur" or that such lower earnings would not have a material impact on Caterpillar's results of operations for 1990.

The Caterpillar action should serve as a warning to issuers that the SEC intends to vigorously pursue enforcement of the MD&A rules. Regardless of any elaborate procedures for preparing and reviewing the MD&A, boiler-plate descriptions of items will not suffice where management has knowledge of, and has internally expressed concern regarding, events which have had or could have an impact on a company's financial condition or results of operations.[357]

356/ Exch. Act Rel. No. 30532, at 152. The SEC specifically referenced the following: Item 303(a) which requires a discussion in the MD&A of a registrant's segments or other subdivisions where such a discussion would be appropriate to an understanding of the registrant's business; Item 303(a)(3)(i) which requires a description of any unusual or infrequent events or transactions that materially affected the amount of reported income from continuing operations; and Item 303(a)(3)(ii) which requires a description of any known trends or uncertainties that the registrant reasonably expects to have a material impact on net sales or results from continuing operations.

357/ Linda Quinn, director of the SEC's Division of Corporate Finance, has cautioned that practitioners who read Caterpillar as mandating even more extensive "procedures" in the preparation of a company's MD&A may be missing the point. According to Ms. Quinn, the procedures used by Caterpillar in the preparation of its MD&A were found to be inadequate because they resulted in inadequate disclosure. Ms. Quinn stressed that corporate counsel and issuers should look not only to the discussion in Caterpillar for guidance in MD&A preparation, but also should constantly review the 1989 MD&A Release, which Ms. Quinn stated remains the "best overall summary of the Commissions views". In addition, Ms. Quinn pointed to the 1988
Release discussing the disclosure requirements brought on by the defense industry, which Ms. Quinn stated applies to disclosures relating to any industry when events calling into question business practices or responsibilities come into play. See 25 Sec. Reg. & L. Rep. (BNA) 399 (Mar. 13, 1993). Additionally, see Steckman v. Hart Brewing, Inc., Fed. Sec. L. Rep. (CCH) ¶90,205 (9th Cir. May 14, 1998) (Item 303 "mandates not only knowledge of an adverse trend...and material impact..., but also that the future material impacts are reasonably likely to occur from the present day perspective...Only when future impacts are

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D. Shared Medical Systems Corporation

In In re Shared Medical Systems Corporation[358], the SEC makes clear that all material disclosures should be included in 1934 Act periodic reports. Press releases or other public disclosures cannot act as replacements for required disclosures and, in fact, may be used as evidence that 1934 Act filings are deficient. In a consent order, the SEC found that Shared Medical Systems ("SMS") failed, as required by Item 303(a) of Regulation S-K, MD&A, to state in its Form 10-K for the year ended December 31, 1986, and in its Form 10-Q for the quarter ended March 31, 1987, that it was experiencing a material slowdown in growth due lower than expected sales activity.

1. The Press Release

On February 17, 1987, SMS disclosed in a press release "that business activity in the latter of the fourth quarter of 1986 and in early 1987 was below expectations and that this may make it more difficult for the company to achieve its growth goals in 1987." However, SMS's Form 10-K for 1986 and Form 10-Q for the quarter ended in March 1987, which were both filed after the press release, failed to state that the company was experiencing a slowdown in growth. In the Company's MD&A in the Form 10-Q for the quarter ended in June 1987, SMS belatedly stated that it was experiencing a "slowdown in growth" which was "primarily attributable to weaker sales activity during late 1986 and the early of 1987."

The Commission pointed to the February press release as evidence that SMS knew, or reasonably expected, that a lower than expected trend in sales activity in late 1986 and early 1987 was likely to have a materially unfavorable impact on SMS's net sales, revenues and earnings during 1987, at the time of filing the 1986 Form 10-K and the first quarter 1987 Form 10-Q.

2. Deficient MD&A

Consequently, on February 15, 1994, the Commission determined that SMS failed to state material information required by Item 303(a) of Regulation S-K, in violation of Section 13(a) and Rules 12b-20, 13a-1, and 13a-13. Accordingly, the Commission accepted an offer of settlement from SMS consenting to cease and desist from violating the subject

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'reasonably' likely to occur do they cease to be optional forecasts and instead become present knowledge subject to the duty of disclosure.").

358/ Exch. Act Rel. No. 33632 (Feb. 17, 1994).

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sections of the 1934 Act, without admitting or denying the Commission's findings.

The Commission's willingness to use enforcement proceedings in Caterpillar and Shared Medical illustrates the increasing importance of including material disclosures in 1934 Act filings. Press releases, or otherwise, cannot replace required SEC disclosures.

E. Liquidity Analysis

As noted earlier, Item 303(a) requires the registrant to discuss in its MD&A, among other information, the liquidity, capital resources, and results of operations of the registrant. Liquidity is defined as "the ability of the enterprise to generate adequate amounts of cash to meet the enterprise's needs for cash."[359] Financial items that are believed to be indicators of the company's liquidity, such as unused credit lines, debt-equity ratios, bond ratings, and existing restrictions under debt agreements, must be included in the liquidity analysis.[360]

1. Salant

In Salant Corporation and Martin F. Tynan,[361] the Commission found that Salant Corporation's ("Salant") Form 10-K for the fiscal year ended December 30, 1989 and its Form 10-Q for the first quarter of 1990, failed to fully discuss known uncertainties relating to Salant's liquidity as required by the MD&A rules.

In August 1988, pursuant to a plan of growth and diversification, Salant entered into a credit agreement with a group of five banks to finance Salant's acquisition of Manhattan Industries, Inc., for approximately $99 million. The credit agreement provided Salant with a $100 million secured six-year term loan and access to an additional $90 million in credit until May 1991 through a revolving credit facility.

Beginning in the second half of 1989, and continuing through the filing of Salant's 1989 10-K, there were several indications that Martin Tynan ("Tynan") and other members of Salant's senior management knew that the company's liquidity was declining. First, Salant had to reduce by 57 percent the net worth requirement of its credit agreement for the period

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359/ Reg. S-K, Item 303(a), Inst. No. 5.

360/ Exch. Act Rel. No. 33-6349 (Sept. 28, 1981).

361/ Exch. Act Rel. No. 34046 (May 12, 1994).

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ended December 30, 1989.[362] Second, Salant began to seek additional sources of cash to fund current operations. Further, by the end of 1989, Salant had $46 million outstanding on its revolving credit facility. Third, Salant had approximately $37 million in excess inventory at the end of 1989, generally indicating Salant's declining financial condition. Fourth, Salant obtained a fourth amendment to the credit agreement to, among other things, reduce the requirements of various financial ratio tests. Moreover, in the fourth amendment, the bank group required Salant to provide it with additional collateral.[363] Fifth, Salant's actual operating results fell short of its budgeted results. This included, for the first two months of 1990, a $1.7 million loss as well as Salant operating below the minimum net worth requirements of the credit agreement. Sixth, during the first quarter of 1990, Salant, at Tynan's direction, delayed approximately $2 million in payments to certain vendors because it did not have sufficient cash to make the payments. This last practice had preceded Salant's prior bankruptcy filing in 1985. Lastly, certain cash flow forecasts generated prior to Salant's filing of the 1989 Form 10-K raised questions as to whether Salant could continue operations without additional sources of cash.

The Commission found that by failing to discuss its decreasing liquidity, how that decline resulted in uncertainties about its future liquidity, and how Salant intended to remedy the problem, Salant failed to comply with the liquidity provision of Item 303 of Regulation S-K. Consequently, the MD&A section failed to give the investor a view of the company "through the eyes of management." The Commission ordered both Salant and Tynan to cease and desist from committing or causing any violation, and committing or causing any future violation, of Section 13(a) of the Exchange Act and Rules 12b-20, 13a-1 and 13a-13 promulgated thereunder.

2. America West

On May 12, 1994, the Commission found that America West Airlines, Inc. ("America West") failed to disclose known uncertainties relating to its liquidity, as required in the MD&A sections in its Form 10-

[362] Salant ultimately reduced its 1989 year-end net worth requirement from $37 million in the original agreement to $16 million in the fourth amendment.

[363] Note that changes in credit agreement provisions reflecting management's internal projections may serve as evidence that management knew or should have known that the trend or uncertainty was likely to be material. Thus, internal paperwork should be carefully considered when preparing the MD&A.

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K for the fiscal year ended December 31, 1990, and its Form 10-Q for the first quarter of 1991.[364]

From late 1990 throughout 1991, America West experienced severe losses due to decreased passenger traffic levels and increased fuel costs, which subsequently resulted in a severe weakening of the Company's liquidity position. As a result of its liquidity problems, America West violated its financial covenants on four separate occasions during the period 1990 and 1991.

During a January 29, 1991 board meeting, senior management requested and received authority from the board of directors to continually amend the covenant provisions as needed in order to avoid future defaults. In February, America West initiated negotiations with certain lenders for long-term financing in an effort to comply with its future covenant provisions, and to restore its weakened liquidity provisions. In addition, America West also conducted a half-price ticket sale to raise revenues and improve the Company's long-term liquidity. However, the rapid use of the discounted tickets displaced full fare passengers and generated immediate operating expenses which only intensified the Company's liquidity problems. On June 27, 1991, America West filed a Chapter 11 bankruptcy petition.

The Commission concluded that it was not reasonably likely that America West would have been able to generate sufficient cash through financing or otherwise to restore its weakened liquidity and to comply with its financial covenants. Thus, the Company was required to include a discussion of the material uncertainties relating to its liquidity, as well as an objective evaluation of how the known uncertainty would impact upon the financial viability of the Company in the MD&A portion of its 1990 Form 10-K, and the MD&A portion of its first quarter 1991 Form 10-Q. America West, however, failed to make such necessary disclosures. The Commission's Order required America West to cease and desist from committing or causing any violation, and committing or causing any future violation, of Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13.

F. Bank of Boston

On December 22, 1995, an SEC Administrative Law Judge issued the first fully litigated SEC decision based entirely on allegations of deficient MD&A disclosure.[365] The

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364/ Exch. Act Rel. No. 34-34047 (May 12, 1994).

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Commission alleged that Bank of Boston Corp. ("Bank of Boston") violated Section 13(a) of the Exchange Act and Rules 12b-20 and 13a-13 in connection with MD&A disclosure in the Bank of Boston's Form 10-Q for the second quarter ended June 30, 1989. Specifically, the Commission found that in its Form 10-Q, Bank of Boston failed to disclose "material facts and known trends and uncertainties concerning the deterioration of its loan portfolio which Bank of Boston reasonable could expect would have a material unfavorable impact upon its financial condition and results from operations."

The record indicated that during the last three quarters of 1988 and the first two quarters of 1989, Bank of Boston experienced a significant deterioration in the value of its domestic real estate loan portfolio. However, Bank of Boston's 1989 first quarter MD&A merely stated that the company "continues to monitor the real estate portfolio closely in light of the current weakness in the real estate market."[366] The MD&A for the second quarter of 1989 stated: "With the further weakening of the real estate market during the second quarter, the Corporation continues to closely evaluate and manage its real estate portfolio."[367] The Commission found, however, that between May 12, 1989, and August 10, 1989, the respective filing dates for the first and second quarter 10-Qs, management had additional, "hard" information about the trend in its real estate portfolio, and other developments, that should have caused management to revise the MD&A discussion to address the effect of this trend on future results.

Specifically, the Commission found that management was required to discuss that it could reasonably expect that the quarterly addition to the reserve in the third quarter would need to be increased materially from the amount that had been the norm for the preceding six quarters. In support of its findings, the Commission cited the Bank's internal reports and memorandums which highlighted management's awareness that the reserve amount would increase significantly. The Commission also cited reviews conducted by the Office of the Comptroller of the Currency ("OCC") of Bank of Boston's domestic real estate loan portfolio. In these reviews, the OCC was highly critical of Bank of Boston's deteriorating real estate portfolio, the accuracy of management's risk assessment, and the lack of management's leadership abilities. After the review, the OCC downgraded numerous internally rated loans. The Commission then cited a highly leveraged transaction in which the obligor failed to remain solvent as further evidence of deficient MD&A. Finally, the Commission considered the declining New England real estate market in 1989 which made it "especially necessary for banks to carefully monitor reserves."

365/ Initial Decision Release No. 81, 60 SEC Docket (CCH) 2695 (Dec. 22, 1995) (since the Bank of Boston did not seek Commission review of the initial decisions, the decision was made final and adopted by the Commission as its final decision in Exchange Act Release No. 34-36887, 61 SEC Docket (CCH) 882 (Feb. 26, 1996).

366/ Id. at 2706.

367/ Id.

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Each of these factors contributed to the Commission's conclusion that given all the information available to management prior to the filing of the second quarter Form 10-Q, management reasonably should have expected that a material increase in the Bank's reserve would be required. Applying the 1989 Interpretive Release standard, the Commission found that Bank of Boston was required to disclose "further information" (1) because the deterioration of the real estate loan portfolio was likely to continue, and (2) even if Bank of Boston could not make this determination, it was reasonable to expect a material impact on earnings if the trend continued. Indeed, Bank of Boston's second quarter 10-Q showed a reserve Provision Expense of $36 million and net income of $97.8 million, but in the third quarter, the Provision Expense ballooned to $370 million resulting in an after-tax net loss of $125 million. The second quarter MD&A, however, merely repeated the first quarter disclosure. According to the Commission: "No one who read [the Bank's] second quarter financials in its Form 10-Q would have anticipated what management knew was highly likely to happen, and did happen, to [the Bank's] earnings in the third quarter 1989."[368]

Unfortunately, the Commission did not specify the exact type of disclosure Bank of Boston was required to make in the second quarter stating only that the "failure to provide additional information made the information contained in the Form 10-Q misleading."[369] The Commission did not say that all of its findings should have been disclosed in the MD&A. At the least, however, management should have disclosed that the reserve amount was likely to increase due to the deteriorating real estate loan portfolio caused by the declining trend in the New England real estate market.

The Commission's Order required Bank of Boston to cease and desist from committing or causing any violations and any future violations of Section 13(a) of the Exchange Act and Rules 126-20 and 13a-13.

G. Sony

In the matter of Sony Corporation and Sumio Sano[370] is a glaring example of the need to separately disclose in the MD&A under-performing major businesses that are included in larger segments. Sony consisted of only two reportable segments, namely, the entertainment and the electronics segments. The entertainment segment consisted of

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368/ Id. at 2698.

369/ One practitioner noted that this finding implies that when circumstances change between periods, repeating an earlier statement in the MD&A may be misleading if the effect is to convey that no interim developments have occurred which might materially impact the registrant's financial condition or results of operations. Schulte, Stephen J., Management's Discussion and Analysis of Financial Condition and Results of Operations: A Primer for the Practitioner, in 2 Preparation of Annual Disclosure Documents 219, 242 (Practicing Law Institute, 1996).

370/ Exch. Act Rel. No. 34-40305 (August 5, 1998).

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music and movies. Sony Music performed well, but in contrast, Sony Pictures was operating at substantial losses, reaching approximately $967 million by 1994. However, under the guidance of Sumio Sano, the General Manager of Sony's Capital Market & Investor Relations Division, Sony did not disclose in either its consolidated results or segment results the nature of the losses due to Sony Pictures. Instead, Sony focused on the music segment and on recent movie "hits," implying that Sony Pictures was, in fact, as a whole, doing well.[371]

The SEC found in a consent cease and desist Order that Sony violated Section 13(a) of the Exchange Act by failing to provide adequate and appropriate MD&A disclosure. Adequate and appropriate MD&A disclosure must, according to Sony, include in MD&A, on both a consolidated and segment basis, a discussion of the differing trends within a major business unit. The disclosure in the MD&A must include qualitative as well as quantitative information because in the absence of such disclosure, "a company's financial statements and accompanying footnotes may be insufficient for an investor to judge the quality of earnings."[372]

Sony consented to the SEC Order, and agreed to, as part of the settlement, among other things, engage an independent auditor to conduct an examination of its 1998 MD&A presentation.[373] Sony also agreed to adopt Statement of Financial Accounting Standards No. 131 (which it was required to do anyway) beginning with the fiscal year ended March 31, 1998. Statement 131 requires that companies disclose separate operating business data based on how management makes decisions about allocating resources to these separate business units and measuring their performance. Under FAS 131, Sony probably would have had to report separately its motion pictures and music businesses.[374] By failing to ensure that Sony's disclosures were adequate, Sumio Sano was found to be a cause of Sony's violations.

In a separate civil action filed simultaneously with the administrative proceeding, Sony consented to an injunction and the payment of a $1 million civil penalty.[375]

H. MD&A in the Courts

In the past, courts addressed the issue of whether plaintiffs may bring a private action and allege a violation of Item 303 of Regulation S-K. The courts, however,

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371/ Exch. Act Rel. No. 34-40305, at 3.

372/ Id at 5, quoting SEC Release Nos. 33-6835, 34-26831, IC-16961, FR-36 (May 18, 1989).

373/ Id. at 6. Also, see Section IV. H, New Accounting Procedure - SSAE No. 8.

374/ The SEC has proposed revisions to Regulation S-X to include FAS 131.

375/ SEC v. Sony Corporation, Civil Action No. 1-98CV01935 (LFO) (D.D.C. 1998).

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dismissed these claims based on the insufficiency of the pleadings. For example, in In re Gap Securities Litigation, the court rejected the claim that The Gap should have discussed in the MD&A of its 10-Q filings, the continuing inventory build-up and margin trends, and the causes of these trends. Plaintiffs' failure was, in part, the result of poor pleading and the court's misinterpretation of the MD&A requirements. The plaintiffs alleged a violation of Item 303(a) of Regulation S-K which relates only to annual Form 10-Ks. Consequently, the court summarily dismissed the MD&A as requiring discussion of the alleged omissions in the quarterly Form 10-Qs.

The plaintiffs and the court completely ignored Item 303(b) which provides that interim reports, including Form 10-Qs, "shall include a discussion of material changes in those items specifically listed in paragraph (a) of this Item 303."[376] In the 1989 MD&A Interpretive Release, the SEC stated that Item 303(b) requires discussion of every disclosure requirement contained in Item 303(a), including known trends or uncertainties arising during the interim period which are reasonably likely to have material effects on financial condition or results of operations.[377] Given the eventual inventory write-downs and decrease in earnings, the developments omitted by The Gap may have materially impacted the company's results of operations and the information arguably should have been discussed in the MD&A of its quarterly reports.[378]

In Oran v. Stafford, however, the Third Circuit finally addressed the issue of whether a private right of action exists for alleged violations of Item 303(a) of Regulation S-K where the claim is pleaded well.[379] In holding that no such private right of action exists, the court also noted that a violation of Item 303 is not the equivalent of a Section 10(b) violation as a matter of law.[380] The court reasoned that based on prior case law, the

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376/ 17 C.F.R. ¶229.303(b).

377/ See Exch. Act. Rel. No. 26831, infra note 291 and accompanying text.

378/ The district court also summarily disregarded similar MD&A pleadings in Alfus v. Pyramid Technology Corp., 745 F. Supp. 1511 (N.D. Cal. 1990), and In re Sun Microsystems, Inc. Securities Litig., Fed. Sec. L. Rep. (CCH) ¶95,504 (N.D. Cal. 1990). The plaintiffs in Alfus alleged that Item 303(a) required Pyramid to disclose in its annual report and press releases known adverse data about the future prospects for its products. Likewise, the plaintiffs in Sun alleged that Item 303 required disclosure in a press release announcing second quarter earnings of the impact a competitive product would have on future results. In both these cases, the court stated that Rule 10b-5 did not require disclosure of the omitted information and that Item 303(a) applied only to annual report Form 10-K filings with the SEC. Due to poor pleadings, the court did not address in either of these cases whether the companies should have made the disclosures in the MD&A of their quarterly reports.

379 Fed. Sec. L. Rep. (CCH) ¶ 91,205 (Third Circuit 2000).

380 Id.

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language of the Regulation, and the interpretive releases of the SEC, no private cause of action exists under S-K 303.[381]

This case demonstrates the reemerging significance of MD&A disclosure obligations as the court ruled that disclosure obligations for MD&A differ greatly from the materiality test for securities fraud established in Basic. Because the materiality tests for Rule 10b-5 and SK-303 differ, the violation of one does not necessarily result in the violation of the other. Factual claims which once served as the basis for the violation of Item 303 may now arguably be used to support 10b-5 claims. Accordingly, where the plaintiffs failed to plead an actionable misrepresentation or omission on the part of the defendant drug manufacturer, AHP, SK-303 alone does not provide a basis of liability.[382]

I. New Accounting Procedure–SSAE No. 8

Traditionally, accountants have delivered to underwriters "cold comfort letters" to bring down the Annual Audited Financial Statements in connection with underwritings. Less frequently, cold comfort letters are delivered to parties to a business combination. These cold comfort letters in the context of underwritten offerings provide underwriters with due diligence support.

In the middle of 1998, the AICPA adopted standards in SSAE No. 8 for the examination or review of MD&A.[383] Examinations can only be made with respect to previously audited financial statements, and the report on the examination can be published. Moreover, the new standards also provide for a more limited "review" which can be made of either audited or interim financial statements. An examination report will:

- express an opinion on whether the MD&A, taken as a whole, includes full and complete disclosure;
- determine whether all necessary historical financial data is correct; and

[381] Id.

[382] Id.

[383/] The full version of Statement on Standards Attestation Engagements is published in the Journal of Accountancy, June 1998 at page 103. In connection with the adoption of SSAE No. 8, the AICPA also adopted amendments to SAS No. 72, reflecting changes required as a result of SSAE No. 8. *See* SAS No. 86 - Amendment to Statement on Auditing Standards (if the accountant has performed an SSAE No. 8 examination or review, he or she may refer in the comfort letter to that SSAE report) and No. 72, *Letters for Underwriters and Certain Other Requesting Parties.* See Berkeley, Alan J., Outside Auditors' Examinations of MD&A Presentations: SSAE No. 8, ALI-ABA Postgraduate Course in Federal Securities Laws (1998).

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- ensure that the underlying information provides a reasonable basis for the MD&A disclosures.[384]

SSAE No. 8 sets forth a number of procedures that the auditor is to use to support the issuance of the examination report. For example, the auditor is required to exercise (a) due professional care in planning, performing, and evaluating the results of his or her examination procedures and (b) the proper degree of professional skepticism to obtain reasonable assurance that material misstatements will be detected. The practitioner should also consider relevant portions of the entity's internal control system applicable to the preparation of MD&A and consider the effect of events subsequent to the balance-sheet date.[385]

These reports have not yet been used often. Indeed, not all accounting firms have offered to do them. If issued, the reports should provide extra protection for company boards, audit committees, and underwriters. The independence, expertise and focus that outside accountants bring to the examination or review should help shield against claims that the MD&A was materially misleading or omitted material disclosures. Perhaps one of the reasons this has not been more widely adopted is because of the concern that the procedures mandated by SSAE No. 8 are not adequate to ferret out undisclosed information, uncertainties, trends or future results.[386] Moreover, how equipped are accountants to report on these issues which generally involve legal questions?

J. Conclusion

Although there is no general duty to disclose material information, the SEC's 1989 MD&A Interpretive Release and the enforcement actions against Caterpillar, Shared Medical, Bank of Boston, and Sony above, illustrate that the SEC construes and will enforce the MD&A as a quarterly disclosure vehicle for various material corporate occurrences, especially "bad news."[387] Notwithstanding the somewhat curious statements

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384/ See *Earnings Per Share: Accountants' Review or Examination of Managements' Discussion and Analysis.* McLaughlin, Joseph. Insights, Volume 12, Number 10, October 1998.

385/ Id at 107.

386/ See *MD&A Audits: A New Tool for Boards of Directors and Underwriters*. Butler, Samuel C. and White, John W. Published in 30th Annual Institute on Securities Regulation, Volume Two. Practicing Law Institute (1998).

387/ See James J. Maiwurm, Annual Disclosure in a Declining Economy - Some Year-End Reminders, Insights, Jan. 1991, at 3. Query: whether issuers who anticipate exceptionally positive financial developments could incur liability for failure to fully disclose such favorable events in the MD&A? Probably not; however, the SEC takes a strong opposing position regarding this issue. Although the 1989 MD&A Release does not explicitly dismiss the disclosure of positive corporate developments, most examples in the 1989 MD&A Release involve either (1) the disclosure of adverse business developments or (2) the tempering of good news with the negative side effects of relevant transactions. See, also, Karl A. Groskaufmanis, Matt T. Morley and Michael J. Rivera, To Tell or Not to Tell: Reassessing Disclosure of Uncharged Misconduct, Insights, June 1999 at 9. While there is no affirmative duty to disclose in MD&A

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in the 1989 MD&A Release regarding the appropriate standard of materiality for MD&A purposes, the Release clearly requires that registrants discuss in the MD&A "known contingent events" which are "reasonably likely to have a material effect on financial conditions or results of operations." Hence, troubled companies can no longer brighten their financial reports by filtering out unfavorable news.

As cases such as Salant and Bank of Boston demonstrate, issuers in preparing their MD&A should consider internal paperwork which may provide evidence that management knew or should have known that the trend or uncertainty was likely to be material. Moreover, the SEC's 2000 Audit Risk Alert also emphasizes MD&A as a hot issue in need of further clarification by the Commission.[388] For example, the SEC's 2000 Audit Risk Alert even provided a list of current developments in the economy and business world which most likely affect registrants and require disclosure in MD&A. These developments included: 1.) Increasing prices for oil and gas which may materially affect costs in current or future periods; 2.) increasing interest rates; and 3.) acquisitions by companies of their own stock, which may materially affect trends in earnings per share.[389] In conclusion, though there are relatively few cases on this subject, the Third Circuit's recent decision striking down a private right of action under SK-303 and the 2000 Audit Risk Alert only demonstrate a renewed emphasis on MD&A issues by the SEC.

V. REGULATION FD AND CURRENT PRACTICES INVOLVING ANALYSTS

A. Background

Communications between the issuer and analyst serve a significant market function in ensuring the dissemination of information to the marketplace. As noted by the Supreme Court: "the value to the entire market of [analysts'] efforts cannot be gainsaid; market efficiency in pricing is significantly enhanced by [analysts'] initiatives to ferret out and analyze information and thus the analysts' work redowns to the benefit of all investors."[390]

Issuers, however, face risks in communicating with analysts. True, meetings and discussions with analysts serve an important function in evaluating and disseminating

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uncharged misconduct, management must consider the likelihood of a charge and the potential effect on the financial situation of the company.

[388] See Office of the Chief Accountant, "Letter: 2000 Audit Risk Alert to the American Institute of Certified Public Accountants," http://www.sec.gov/offices/account/audrsk2k.htm, October 13, 2000.

[389] See id.

[390/] Dirks v. SEC, 463 U.S. 646, 658 n.17 (1983) (quoting 21 SEC Docket 1401, 1406 (1981)).

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information for public use. Indeed, most issuers cannot avoid the free flow of information to analysts; otherwise, their stock prices will suffer from inadequate analyst coverage upon which the "street" and money managers depend. These dialogues, however, create a number of pitfalls. First, selective disclosures to analysts may be viewed as unlawful tipping in violation of Rule 10b-5.[391] The general rule for issuers when dealing with analysts is that it is improper for a corporate executive to reveal material, non-public information if he or she acts (i) in breach of an independent fiduciary duty and (ii) for the personal benefit of the insider.[392] Second, information conveyed to analysts about fluid business situations can turn out to be misleading, such as "early warning" signals, and the practice of reviewing and/or correcting analysts' reports might make issuers responsible for the accuracy of the entire report and establish a duty to keep the information current.[393] As a result of these potential pitfalls, in August 2000, the SEC adopted Regulation FD (Fair Disclosure) to combat issuers' selective disclosure to market analysts and institutional investors.[394] The rule, which took effect on October 23, 2000, requires that if a company discloses to market participants any non public material information, it must broadly and publically disseminate that same information to both the investing public and analysts at the same time.[395]

Prior to the adoption of Regulation FD, the Supreme Court in the Dirks case established the line between permissible and impermissible disclosure. In Dirks, Raymond Dirks, a well known investment analyst was informed by a former employee of Equity Financing Corporation that the company was involved in massive financial fraud. Dirks investigated the allegations and exposed the company's fraud, but not before revealing the company's wrong-doings to his own clientele. The SEC concluded:

> "in tipping potential traders, Dirks breached a duty which he had assumed as a result of knowingly receiving confidential information from Equity Funding insiders. Tippees such as Dirks who receive non-public, material information from insiders become subject to the same duty as [the] insiders."[396] As noted by

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391/ SEC Chairman Arthur Levitt stated in an October 18, 1999 address to the Economic Club of New York that the "behind-the-scenes feeding of material non-public information from companies to analysts is a stain on our markets." Levitt's entire speech can be viewed on the SEC Web site at www.sec.gov/news/speeches/spch304.htm (the "Levitt Speech").

392/ Dirks v. SEC, 463 U.S. 646 (1983).

393/ See Robert B. Robbins, Corporate Communications, Insights, Apr. 1994, at 10. See also James J. Junewicz, Securities Disclosure: Handling Wall Street Analysts, Insights, January, 1995, at 9-16.

394 See Securities and Exchange Commission Final Rule: Selective Disclosure and Insider Trading, http://www.sec.gov/rules/final/33-7881.htm (hereinafter "Regulation FD"); 17 CFR 243.100-103.

395 Id.

396/ Dirks, 463 U.S. at 655.

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the Supreme Court, the SEC's theory of liability was "rooted in the idea that the anti-fraud provisions require equal information among all traders."[397]

The Court, however, expressly rejected the notion that all traders must enjoy equal information before trading and ruled that those who receive material non-public information from insiders are not banned from trading unless: (1) the insider breached a fiduciary duty for personal gain and (2) the recipient knew or should have known of the breach.[398] The SEC has never been happy with this result – believing that all investors require equal information. Regulation FD was crafted to avoid the Supreme Court's rejection of the concept that the anti-fraud provisions require equal information: Regulation FD was adopted as a disclosure rule and not an anti fraud rule.

On the civil side, issuers have also been sued by investors claiming entanglement between the issuer and analyst and the failure of the issuer to update analysts' reports. Issuers and analysts have also faced a series of recent class actions suits where investors claimed that issuers and analysts defrauded investors by issuing overly optimistic research reports, thereby manipulating the issuer's stock price subsequent to an IPO. Former SEC Chairman Arthur Levitt called on self-regulatory agencies to require "meaningful," not "boilerplate" disclosure when an analyst's employer has a relationship with the firm the analyst recommends.[399] At the Ray Garrett Corporate and Securities Law Institute in April 2001, Acting Chairman Laura Unger questioned how analysts can maintain their independence in the face of potential conflicts between research and investment banking.[400/]

Despite the Court's efforts to establish a clear line between permissible and impermissible disclosure, the SEC continued to push for equal access to information among all market participants as it initiated at least one enforcement action (and

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[397/] Id. at 659.

[398/] Id. at 670.

[399/] Rachel Witmer, Levitt Lambasts Analysts, Firms for "Gamesmanship," Selective Disclosure. Sec. Reg. & L. Rep. Vol. 31, No. 41 at 1390 (Oct. 1999), quoting the Levitt Speech, supra Section V. A.

[400/] "How Can Analysts Maintain Their Independence?", April 19, 2001, www.sec.gov/news/speech/spch477. As of June 2001 this is a very hot topic. The Wall Street Journal reported that the New York Attorney General's office has begun an investigation into stock research practices and whether analysts are presenting unbiased information to investors. Wall S. J. p. C-15, col. 3, June 7, 2001. Congressional hearings on this issue are scheduled for the week of June 11, 2001. See Charles Gasparino, "Outlook for Analysts: Skepticism and Blame. Wall S. J., col. 3, p.C1, June 13, 2001; Jeff D. Opdyke, Guidelines Aim to Polish Analysts' Image, id. p.C1, col. 4 (reporting that the SIA has adopted a set of best practices; for further information see Securities Industry Association, "Best Practices For Research" at www.sia.com/pdf/BestPractices_F.pdf and Securities Industry Association, "Best Practices: A Guide For The Securities Industry" at www.sia/com/publications/pdf/best.pdf); Raymond Hennessey & Lynette Khalfani, "Analysts' Link to IPOs Mean Losses for Investors, Study Finds, id. p. C14, col. 4 (describing four year study by Investors.com).

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threatened others) against selective disclosure, relying on a theory, which "substantially dilutes" the potency of Dirks.[401] This theory ultimately emerged as Regulation FD.

It has been argued, that the SEC's fixation on the abolition of selective disclosure will negatively impact the market in two respects: First, because issuers may no longer offer any type of one-on-one earnings advice, issuers may decide to remain silent and dry up all information previously available in the market via private discussions with analysts; and second, the enforcement of Regulation FD may result in more market volatility as analysts note that the rule "could make for more dramatic single-day movements as news hits the markets all at once, rather than trickling out more gradually."[402] Accordingly, this section will primarily examine the role of the analyst in offerings, the relationship between the issuer and analyst during both the pre and post-Regulation FD periods, and the Regulation itself.

B. Analysts Involved in Initial Public Offerings.

1. Benefits of Analyst Involvement

In many ways the analyst is indispensable to an issuer in the context of an IPO as the public has little basis to make informed investment decision making. Issuers recognize this and, indeed, often select an underwriter who has a known analyst. Moreover, the analyst is frequently involved in the offering process. Analysts, moreover, aside from getting a company's name before investors, can also play a major role in an underwriter's due diligence process by identifying weaknesses in product, management or business strategies because of the analyst's knowledge of the industry and the competition. The analyst can also advise on how a company's strengths and weaknesses should be disclosed in the company's prospectus.

More significant is the analyst's involvement in developing earning projections. As one commentator has pointed out:

> [I]nstitutional customers, in particular, will not buy IPO shares without [earnings] estimates . . . .Estimates therefore are provided orally to investors, either at road shows or by the sales force on the telephone. The issuer typically will not take responsibility for these estimates, leaving it in

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[401]/ See Donald C. Langevoort, The Demise of Dirks: Shifting Standards for Tipper-Tippee Liability, Insights, June 1994 at 23 and the Stevens case discussed at n. 505 and accompanying text.

[402] Frye-Louis Capital Management, Inc., "Market Outlook: More Volatility Anyone?", October 17, 2000, p.6.

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> many cases to the investment bankers working on the IPO to supply estimates based on discussions with the issuer and access to internal projections. Investment bankers, however, are not experienced in coming up with earnings estimates and sales persons and customers alike may regard such estimates as "tainted" . . .
>
> The analyst, on the other hand, is experienced in coming up with earnings estimates and has a track record of credibility with sales people and customers. The analyst is also more likely to identify unrealistic assumptions built-in to the issuer's internal projections. For this reason, analysts are increasingly permitted access to the issuer's internal projections . . .[403]

Because of the importance of analysts to the offering process, underwriters are often selected to lead an offering based on the ability or reputation of the firm's analysts. Of course, this is a two-way street, and analysts may be more willing to cover a particular company if the analysts' firm is selected to manage the underwriting.

2. Costs of Analyst Involvement

Once the offering is completed, the analyst generally publishes a research report on the issuer subsequent to the "cooling down" period. It is at this point that issuer and analyst alike generally are concerned that the analyst is "tainted" or possesses material non-public information having participated in the due diligence process. It is also at this point that issuer and analyst risk enforcement by the SEC as well as civil suits.

The SEC, as discussed below, has expanded the "personal benefits" test established by the Dirks Court and has argued that even enhancement to reputation which does not result in pecuniary benefit is sufficient for a finding of insider trading. To my knowledge, the SEC has not prosecuted analysts on this theory.

Issuers also face exposure to claims based on entanglement. Traditionally, the entanglement theory holds that if a company puts its imprimatur, expressly or impliedly, on an analyst's report, the company will be deemed to have adopted the report and be responsible for its accuracy, and will have a duty to update it. A new form of entanglement

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403/ Joseph McLaughlin, The Changing Role of the Securities Analyst in Initial Public Offerings, Insights, August 1994 at 7.

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theory has emerged. Plaintiffs have brought class action suits alleging that analysts and their firms defrauded investors by issuing reports containing overly optimistic earnings forecasts and other projections, called "booster shots" thereby manipulating the issuer's stock price immediately after an IPO. This entanglement theory has been described as a "devil's bargain" whereby weak companies are brought public and the company's stock price is inflated until issuers' officers and directors can sell their personal holdings.[404]

These cases name analysts as individual defendants and suggest a complex conspiracy between issuer, analyst and underwriter to defraud investors. As noted in one 1994 complaint:

> Defendants accomplished their scheme and common course of conduct through the issuance of a series of interrelated and interdependent false and misleading reports to shareholders, filings with the SEC, financial statements and press releases to the public as well as approving the issuance of [and reprinting] false and misleading analysts' reports which misrepresented the true facts regarding Coastcast's business, new products, manufacturing expertise, and future business prospects and created a false impression of continuing growth and future profitability. The individual Defendants all benefited from the illegal course of conduct by selling Coastcast stock owned by them at artificially inflated prices . . .[405]

As the above complaint illustrates, the "devil's bargain" suggests an intricate level of market manipulation over a sustained period of time. Several of the suits alleging this new form of entanglement have been voluntarily dismissed. It is still unclear, however, how the trial courts will respond to these class action suits, especially because analysts apparently issue more favorable earnings forecasts and recommendations for their firm's underwriting clients than for issuers with whom they have no preexisting relationship.[406]

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[404] Johnathon C. Dickey, The New "Entanglement" Theory: Securities Analyst are Sued in Class Action Complaints, Insights, March 1995, at 3. See also Acting Chairman Unger's speech at note 386 supra.

[405] Stark v. Present, No. 94-5712, at p. 17 (C.D.Cal., filed Aug. 22, 1994).

[406] Lin and McNichols, Underwriting Relationships in Analysts Research Reports, Stanford, March, 1993. See also Roni Michaely and Kent L. Womack, Conflict of Interest and the Credibility of Underwriter Analyst Recommendations, April, 1996.

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3. Cost Benefit Analysis

Issuers should involve analysts in the due diligence phase of an IPO. While there is a risk of selective disclosure, there are sound business reasons for their involvement in the IPO process which counterbalances these risks and which makes an SEC argument of "personal benefit" less likely. As one author has noted:

> [T]he IPO issuer has eminently reasonable corporate business purposes in permitting an analyst full access to its internal information. These include permitting the underwriters to conduct more effective due diligence . . . increasing the underwriter's confidence level in the issuer's business plan and projections, and assuring that the analyst's earnings estimates . . . are in turn based on all available information about the issuer. Indeed, these business purposes are in full accord with the public policy of the Securities Act, which is to ensure full disclosure to investors in securities distributed in the course of registered public offerings.
>
> By contrast, the corporate officers working on the IPO derive no personal benefit from the disclosure to the analyst. Even taking the SEC's broad views of 'personal benefit' into consideration, this may be one of the few examples of a 'completely business-justified disclosure' that should therefore be 'immunized from liability.[407]

With respect to liability on the basis of entanglement, as discussed below, the courts are consistently dismissing such claims on motions to dismiss or summary judgment motions because the plaintiffs have been unable to plead specific facts such as time, place, and statements made.

Finally, an issuer can take additional measures to guard against selective disclosure or entanglement law suits. For example, an issuer can designate a handful of corporate officers who can monitor written or oral information supplied to the analyst. An issuer can also adopt a written policy statement indicating how far they will participate with the analyst in the due diligence process and that the company will not review the analyst's projections. If the company does elect to review the analyst's

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407/ McLaughlin, supra note 296, at 11.

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report, it can provide a disclaimer describing the purpose of the review. Such a disclaimer may include the following:

> Our review of the report has been limited to the accuracy of the factual information contained therein as of the date of our review. As a matter of corporate policy, we do not comment on analysts' projections or earning estimates and our review of the report should not in any manner be viewed as agreement or acquiescence on our with the projections, predictions or opinions set forth therein. In addition, we assume no responsibility to provide you with any material information which may not be included in the report or to update any information which may become inaccurate following our review.[408]

C. Analyst Participation in Public Offerings of Already Public Companies

Analysts in the majority of offerings involving already public issuers generally participate in the due diligence process and contribute the same insights to the process as discussed above. However, analysts generally do not obtain projections from the company and the need for a "chinese wall" between analysts and investment banking firm is even greater than in the IPO setting because the analyst is already in communication with investors and the company's stockholders. Because of this and to avoid the analyst being restricted in his or her advice, they are not generally brought "over-the wall" until late in the registration process.

Some commentators have noted that analysts should refrain from publishing detailed reports about a company if a company is making a public offering. While there are limitations imposed on analysts circulating reports during an offering, analysts should probably avail themselves of Rules 138 and 139 of the Securities Act which define the circumstances under which a report is not deemed to be an offer for the sale of securities.

Rule 139 provides that with respect to an issuer who proposes to file or who has filed a registration statement, a publication by a broker or dealer of an opinion with respect to the registrant will not be deemed to be an offer to sell securities even though such broker or dealer is a participant in the distribution of such securities if:

408/ James J. Junewicz, Handling Wall Street Analysts, Insights, January 1995 at 11. One author has suggested that underwriters, in order to minimize their exposure, should obtain issuer consent when an analyst participates in all facets of the due diligence precess and then publishes a post-offering analysis. See McLaughlin, supra note 296. I am not aware of any underwriting firms which deliver such a letter other than Goldman Sachs.

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[t]he registrant meets the registrant requirements of Form S-3 . . . and such information, opinion or recommendation is contained in a publication which is distributed with reasonable regularity in the normal course of business; or . . .

[for non Form S-3 issuers] such information, opinion or recommendation is contained in a publication which: (i) is distributed with reasonable regularity in the normal course of business, and (ii) includes similar information, opinions or recommendations with respect to a substantial number of companies in the registrant's industry or sub-industry, or contains a comprehensive list of securities currently recommended by such broker or dealer; . . . (2) such information, opinion or recommendation is given no materially greater space or prominence in such publication than that given to other securities or registrants; and (3) an opinion or recommendation as favorable or more favorable as to the registrant or any class of its securities was published by the broker or dealer in the last publication of such broker or dealer addressing the registrant or its securities prior to the commencement of participation in the distribution.[409]

D. Pre-Regulation FD Cases

1. Selective Disclosure

In the aftermath of the Supreme Court's decisions in Chiarella v. United States[410] and Dirks v. SEC,[411] a duty to disclose or refrain from trading on the basis of material, non-public information arises only when such trading constitutes a breach of fiduciary duty. In Dirks, the Court ruled that "whether disclosure is a breach of duty . . . depends in large on the purpose of the disclosure . . . Thus, the test is whether the insider personally will benefit, directly or indirectly, from the disclosure."[412] The Court defined "personal benefit" as a "pecuniary gain or a reputational benefit that will translate into future earnings."[413]

In March 1991, the SEC applied the Dirks "personal benefits" test in SEC v. Stevens.[414] In Stevens, the SEC charged a corporate executive of

[409] Rule 139 of the Securities Act.

[410] 445 U.S. 222 (1980).

[411] 463 U.S. 646 (1983).

[412] Id. at 662.

[413] Id. at 663.

[414] 48 S.E.C. Docket 739 (S.D.N.Y. Mar. 19, 1991); see also SEC v. Bausch & Lomb Inc., 565 F.2d 8 (2d Cir. 1977).

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Ultrasystems, Inc., with unlawful tipping when he called a few analysts who provided research coverage of the company to let them know of an anticipated earnings decline. The SEC alleged that Stevens placed these calls "to protect and enhance his reputation as a corporate manager," and therefore the calls "had direct, tangible benefit to his status as a corporate manager."[415]

After Stevens' calls, two of the analysts called their clients, who then sold Ultrasystems' stock prior to Ultrasystems' issuance of a press release announcing its lower than expected revenues and earnings. The SEC alleged that the loss avoided by these clients was of at least $126,455. Stevens agreed to pay the $126,455 as well as to be permanently enjoined from violating Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act.

Stevens stretches the "reputational benefit" test of Dirks to its limit. There was no allegation that Stevens received any type of substantial reputational benefit that "translates into future earnings." The danger of the Commission's rationale in Stevens is that virtually all selective disclosures are likely to have been made on some element of personal motivation.[416] Thus, any executive, even one who is driven by a desire to serve the corporation, may be charged with deriving a "reputational benefit" when he or she communicates with analysts. Steven's monetary liability, representing the trading profits of remote tippees, further serves as a significant *in terroram* deterrent for executives who deal with analysts.

The SEC continued to fight selective disclosure and promote equal access to material information. At the 1999 Ray Garrett Institute, Commissioner Laura S. Unger stated:

> "The recent concerns expressed by the Commission and its staff on selective disclosure have centered on a scenario where there is suspicious market-moving trading activity occurring shortly after, or even during, analyst calls. At the very least, such activity may undermine the confidence of investors in the fairness of our markets."

415/ 48 S.E.C. Docket 739 (S.D.N.Y. Mar. 19, 1991).

416/ See Edward H. Fleischman, Ferreting in the Interstices of SEC Attitudes to Securities Analysts, Speech at the Eighteenth Annual Securities Regulation Institute, University of California, San Diego (January 24, 1991). Former SEC Commissioner Fleischman suggested that every corporate officer who communicates with analysts could be viewed as seeking to "build" or "preserve" or "redeem" or "maintain" his or her reputation with analysts.

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> …"which is why our Office of General Counsel is currently reviewing insider trading law to determine whether it should recommend that the Commission propose rulemaking to address a number of insider trading-related topics, including selective disclosure by issuers to analysts and institutional investors."[417]

On October 14, 1999, the Wall Street Journal reported that Abercrombie & Fitch ("Abercrombie"), the men's retailing chain, may have leaked information negating overly-optimistic "whisper estimates" to Lazard Freres, leading Lazard Freres clients to get out of Abercrombie stock before official news of sluggish sales was announced.[418] When the stock went into a deep decline, other analysts and investors scrambled for an explanation, only to find out the information from Lazard Freres, and not from the company itself. Whether any investors will file a suit based on improper trading methods remains to be seen, as does any possible SEC action against either Abercrombie or Lazard Freres.

2. Entanglement Cases

The entanglement theory presents two distinct problems for an issuer involved in dialogue with an analyst. First, an issuer may become responsible for what is contained in an analyst's report, including the analyst's own projections, even when the company does not want to comment on some of the findings included in the analyst's report. Second, as a result of an analyst's report being attributable to the company, the company may have a duty to update and correct material errors or omissions contained in the analyst's report. One key factor in determining the level of entanglement is whether the statement can be called "mere puffery," or if it is an adoptive statement.

In the leading case of Elkind v. Liggett & Myers, Inc.,[419] the Second Circuit addressed the issue of whether an issuer had a continuing duty to correct analyst reports when the defendant company instituted a policy of regularly meeting with analysts and reviewing their reports. The court

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417/ See *Remarks by* Laura S. Unger, *Commissioner U.S. Securities & Exchange Commission* at the 19th Annual Ray Garrett Jr. Corporate and Securities Law Institute dated April 23, 1999, entitled "Corporate Communications Without Violations: How Much Should Issuers Tell Their Analysts and When" (Web site http://www.sec.gov/news/speeches/spch273.htm). See also Brian Lane's *Remarks* at the same Institute at footnote 4 supra.

418/ Susan Pulliam, *Abercrombie & Fitch Ignites Controversy Over Possible Leak of Sluggish Sales Data*, Wall Street Journal, p.C1 (October 14, 1999).

419/ 635 F.2d 156 (2d Cir. 1980).

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held that management did not assume a continuing duty to correct the analysts' projections because while company personnel would correct factual errors in the reports, it had generally not commented on earnings projections. The court explained that:

> [T]he controversy before us is whether Liggett sufficiently entangled itself with the analysts' forecasts to render those predictions 'attributable' to it . . . We have no doubt that a company may so involve itself in the preparation of reports and projections by outsiders as to assume a duty to correct material errors in those projections. This may occur when officials of the company have, by their activity, made an implied representation that the information they have reviewed is true or at least in accordance with the company's views.[420]

After reviewing the facts, the Second Circuit affirmed the district court's finding that Liggett did not place its "imprimatur, expressly or impliedly, on the analysts' projections."[421] The court warned, however, that:

> [C]orporate pre-release review of the reports of analysts is a risky activity, fraught with danger . . . . A company which undertakes to correct errors in reports presented to it for review may find itself forced to choose between raising no objection to a statement which, because it is contradicted by internal information, may be misleading and making that information public at a time when corporate interests would best be served by confidentiality.[422]

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[420] Id. at 163.

[421] Id.

[422] Id. See, also Plevy v. Haggerty, Fed. Sec. L. Rep. ¶ 90,309 (D. Ca. 1998); In re Kidder Peabody Securities Litigation, 10 F.Supp.2d 398 (S.D.N.Y 1998) (evidence of entanglement not sufficient because no direct involvement in generating the analysts' reports shown); In re Syntex Corp. Securities Litigation, 95 F.3d 922 (9th Cir. 1996) (company must put their imprimatur, express or implied, on analysts' projections to create inference of entanglement). But see, In re Seagate Technology II Securities Litigation, Fed. Sec. L. Rep. (CCH) ¶98,530 (N.D. Cal. 1995) (where court cited Elkind to support ruling that guidance alone does not make a company liable for analyst's forecast) and See In re Burlington Coat Factory Securities Litigation, 114 F.3d 1410 (3rd Cir. 1997) (Reports of Chief Accounting Officer's expression of feeling "comfortable" with analysts' estimates of earnings per share imputed enough imprimatur to create entanglement).

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One difficulty plaintiffs encounter in pleading entanglement is that the courts have required specific facts which definitively link analysts' statements to insiders of the company. In Raab v. General Physics Corp.,[423] stockholders of General Physics sued claiming the company had misled investors through false statements to analysts and the media. The district court dismissed plaintiffs' complaint for lack of particularity. The Fourth Circuit affirmed the dismissal, and held that plaintiffs had not pled specific facts from which the analysts' report could be attributed to the company. The court concluded that "soft" or "puffing statements" are generally not material because the market price is not driven by such vague declarations. The court concluded that the company's statement that profits should be in line with analysts' current projections did not constitute a guarantee that earnings would be forthcoming in particular amounts. The court considered this forecast immaterial.[424]

A Second Circuit opinion adopted a similar line of reasoning. In San Leandro Emergency Medical Group Profit Sharing Plan v. Philip Morris, plaintiffs alleged that the cigarette maker failed to disclose plans to lower prices on its flagship Marlboro brand.[425] Plaintiffs alleged that failure to disclose this information rendered several statements made in analyst meetings and press releases misleading, including statements that the company would deliver consistent income growth. The Second Circuit affirmed the dismissal of the complaint, stating that Philip Morris' announcement that it expected Marlboro to perform well and was "optimistic about its earnings" was mere puffery.[426]

California case law has also been very favorable to issuers by making it difficult for plaintiffs to plead entanglement. In In re Time Warner Securities Litigation,[427] the plaintiffs alleged that statements made by unidentified Time Warner insiders in discussions with analysts and newspaper reporters misled the public by suggesting that Time Warner would reduce certain outstanding debt. In upholding the district court's dismissal pursuant to Rule 9(b), the Second Circuit ruled that the

[423] Raab v. General Physics Corp., 4 F.3d 286 (4th Cir. 1993).

[424] Id. See, also, Fishbaum v. Liz Claiborne, Inc., Fed. Sec. L. Rep. (CCH) ¶90,676 (2d Cir. 1999), citing San Leandro and stating that the case involved "'soft' optimistic projections that could not support a securities fraud claim." Id at 93,195.

[425] Fed. Sec. L. Rep (CCH) ¶99,017 (2nd Cir. 1996).

[426] Id. at 93,982.

[427] 9 F.3d 259 (2nd Cir. 1993).

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circumstances constituting fraud must be stated with particularity and noted that "at a minimum, the [plaintiff] must identify the speaker of the allegedly fraudulent statements."[428] Following Time Warner, a number of California district courts have required plaintiffs to plead specific facts to withstand a motion to dismiss and have articulated which facts plaintiffs must set forth in their complaint. In Fisher v. Acuson Corp., the Court cited Time Warner and noted that:

> [T]he heightened pleading requirements of Rule 9(b) require plaintiffs who are claiming that insiders are liable for third party financial analyst's statements to show adoption by alleging the following: (1) specific reports and the name of the insider who adopted them; (2) specific interactions between the insider and the analyst; and (3) dates on which the interactions occurred.[429]

The "heightened" pleading requirements of Fisher appears to be the current trend in entanglement cases.[430] Courts have continued to be antagonistic towards holding companies responsible for statements of analysts.[431]

However, an issuer is still at risk if the particularity requirements for an analyst's report based on an issuer's statements are fulfilled. In re DSP Group, Inc. Securities Litigation showed a situation where defendant-

[428] Id. at 265. Echoing the Dirks court, the Second Circuit noted that "the function of financial reporters and security analysts is to determine the truth about the affairs of publicly-traded companies." Id.

[429] 1995 WL 261439, *6 (N.D. Cal); See also Stack v. Lobo, 903 F.Supp. 1361 (N.D. Cal. 1995); In re Cypress Semiconductor, Fed. Sec. L. Rep. (CCH) ¶98,462 (N.D. Cal. 1995); But see, In re Rasterops Corporation, Fed. Sec. L. Rep. (CCH) ¶98,467 (N.D. Cal. 1994) (court ruled that plaintiffs need only allege insiders provided false information, approved drafts of analyst's reports and circulated reports to investors).

[430] Indeed, the California courts still appear to be moving in the same direction. See Shuster v. Symmetron, Inc., Fed. Sec. L. Rep. (CCH) ¶99,437, 96,868 (N.D. Cal. 1997) (court dismissed complaint, with leave to amend, after citing the Fisher requirements stating "plaintiff pleads only that various employees communicated with [the analyst] without setting forth what statements were made and why they were false or misleading"; See also Gross v. Summa Four, Inc. et al., Fed. Sec. L. Rep (CCH) ¶98,999 (D.N.H. 1996) (where court ruled that absence of guarantees, specificity or time frame made companies' predictable statements immaterial).

[431] The District Court of Maryland in In re Manugistics Group, Inc. Securities Litigation stated that an executive stating that he "was comfortable" with analysts' expectations was not actionable, where no facts were plead leading to the conclusion that he had actual knowledge that he was making any false statements. "Neither the corporate documents nor the same of 1% of the [executive's] holdings or other alleged 'insider sales' suffices." In re Manugistics Group, Inc. Securities Litigation, Fed. Sec. L. Rep. (CCH) ¶90,638 (1999).

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company's managers allegedly made inaccurate statements to analysts during routine quarterly meetings, creating a potential for securities fraud entanglement as the analysts conveyed the misinformation to the market.[432] Furthermore, plaintiffs met the particularity requirements by identifying specific analysts' reports, dates of conversations between managers and analysts, and other specific communications between the parties.

Similarly, the 9th Circuit reversed the dismissal in Cooper v. Pickett based on the district court's misinterpretation of the particularity requirement.[433] The 9th Circuit focused on (i) the falsity of defendant-company's representations at the time the statements were made, and (ii) the general accuracy to which plaintiffs described the fraudulent transactions. Defendants attempted to argue that Plaintiffs needed to plead and describe a specific fraudulent transaction, but the court held that the complaint "'identifie[d] the circumstances of the alleged fraud so that defendants [could] answer'" and thus "declined to require that a complaint . . . allege specific shipments . . . customers . . . times [and] dollar amounts."[434]

E. Regulation FD.[435]

On August 18, 2000, Katten Muchin Zavis released its client advisory titled "SEC Adopts New Rules Regarding Selective Disclosure of Information by Issuers and Insider Trading." The following section of this article is a revised partial reproduction of the Katten Muchin Zavis Client Advisory.

1. The Rule and its Purpose

On August 10, 2000, the Securities and Exchange Commission adopted Regulation FD (Fair Disclosure), which is designed to eliminate selective disclosure of material information by public companies. This new rule reflects the SEC's current view that "the practice of selective disclosure leads to a loss of investor confidence in the integrity of our capital markets." The SEC originally proposed this rule in December 1999 and received nearly 6,000 comments, in large part from individual investors. A number of changes suggested by commentators were

432 Fed. Sec. L. Rep (CCH) ¶99,525 (N.D. Cal. 1997).

433 122 F.3d 1186 (9th Cir. 1997).

434/ Cooper v. Pickett, 122 F.3d 1186, 1196 (9th Cir. 1997), quoting Kaplan v. Rose, 49 F.3d 1363, 1370 (9th Cir. 1994).

435 Regulation FD became effective on October 23, 2000.

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incorporated by the SEC into the final rule. Although the Regulation, as adopted, corrected some of the flaws in the proposal, it is subject to pointed criticism. Regulation FD has and will have a significant impact on communication between public companies and market professionals.

Regulation FD is designed to prevent companies from disclosing information selectively – e.g., only to certain analysts or institutional investors – before making broad public disclosure by a press release or SEC filing. The Regulation requires that public companies make all intentional disclosures of material information on a widespread, public basis and that, if they unintentionally disclose material information selectively, they quickly remedy the selective disclosure through public release of the information. The Regulation does ***not*** impose upon companies any new general duty to disclose material information in the absence of selective disclosure. It will, however, have a major effect on ongoing communications with analysts and other securities industry professionals, particularly the now common practices of reviewing analyst reports and conducting calls and meetings with selected analysts or institutional investors, and participating in investor conferences, where nonpublic financial information is discussed.

Regulation FD requires that, whenever an issuer, or any of its senior officials or other employees or agents who normally communicate with investors and analysts, discloses material nonpublic information to certain enumerated persons, such as securities analysts or institutional investors, the issuer must either (a) simultaneously (for intentional disclosures), or (b) promptly (for non-intentional disclosures) make public disclosure of that same information.

Regulation FD applies to companies with securities subject to the Securities Exchange Act of 1934, which include all companies with equity listed on a national securities exchange, Nasdaq or the OTC Bulletin Board, as well as closed-end investment companies. However, the Regulation does not apply to any other investment companies or to foreign governments or foreign private issuers.

A. What is "Material Nonpublic Information" subject to the Regulation?

To answer the fundamental questions of what information is "material" and "nonpublic", Regulation FD refers companies and investors to the following traditional standards established by the courts:

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- Information is considered "nonpublic" if "it has not been disseminated in a manner making it available to investors generally."

- Information is material if "there is a substantial likelihood that a reasonable shareholder would consider it important in making an investment decision," or if it would have "significantly altered the 'total mix' of information made available."

The determination as to whether information is material requires a very difficult judgment to be made by the person considering disclosure of the information. For example, this judgment must be made in light of the SEC's pronouncement in August 1999 in SAB 99 that assessments of materiality, for financial statement purposes, require consideration of both "quantitative" (i.e., numerical thresholds) and "qualitative" factors. SAB 99 indicates that, among other things, expected market reaction should be taken into account in considering whether information is material. This has created considerable uncertainty and may very well reflect a poor policy choice. Often, statements that, when made, did not seem significant may appear material with the benefit of hindsight. The SEC's indication in the Regulation FD Adopting Release (hereinafter "FD Adopting Release") that it does not intend to second-guess mistaken judgments about materiality made in "close calls" has not provided companies with much comfort in this regard.

The SEC unfortunately provided a non-exhaustive list of types of information or events that will often, but not necessarily in all cases, be material. These include:

- earnings information (this has caused more confusion than help);

- mergers, acquisitions, tender offers or similar transactions;

- developments regarding new products, customers or suppliers;

- changes in management;

- events regarding a company's securities, such as stock splits and public or private offerings;

- changes in audits or audit reports; or

- bankruptcies.

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Perhaps the most troubling aspect of the release adopting Regulation FD is the discussion by the SEC of materiality in the context of analyst guidance. According to the FD Adopting Release:

> When an issuer official engages in a private discussion with an analyst who is seeking guidance about earnings estimates, he or she takes on a high degree of risk under Regulation FD. If the issuer official communicates selectively to the analyst nonpublic information that the company's anticipated earnings will be higher than, lower than, or even the same as what analysts have been forecasting, the issuer will likely have violated Regulation FD. This is true whether the information about earnings is communicated expressly or through indirect "guidance," the meaning of which is apparent though implied. Similarly, an issuer cannot render material information immaterial simply by breaking it into ostensibly non-material pieces.

On the other hand, if a senior official provides a market professional with non-material information that the analyst uses to complete a "mosaic of information," the company would not, according to the SEC, be in violation of Regulation FD. The SEC claims that it does not intend to discourage analysts from "sifting through and extracting" information that may not be of interest to the ordinary investor. Nonetheless, it is clear that any guidance regarding financial forecasts or models should be considered material under the Regulation. Moreover, based upon the SEC's statements in the release, a company official is most likely violating Regulation FD even if he or she merely states, "I am comfortable with street expectations" to an analyst without making the same statement publicly. As a result, companies will need to use caution in discussing with analysts their earnings models, whether in private conversations or at investor conferences, and in reviewing analyst reports, if they elect to do either.

B. To what disclosures does the Regulation apply?

- Regulation FD applies to disclosures made to certain enumerated persons by a company's senior officials or any other officers, employees or agents of the company who normally communicate with investors and analysts, when the person making the disclosure knows, or is reckless in not knowing, that the information disclosed was *both* material *and* nonpublic.

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- Senior official" means any director, executive officer, investor relations or public relations officer, or other person with similar functions.

- The SEC has made clear that a company can be held liable for selective disclosure of material nonpublic information made by any other person who acts at the direction of a senior official.

- The Regulation does not apply to communications made in connection with most registered securities offerings (e.g., "roadshow" presentations to potential investors in a public offering). Regulation FD does, however, apply to regular communications that happen to occur during a registration, such as regularly scheduled conference calls with analysts.

C. Who are the "Enumerated Persons' to whom Regulation FD applies?

Regulation FD covers only disclosures made by a company to analysts and other securities market professionals, including broker-dealers, investment advisors, investment companies and hedge funds, and to holders of the company's securities when it is reasonably foreseeable that the security holders will trade on the information.

Regulation FD does not apply to:

- communications with the press or rating agencies (where the ratings are made publicly available) or ordinary-course business communications with customers and suppliers; or

- disclosures of material information to persons who are bound by duties of trust or confidence not to disclose or use the information for trading, such as outside legal counsel and independent auditors.

- Under the Regulation, companies and their officials may also share material nonpublic information with outsiders when those outsiders expressly agree, orally or in writing, to keep the information confidential (e.g., with parties engaged in discussions with a company regarding a potential merger transaction).

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D. What are "Intentional" and "Non-Intentional" disclosures?

- Disclosure is considered intentional when the person making the disclosure either knew, or was reckless in not knowing, prior to making the disclosure that he or she would be communicating material nonpublic information. *If an intentional disclosure is made, broad public disclosure must also be made simultaneously. Therefore, Regulation FD provides, in effect, that companies are prohibited from intentionally selectively disclosing material information to analysts or other securities industry professionals.* According to the SEC, in the case of selective disclosure due to a mistaken determination of materiality, the company will be liable only if "no reasonable person under the circumstances" would have made the same determination.

- Non-intentional disclosure occurs when the person making the statement reasonably believed it was immaterial or already public. *If a non-intentional disclosure is made, Regulation FD requires "prompt" public disclosure. Prompt disclosure is disclosure made within 24 hours, or by the start of the next trading day (applicable in the case of non-intentional disclosure made on a Friday or weekend), whichever is later, after a senior official of the company learns that the information has been disclosed and knows, or is reckless in not knowing, that the selectively disclosed information is material and nonpublic.*

E. How do companies make the public disclosure required by Regulation FD?

A company can comply with its obligation to make public disclosure by filing a current report on Form 8-K containing the disclosed information under Item 5 or by furnishing (rather than filing) the information to the SEC on Form 8-K under new Item 9. The SEC maintains that the filing or furnishing of information on a Form 8-K solely to satisfy the requirements of Regulation FD will not, by itself, be deemed an admission of materiality.

- A company has alternatives to filing a Form 8-K:

– A company may make public disclosure by disseminating 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.

– A company may make public disclosure by disseminating information through any other method, or combination of methods, of disclosure that is reasonably designed to provide broad public access and does not exclude

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access to members of the public – such as announcement at a press conference to which the public is granted access (by personal attendance or by live telephonic or electronic transmission). In order to afford broad public access, a company must provide notice of the disclosure in a form that is reasonably available to investors, such as a press release. Although a company may also post information on its website, that posting by itself generally will not be considered to be a sufficient means of public disclosure under Regulation FD[436].

The SEC states that, in evaluating public disclosure under Regulation FD, it will take into account facts and circumstances in determining whether the method used was reasonably likely to widely disseminate the information.

F. How is Regulation FD enforced?

- If a public company fails to comply with Regulation FD, the SEC has authority to bring an administrative action seeking a cease-and-desist order or a civil action seeking an injunction or civil money penalties.

- There is no private liability under Regulation FD, and no private liability under Rule 10b-5 will arise ***solely*** from a company's failure to file or make public disclosures required by Regulation FD. As the SEC clearly notes in the FD Adopting Release, however, the actions that constitute violations of Regulation FD can still give rise to 10b-5 liability. For example, liability for "tipping" and insider trading may exist if selective disclosure is made by a person who receives a "personal benefit" in exchange for making the disclosure. A company could also potentially be held liable under 10b-5 for adopting, or entangling itself with, analyst forecasts. Thus, Regulation FD does not provide insulation from any 10b-5 liability that might otherwise exist. Further, a company may be liable under 10b-5 if any public disclosure made under Regulation FD contains false or misleading statements or omits material information.

- Failure to comply with Regulation FD will ***not*** result in a public company's loss of eligibility to use short-form registration for a securities offering (e.g., on Form S-3) or affect stockholders' ability to resell pursuant to Rule 144 under the Securities Act of 1933.

[436] Former SEC General Counsel Ralph Ferrara has described the 8-K Item 9 filings of a number of issuers. Ralph C. Ferrara and Ellen D. Marcus, "Item 9 Trends: A Window on Regulation FD in Action, 6 no. 16 Andrews Sec. Litig. & Reg. Rep. 15, March 28, 2001

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G. What are KMZ's recommendations for compliance with Regulation FD?

Regulation FD was recently adopted. There are no cases yet and the SEC has issued some telephone interpretations. Accordingly, any advice that can be given now is, of necessity, preliminary and involves some speculation. At the same time, we recognize that many companies are being inundated by wide-ranging recommendations from various sources, some of which simply may not be practical. We believe it will take some time before anyone can truly recommend best practices for compliance with Regulation FD. Furthermore, appropriate responses to the Regulation may differ from company to company. We urge every public company to work with its legal counsel and investor relations professionals to understand the scope of the Regulation and to establish its own plans for complying with the Regulation and for staying apprised of developments. These efforts should include a review of current company practices, considering the types of information that previously have been requested by, and provided to, analysts and institutional investors.

Nevertheless, we have some initial general recommendations:

- Companies with comprehensive written disclosure policies should carefully review and, if necessary, modify them to ensure that they are consistent with the requirements of Regulation FD.

- Companies that do not currently have comprehensive written disclosure policies are strongly recommended to adopt such policies that are consistent with the requirements of Regulation FD or, at a minimum, adopt detailed guidelines for compliance with Regulation FD.

- Each company should consider including in its disclosure policy (or Regulation FD compliance guidelines):

  - limitations on who is authorized to talk to analysts and investors on behalf of the company;
  - clear limits on the permitted scope of communications during private sessions with analysts or other market professionals or at investor conferences;
  - specific procedures to inform designated company officials if material information is inadvertently selectively disclosed and, in any such case, to rapidly make the requisite public disclosure;
  - a requirement that more than one company representative participate in conversations with analysts and institutional investors;
  - a requirement that, before any authorized representative discloses any information that is in a "gray area" as to materiality, the representative should review the proposed disclosure with designated company

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officials, including internal legal counsel and, where appropriate, outside counsel;

- a requirement that earnings calls and other conference calls with analysts and institutional investors be webcast and/or opened up to the public and media on a "listen only" basis, with advance public notice of the calls, and then be made available for replay on the company's website for a limited time period; and
- specific policies regarding reviewing (or not reviewing) drafts of analyst reports to avoid giving financial guidance or other material information that would have to be publicly disseminated.

• Companies should also consider regular public dissemination of forward-looking data that has been typically provided to analysts. By providing more information publically, perhaps even between regularly scheduled earnings conference calls, we believe companies will be able -- based on the SEC accepted mosaic concept -- to have more productive one-on-one calls or meetings with analysts; analysts and investors can drill down for more details concerning the already public information. To the extent companies publish forecasts or other prospective information, they should be certain to take advantage of the "safe harbor for forward-looking statements." Any safe harbor language should be carefully crafted and tailored to the particular statements being made. "Boilerplate" language should be avoided.

• Those individuals who administer a company's disclosure policy or are authorized to talk to analysts on behalf of the company should be properly trained and should clearly understand the requirements of Regulation FD.[437/]

2. SEC Telephone Interpretations of Regulation FD

The Commission continues to receive numerous questions regarding the application of the rule. On October 19, 2000, just prior to the rule's effective date, the SEC published answers to several Regulation FD questions and subsequent interpretations were issued in December 2000 and May 2001.[438]

437/ John Huber and colleagues at Latham & Watkins have assembled the advice of a member of public relations and law firms to their clients on how to comply with Regulation FD. This information can be found at John J. Huber, Thomas J. Kim, Brian G. Cartwright, Kirk A. Davenport, Erica H. Steinberger, "The SEC's Regulation FD – Fair Disclosure", May 4, 2001 at pp. 85-92.

438 See SEC Staff Releases Interpretive Guidance for Regulation FD, www.sec.gov/news/guidefd.html (Oct. 19, 2000, Dec. 6, 2000 and May 30, 2001) (hereinafter referred to as the "Regulation FD Telephone Interpretations"); Katten Muchin Zavis, Client Advisory, "SEC Answers Questions Regarding Regulation FD (Fair Disclosure)," (Oct. 23, 2000).

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Confirmation of Forecasts: The SEC indicated that Regulation FD allows selective confirmation by an issuer of its own forecasts only if the confirmation does not convey any new material information. The materiality of the confirmation depends on the amount of time that has passed since the forecast was made, as well as any intervening events that may have taken place during that time.[439]

Notice of Conference Calls: Under Regulation FD, material nonpublic information may be disclosed through conference calls open to the general public or by Webcasting. The SEC requires the companies to give adequate advance notice of any conference call, and any such notice must contain the time, date and dial-in information for the call.[440]

Public Filings Other than Form 8-K: Form 8-K is not the only form which satisfies the disclosure requirements under Regulation FD. Companies may satisfy their obligation under the rule by including the material information in any public filing on EDGAR, such as a 10-Q or proxy statement, however, companies should highlight that information in the filing.[441]

Waiting Period Following Disclosure: As soon as the public filing is made, the issuer may selectively disclose such information in private meetings with analysts. The issuer must only confirm that the filing precedes the private conversations.[442]

Agreement to Maintain Confidentiality: An issuer may disclose material nonpublic information to an analyst if the analyst expressly agrees to maintain a confidential relationship.[443]

Disclosures Made to Employees: Disclosures made to employees are not subject to Regulation FD as the Regulation only applies to disclosures made to persons "outside the issuer."[444]

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[439] Katten Muchin Zavis, Client Advisory, "SEC Answers Questions Regarding Regulation FD (Fair Disclosure)," (Oct. 23, 2000).

[440] Id.

[441] Id.

[442] Id.

[443] Id.

[444] Id.

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3. April 2001 SEC Roundtable

While it is still too soon to assess Regulation FD's effect on issuer/analyst relations, this topic is currently the subject of considerable debate. Many commentators speculate that the new rule will result in a chilling effect on analysts' access to vital corporate information. Accordingly, analysts are concerned that there will be greater risks of error in preparing earnings estimates as a result of being barred from private conversations with issuers.[445]

Moreover, during this adjustment period, analysts' daily jobs are arguably more difficult and time consuming. For example, during the pre-Regulation FD period, if an analyst had a specific question about a public company, he or she would use corporate contacts to quickly talk to the issuer and adjust any calculations. Now, however, analysts must sit through long conference calls with other analysts and "Main Street" investors. The analysts must now listen to all mundane questions as they are forced to weed through corporate data looking for figures, upon which they can base earnings estimates. For Wall Street professionals and corporate executives, the once-mundane conference call is a necessity to either give or gather corporate information despite its frustrating characteristics.[446]

There have been a number of studies of the effects of Regulation FD, but none of them is conclusive especially in light of the volatile markets we have had since the Regulation's adoption.[447/] To demystify the effects of Regulation FD, the SEC held a Roundtable discussion in New York on April 24, 2001. Acting Chairman Laura Unger convened the Roundtable and Commissioner Hunt participated. The presentors included representatives from issuers, information disseminators and the media, analysts, institutional investors and the bar, including the author. There was a lively discussion extensively reported in the press. As could be anticipated, there were pro and con positions on (i) whether Regulation FD has been a cause of the market's recent volatility, (ii) whether issuers

[445] See Jeff Opdyke, "The Big Chill: Street Feels Effect of 'Fair Disclosure' Rule," The Wall Street Journal, October 23, 2000, p. C1.

[446] Id.

[447/] National Investor Relations Institute, Corporate Practices Survey 2001, http://niri.org/publications/cdps 2001.pdf (March 7, 2001); Association for Investment Management and Research, Regulation FD e-Survey Summary, www.aimr.org/pressroom/01releases/regFD_survey.html (March 26, 2001); the Federal Regulation of Securities Committee of the Business Law Section of the American Bar Association asked its members to evaluate the operatoins of Regulation FD; the preliminary results can be found at www.abanet.org/buslaw/fedsec/comnews.html, see Preliminary Survey.

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are releasing less information, (iii) whether analysts are finding it more difficult to build a mosaic picture, (iv) what are the real costs of compliance, (v) the ease or difficulty of compliance and (vi) whether more guidance from the SEC is necessary. My take away was that (i) it is too early and we do not have enough information to determine whether Regulation FD has been a factor (and, if so, to what extent) in the market's volatility, (ii) there is more widely dispersed information being made available, but the information is below the quality of information communicated prior to Regulation FD's adoption, (iii) the professional disseminators and the media generally love Regulation FD and (iv) issuers have found some problems with Regulation FD but are not unduly unhappy with it while analysts and institutional investors admit they can live with Regulation FD but do genuinely believe they are receiving less quality information.

My presentation to the Roundtable focused on three issues:

because of the almost unlimited scope of Regulation FD, it is too early to assess the Regulation's full impact;

in the Release adopting Regulation FD, the SEC unnecessarily added confusion and uncertainty to the concept of materiality; and

the SEC's goal of more public disclosure of material information -- especially forecasts – would be advanced if either the courts or the SEC untangled the duty to update doctrine.

Too Early To Tell: As a disclosure rule, Regulation FD cuts across almost aspects of securities laws. I do not think this was fully appreciated when the Regulation was adopted and, consequently, we have not yet had enough experience to evaluate how the rule operates over its full spectrum. Three examples will illustrate this. First, disclosures made at annual stockholders meetings and in annual reports to stockholders are subject to Regulation FD. I do not believe that at the time of adoption anyone realized that if anything material was going to be revealed at an annual meeting of stockholders, the full panoply of Regulation FD disclosure had to be followed.[448/] Moreover, a general counsel discussed with me the following scenario, namely, the company's practice had been to issue its year-end earnings release and have an analyst conference call in mid February, mail its annual report to its stockholders in late February or early March and file its 10-K with the SEC in late March. The question

[448/] SEC, Division of Corporate Finance: Regulation FD Telephone Interpretations (Question 4, Oct. 2000).

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was whether, because the annual report contained complete financials and the MD&A and was thus more detailed than the year-end earnings release, could the annual report be sent to stockholders without complying with Regulation FD? Probably not, even though it would be hard to argue that the company was making improper selective disclosure by mailing its annual report to its stockholders. Second, the broad reaches of Regulation FD have not been fully integrated with Regulation M-A.[449/] Care must be taken that both Regulations must be satisfied even though they have different timing and filing requirements. Third, Regulation FD applies to private placement disclosure but does not to disclosure made "in connection with a securities offering registered under the Securities Act…"[450/] We simply have not had robust private or public markets to test whether the Regulation's different approaches to these offerings will work.

The SEC's Assault on Materiality: The central defect with Regulation FD is not necessarily the Regulation itself but the SEC's overzealous attempt to extend the concept of materiality beyond the Supreme Court's definition. Had the SEC stopped with the Court's definition of materiality as set forth in the TSC Industries and Basic decisions[451/], it would avoided the mischief it created by attempting to enlarge it. In at least three ways, the SEC went beyond TSC/Basic:

The laundry list of seven items contained in the FD Adopting Release[452/] has only added confusion rather than sunshine. To include the simple phrase "earnings information" in the list along with bankruptcies, creates the impression that any earnings information is material.

The paragraph in the FD Adopting Release that takes special pains to emphasize that anyone who provides analysts with earnings guidance "takes on a high degree of risk under Regulation FD" goes far beyond what was necessary to avoid selective disclosure of material information.[453/]

[449/] Stephen Glover, Should M&A Lawyers Worry About Regulation FD?, the M&A Lawyer, Oct./Nov. 2000, p. 24; Erica H. Steinberger & John J. Huber, The Effect of Regulation FD on Mergers, Acquisitions and Proxy Solicitations and the Requirements of Regulation M-A, id. p. 1.

[450/] Rule 243.100(b)(2)(iv).

[451/] See FD Adopting Release 33-7881, p. 8 and notes 38 and 39, Aug. 15, 2000 (citing TSC Industries, Inc. v. Northway, Inc. 426 U.S. 438, 449 (1976) and Basic v. Levinson, 485 U.S. 24,231 (1988)).

[452/] FD Adopting Release, p.8.

[453/] Id.

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The citation to SAB 99 is confusing. Does the SAB apply "only" to financial statements or does the SEC view it as a general definition of "materiality?"[454] In either case, SAB 99 is not a rule and when published was not subject to comment and review under the Administrative Procedure Act.[455] Its focus, moreover, dealt with known misstatements in financial statements and how to deal with them. The laundry list of considerations in SAB 99 that may make a small misstatement material are really concerned with intentional or manipulative conduct (e.g., "masks"; "hides"; "changes a loss into income"; affects compliance with regulatory requirements or loan covenants; increases management's compensation or conceals "an unlawful transaction."[456] Unfortunately the language in SAB 99 is both overbroad and is unnecessary to combat the evil the SAB was designed to eliminate.

In the FD Adopting Release, the SEC acknowledges the existence of the mosaic doctrine but it is exceedingly difficult to separate non-material mosaic pieces of information from, for example, "earnings information." This, I believe, is the reason lawyers have been conservative and cautious in the disclosure advice they are giving to their issuer clients. Further evidence of the defects in the FD Adopting Release is contained in the Staff's telephone interpretations. In Interpretation 1, the Staff clearly retreats from the advice given in the FD Adopting Release concerning the avoidance of providing earnings guidance: the SEC answers "Yes" to the question "Can an issuer ever confirm selectively a forecast it has previously made to the public without triggering the rule's public reporting requirements?" Moreover, former General Counsel Harvey Goldschmid (one of the architects of Regulation FD) is reported to have stated "I think the final SEC Release [on Reg. FD] is a little too strict on earnings guidance."[457]

The quest for specific bright lines to define materiality is doomed to failure. The SEC institutionally cannot provide a bright line that could be used as a roadmap for those willing to engage in manipulative or fraudulent conduct.[458] If the SEC did provide more guidance on

[454] Id.; see supra note 49 and accompanying text.

[455] The courts have, however, deferred to SAB 99; see supra note 57 and accompanying text.

[456] SEC Staff Accounting Bulletin: No. 99-Materiality, p. 3-4; Aug. 12, 1999.

[457] Sec. Reg. & Law Rep., vol. 33, no. 19, May 14, 2001, p. 723.

[458] The SEC has, however, created at least two such lines when the public policy considerations in favor of doing so are overwhelming and the risk to investors is slight. The first is contained in the 1989 Interpretative Release where an exception for MD&A purposes is made for merger negotiations. See supra

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materiality, I fear it would only enlarge materiality and cause more confusion and uncertainty. As the old proverb goes, "don't wish for it, you might get it."

We should not despair, however, that the SEC will not provide us with further guidance concerning the parameters of materiality. I sincerely believe that we can live with the Supreme Court's definition, if the SEC refrains from enlarging or amplifying it. When the Supreme Court heard the Basic case in 1988, many argued that the Court should have provided a brightline test and they were disappointed when the Court declined to do so. These advocates feared that in the wake of the Basic decision the necessity to conduct a fact-specific materiality analysis would preclude dismissal of many Rule 10b5 actions on a motion to dismiss or a motion for summary judgment. This apprehension did not materialize, however, and is reflected in Section II, B., supra. The Courts have continued to apply traditional materiality concepts and have continued to dismiss Rule 10b5 cases on motion.

The Need to Clarify the Duty to Update: To further the goal of encouraging more disclosure of quality, timely and forward-looking information, the courts or the SEC should adopt the position that there is no duty to update previously disclosed information that was true when released and has become inaccurate.[459/] Although some courts have recognized a duty to update, I believe a credible argument can be made that almost all of the courts are finding ways to narrow the duty – even if they acknowledge it exists -- to the point where they have basically accepted the notion that there is no duty to update except in egregious situations.[460/] Despite my reading of the cases, however, issuers are reluctant to provide more forward-looking information because it is difficult to counsel them as to whether a duty to update exists and if so, when that duty becomes operative other than in required SEC filings.

Many thought that the Reform Act eliminated the duty to update but a number of commentators and the SEC have not accepted this

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Section IV.B.2. and the exception created in Regulation FD for disclosures made in connection "with a securities offering registered under the Securities Act. Rule 243.100(b)(2)(iv).

459/ See generally Sullivan & Cromwell, Regulation FD – Designing Disclosure Policies to Reduce the Risk a "Duty to Update" Will Apply to Earnings and Other Guidance, Feb. 12, 2001. In May 2001, a SEC Task Force urged as a public policy more disclosure of forward looking information as being in the public interest. For further information regarding the SEC Task Force, see Report of an SEC-Inspired Task Force, chaired by Jeffrey E. Garten, Dean of the Yale School of Management, "Strengthening Financial Markets; Do Investors Have The Information They Need?" (May 2001).

460/ See III, F., supra.

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proposition. In the telephone interpretations, the SEC responded to the question of whether Regulation FD created a duty to update by stating "No" and going on to say "Regulation FD does not change the existing law with respect to any duty to update."[461] This stance simply forces us to look at the case law prior to the adoption of the Reform Act. As I have stated, the black letter case law is unclear (even though the results of the decisions appear to negate the duty to update) and thus issuers have been reluctant to provide forward-looking information. This could be remedied by the Supreme Court or the SEC. It is supported, moreover, by the "Bespeaks Caution" doctrine since reliance cannot be justified if updating has been disclaimed.[462] If an issuer makes clear when it discloses information that it does not plan or take on a responsibility to update it, and does so in plain understandable language, this should be sufficient to defeat duty to update claims.

F. Conclusion

Because Regulation FD has recently been adopted, its mandates have not yet been applied to any specific facts. Accordingly, any advice rendered during this period is subject to further refinement. Nonetheless, analysts should continue to work with issuers in both initial public offerings and offerings for publicly-held companies. Issuers should also adopt written policy statements indicating their level of involvement with analysts and their stance on reviewing analysts' reports.[463] Issuers should also adopt internal guidelines which clearly articulate who is responsible for communication with analysts, and who will review any materials supplied to analysts. The company should be certain that these designated individuals understand the requirements of Regulation FD. Furthermore, to ensure the rapid and requisite public disclosure, procedures to inform designated company officials if material information is inadvertently selectively disclosed should be immediately adopted. Finally, in response to the new rule, companies may also wish to regularly disseminate data, such as monthly sales figures previously reserved for analysts, to the public at large. Perhaps if issuers publicly disclose a larger array of detailed information (e.g., projected tax rates, cap x, r&d expenses, etc.) analysts may be better equipped to calculate earnings estimates, draw conclusions based on the statistics and trends, and quiz the issuer about the disclosed information without creating FD

[461] Regulation FD Telephone Interpretations (December 6, 2000).

[462] See III.E., supra.

[463] Regulation FD generally negates the prior practice of giving "comfort" to analysts projections. See, however, Ronald O. Mueller & Gavin A. Beshe, "Securities Disclosure – Cold Comfort: The Risks of Expressing "Comfort" With Analysts' Estimates," Insights, vol. 12, no.7, July 1998; Malone v. Microdyne Corp. See 26 F.3d 471 (4th Cir. 1994) (comfort statements non-actionable unless they rise to a level of a guarantee), contra, In re Pressetek, SEC Rel. no. 34-39472 (Dec. 22, 1997) (very unusual facts).

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problems.[464] The public disclosure, moreover, of more comprehensive information packages on a periodic basis may mitigate market volatility.[465]

VI. ROAD SHOWS

Road Shows are an integral part of the public offering process and other securities transactions. They serve a useful function as the issuer and its principal officers are displayed before potential investors. This leads to incisive questioning by experts and produces, in some respects, a more negotiated transaction.

A. Disclosure of Information at Road Shows

Lawyers generally play a small or non-existent part in the preparation or execution of the road show. Cautious issuer counsel frequently advises the client to confine its presentations at the road show to material included in the registration statement, to refrain from making predictions, and not to distribute other materials.[466] Very little case law or formal SEC rulings exist dealing with statements made at road shows. Many of the class action securities fraud suits brought in the past few years have specifically alleged that the road show was used as a vehicle to create demand for the securities by painting an extremely positive picture of the issuer and by having the issuer and underwriter both make forecasts that the issuer would enjoy continued profit growth.

In In re Hyperion Securities Litigation,[467] the plaintiffs attempted to bolster their allegations of securities fraud through excerpts of information--scripts and slides -- used during the road shows. The court agreed that the "road show scripts were more optimistic about risks and returns than the prospectuses." Despite this, the court, looking at the total mix of information available and applying the "Bespeaks Caution" Doctrine, held that the plaintiffs could not "predicate their claims on inferences drawn

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464 See Edward D. Herlihy, Paul K. Rowe & Craig M. Wasserman, Wachtell, Lipton, Rosen & Katz, "Regulation FD and the New Channels of Financial Communications: Its Bark is Much Worse Than Its Bite", October 20, 2000. If an issuer follows this approach, it is essential that realistic safe harbor language be used and up front disclosure is made concerning updating.

465 See id.

466/ Commentators have noted that materials other than the preliminary prospectus or corporate documents (Forms 10-K, 10-Q, and 8-K reports) should be collected at the end of the presentation. For a general discussion of the procedural do's and don'ts of roadshows, See The Road Less Traveled: The Advent of Electronic Roadshows, Insights, vol. 11, no. 7, July 1997.

On a related subject, see generally SEC Rel. No. 33-7516, Mar. 23, 1998, describing the SEC's views on the "Use of Internet Web sites To Offer Securities, Solicit Securities Transactions, or Advertise Investment Services Offshore."

467/ Fed. Sec. L. Rep. (CCH) ¶98,906 (S.D.N.Y. 1995).

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from statements made during the road shows if, as here, those inferences are contradicted by specific disclosures in the prospectus."

B. Electronic Road Shows

Between the filing date and the effective date of a registration statement, offers which constitute a prospectus may only be made through the filing of a preliminary prospectus. According to §2(10) of the 1933 Act, a prospectus is "any . . . communication, written or by radio or by television, which offers any security for sale or confirms the sale of any security." It is therefore important that road shows, which generally consist of a series of presentations by an issuer and its underwriters to seek interest in a public offering, remain outside the definition of a prospectus. Recently, in a move toward the acceptance of technology, the staff of the SEC ruled that it would not treat the video transmission of a road show presentation to a restricted audience as a prospectus. By concluding that the electronic transmission of a road show is not a prospectus, the SEC would not subject the transmission to the type of review reserved for prospectuses. This ruling will enable road shows to reach a vast audience in a shorter period of time. Additionally, the SEC is beginning to examine the issue of internet road shows.[468]

In its No-Action letter to the SEC, the Private Financial Network ("PFN")[469] proposed to transmit road shows for public offerings to its subscribers, either live or on a delayed basis.[470] PFN stated that these transmissions of road shows would help issuers channel timely and consistent information about themselves and their securities to investors who otherwise could attend the shows, but might find it expensive or difficult to do so. PFN stated that the video transmission of a road show would only be considered a prospectus if it constituted radio or television within the meaning of §2(10) of the 1933 Act. PFN argued that §2(10) refers to broadcasting, not to the use of radio or television technology for closed circuit or other "controlled retransmission of non-prospectus materials."[471] PFN noted that closed circuit television transmissions of road shows are tantamount to live presentations where parties interact face to face.[472]

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468 See, for a general discussion of the No-Action Letters relating to internet road shows to date, Stephen J. Schulte and Steven J. Spencer, *IPO Road Shows in the Electronic Age: SEC No-Action Letters Adressing Use of the Internet and Closed Circuit Systems*. Aspen Law & Business Corporation, June 15, 2000.

469/ PFN is a wholly owned subsidiary of MSNBC Interactive LLC, a joint venture of the National Broadcasting Co., Inc. and Microsoft Corporation. PFN has fewer than 100 subscribers who are principally registered broker/dealers and investment advisors.

470/ Private Financial Network, SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) ¶77,332, at 77,675 (Mar. 21, 1997).

471/ Id. at 77,676.

472/ For a general discussion of PFN, See The Road Less Traveled, supra note 350, at 5-7.

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The SEC indicated that it would not consider the transmission of a road show presentation a prospectus if the following requirements are followed:

- prior to the video transmission, each PFN subscriber must receive a filed prospectus from the issuer or underwriters of the security;
- the video transmission must be made to a restrictive audience (only PFN subscribers) who would agree not to videotape, copy, or further distribute the presentation;
- the issuer and underwriters must take reasonable steps to ensure that the information in the road show presentation is not inconsistent with the filed prospectus (that each subscriber received);
- each transmission must be preceded and followed by visual statements referring viewers to the prospectus for more information and there also must be repeated visual statements that the transmission cannot be videotaped or copied or used in any manner to sell securities to the public.

The SEC expanded its position in accepting other forms of communication for the use of electronically transmitting roadshows in its No-Action Letter to Net Roadshow, Inc.[473] After the filing of a registration statement, Net Roadshow proposed to provide via the Internet a Web site of roadshows for viewing by qualified investors and underwriting banks. Net Roadshow proposed that to access the Web site and to maintain the integrity of the roadshow as not a prospectus within the meaning of Section 2(a)(10) of the Securities Act, the following preconditions occur:

- the qualified investor must contact the investment bank for an access code to view the roadshow;
- the internet roadshow would be the exact same roadshow as the live presentation;
- the preliminary prospectus could be printed from the Web site;
- before accessing the roadshow, the potential viewer would be advised of, and must agree to, the contents of a standard red herring and the prohibition on distributing any roadshow materials;
- periodic text would flow across the screen of prominent sections; and

473/ Net Roadshow, Inc. SEC No Action letter, Fed. Sec. L. Rep. (CCH) ¶77,367 (Sept. 8, 1997).

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- Net Roadshow's fee would not vary with the success or failure of the underlying offer.

Based on the above factors, the SEC indicated it would take a no action position, and that such transmissions would not constitute a prospectus under 2(a)(10) of the Securities Act.[474]

The SEC has visited the issue of Internet road shows in recent months. Activate.net Corp. requested a no-action letter for its business of transmitting road shows for public offerings over the internet under the facts and circumstances described below:[475]

- Access to the road shows must be via underwriter given passwords only. The underwriters will agree not to assign passwords unless a registration statement is on file with the SEC, that passwords will only be given if the viewer is someone who the underwriter would customarily invite to a live road show, and each viewer will have been provided with a copy of the statutory prospectus.

- The presentation would be exclusively controlled by the managing underwriters for the offering, and no questions from prospective investors can be pre-screened or edited.

- Activate.net Corp represented that it would not hold any investor or customer funds, participate in the negotiation or structuring of any transactions in which securities are to be offered or sold, prepare any substantive disclosure transmitted during the roadshows, or be responsible for the solicitation of any prospective investors.

Noting that "because regulatory responses to legal issues raised by technological developments may evolve," and therefore its no-action position "may be reevaluated in the future," the Staff of the SEC issued a no-action letter to Activate.net Corp.[476]

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[474] See also Bloomberg, SEC No Action Letters Ind & Summaries (WSB) #120197011 (December 1, 1997) (SEC takes a no action position over Bloomberg offering similar internet roadshow services). More recently the SEC stated in an interpretative memorandum that, for purposes of the registration requirements only, offshore Internet offers of securities and solicitation activities would not be considered to be made "in the United States" if Internet offerors implement measures similar to those outlined in the Net Roadshow No-Action Letter which are reasonably designed to ensure that such offshore Internet offers are not targeted to the United States or to U.S. persons. See SEC Rel. No. 33-7516 (Mar. 23, 1998).

[475] Activate.net Corp. request for No-Action Letter. Fed. Sec. L. Rep. (CCH) ¶77,626 (1999).

[476] For a discussion of the SEC's response to Activate.net, see, Electronic Road Show Transmission Over Internet Not a Prospectus, Staff Agrees, Securities Regulation & Law Report, Vol. 31, No. 38 (Oct. 1999) at 1318. See, also, Internet 'Road Show' Isn't Prospectus, SEC Says, Corporate Counsel Weekly, No. 39 (Oct. 1999) at 2.

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In November of 1999, the SEC issued a no-action letter to Charles Schwab & Co., Inc., stating that while it's position "rests on policy considerations alone, including the Commission's goal of reducing selective disclosure of material, offering-related information typically provided during roadshows,"[477] it would not recommend action against Schwab for offering internet road shows with the following requirements:

- password-protected environment;
- available only to accounts that have significant trading experience (at least 24 trades per year) *or* asset accumulation of at least $500,000 equity in household investment positions and to independent registered investment advisers;
- only road shows dealing with initial public offerings of securities would be communicated over the internet, and only then after the registration statement had been filed and a preliminary prospectus was distributed;
- the preliminary prospectus will be easily available from the screen displaying the road show, and a statement on the screen will encourage viewers to look at the prospectus;
- Schwab will, to the extent it engaged third-party vendors to promote its internet road shows, abide by the safeguards put upon the third-parties (other than limitations on the qualifications of persons entitled to view the presentation, if they are more restrictive than Schwab's own restrictions); and
- only one version of the live road show will be available on the internet.

The potential benefits of internet roadshows closely track those of PFN, as above.

In February, 2000, however, the SEC, in an attempt to clarify its position, retreated from its broad stance set forth in the Schwab no-action letter[478]. In this follow up letter, the SEC limited its acceptance of Schwab's transmittal of electronic roadshows to the Schwab customers described above to situations where all of the following conditions are met:

477/ SEC No-Action Letter to Charles Schwab & Co., Fed. Sec. L. Rep. (CCH) ¶ 77,650 (dated November 15, 1999) .

478 Charles Schwab & Co., SEC No-Action Letter, Fed Sec. L. Rep. (CCH) ¶77,814 (February 9, 2000)

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- the roadshow may not exclude any material information (e.g., earnings projections) that is intended to be included in any other presentation of the roadshow;
- only one version of the live road show may be available on the internet; and
- the content of the electronically transmitted roadshow must be consistent with the content of the statutory prospectus relating to the offering.

Even with the limitations imposed by the SEC's February, 2000 follow-up letter to Schwab, the SEC's acceptance of electronic road shows will undoubtedly have a substantial effect upon how issuers and underwriters reach prospective investors. These rulings allow American companies and the financial industry to benefit from technology that has never been available before, allowing for a "rapid dissemination of information to investors and financial markets in a more cost-efficient, widespread, and equitable manner."[479]

C. Simultaneous Same Sector IPOs

J.P. Morgan recently lead three separate public offerings and pitched all three deals to investors simultaneously by taking each company on a 10 day roadshow where investors could participate in all three offerings as opposed to the usual one offering.[480] This is a progressive strategy because all three public offerings concerned biotech firms and usually the pushing of so many similar offerings at once by one firm, J.P. Morgan, results in a "cannibalistic effect" as investors often become diluted and invest in only one company in a specific sector.[481] Dilution, however, was not the result of the three simultaneous biotech offerings, rather, some investors, who would normally only invest in one company, invested in multiple companies during the 10-day roadshow.[482] Accordingly, simultaneous same sector IPOs may become a more common occurrence after the recent success of J.P. Morgan's new strategy.[483]

479/ Net Roadshow SEC No Action Letter, supra note 356, at 77,850.

480 See "J.P. Morgan Utilizes Unique Roadshow Strategy for IPOs", Corporate Financing Week, August 28, 2000, p. 4.

481 Id.

482 Id.

483 Id.

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VII. PLAIN ENGLISH

According to SEC Chairman Arthur Levitt, disclosure "has two aspects: the information that is made available to investors, and the information that actually gets across to investors."[484] Information is made available to investors through various disclosure documents, including the prospectus. The SEC wants to make certain that the information contained in these disclosure documents actually reaches investors. In the last few years, there has been a mass migration of investors into our markets, and for that reason, the SEC stresses now more than ever the importance of making disclosure documents more readable. In 1995, Chairman Levitt appointed a Task Force on Disclosure Simplification (the "Task Force"). In 1996, the Task Force reported that prospectuses are generally unreadable and contain too much legal jargon. The Task Force found that material information was often buried in an avalanche of trivial information. In its Report on Disclosure Simplification, the Task Force concluded that "today's prospectus has become a legal document to shield against liability, rather than a useful and informative disclosure document."[485]

In an effort to promote clear and accurate disclosure, the SEC has recently adopted and implemented the plain English rule which requires registrants to use plain English principles in the organization and language of the cover page, summary, and risk factors section of prospectuses.[486] Many critics of the rationale underlying the rule fear that such "simple" language in such a complex document will expose companies to more liability. The Capital Markets Committee of the Securities Industry Association ("SIA") has taken the position that the stylistic use of plain English should be voluntary, rather than mandated. The SIA noted that "any interpretation of whether or not the words in a prospectus are in plain English necessarily is subjective."[487] The SIA further asserted that the "SEC is not designed or equipped to regulate the use of the English language in this way."[488]

Despite this criticism, the SEC disagrees with the notion that companies will be subject to more liability. In fact, the SEC believes that because plain English results in less confusing and ambiguous disclosure, potential liability will actually be reduced. While the precise language in the document may change, the information will not. In essence, plain English requires drafters to (a) know their audience, (b) know what material information needs to be disclosed, (c) use clear writing techniques to communicate information, and (d) design and structure the document so

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484/ SEC Proposes Rules Requiring "Plain English" in Prospectuses, BNA's Corporate Counsel Weekly, Jan. 22, 1997, at 1.

485/ Fed. Sec. L. Rep. (CCH) ¶85,738 at 87,525 (1996).

486/ See SEC Rel. No. 33-7497 (Jan. 28, 1998). The Rule went into effect and required compliance as of October 1, 1998. Securities Act rule 421(d), within Regulation C, is the Plain English rule.

487/ SIA Committee Urges SEC "Plain English" Initiative Should be Voluntary, BNA's Securities Regulation and Law Report, May 2, 1997, at 610.

488/ Id.

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that it is easy and inviting to read.[489]

A. Know Your Audience

The SEC suggests that you identify the investor groups to whom you are writing. It is important to consider the educational background and financial sophistication of the potential investors. While your audience may include analysts and other industry experts, you must keep in mind that your least sophisticated investors are the people who have the greatest need for a disclosure document they can understand. Therefore, you should tailor your writing style to the audience you plan to reach.

B. Know What Material Information Needs to be Disclosed

In essence, you are required to make a judgment as to the importance of the information that you give and the order in which you present it. You must present all material information in a logical and organized fashion. The cover page should highlight key information about the offering such as the name of the company, the type of security offered, the price and amount offered, and to whom an investor should contact to purchase the securities. The cover page should not contain repetitive information and should be inviting to the potential reader. The summary section should contain a clear, concise, and coherent snapshot description of the most significant aspects of the offering. In addition, the risk factor section should also be written in Plain English without the use of boiler plate language or legalese.

C. Use Clear Writing Techniques to Communicate Information

The plain English rule systematically outlines the structure, design, and language style to be used in prospectus writing.

The new Rule requires (1) the front and back cover pages, (2) the summary, and (3) the risk factors section of prospectuses to comply substantially with six principles of plain English:

- active voice
- short sentences
- definite, concrete, "everyday" language
- tabular presentation or bullet lists for complex material
- no legal jargon or highly technical business terms
- no multiple negatives

[489] Note that the SEC considered, but declined to adopt rules limiting the length of the summary and the number of risk factors included, or requiring registrants to prioritize risk factors. See SEC Rel. No. 33-7497 (Jan. 28, 1998), at 10.

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In addition to these six plain English principles, the new Rule provides standards which are designed to guide issuers in writing the entire prospectus:

- descriptive headings and subheadings should be used
- reliance on defined terms and glossaries must be avoided
- vague and imprecise "boilerplate" language should be avoided, especially in the risk factors section
- complex information should not be copied directly from legal documents without providing a clear and concise summary explanation
- disclosure repeated in different sections of the document should be avoided
- complex, legalistic presentations (e.g., cascading margins, use of cross references which disrupt text flow) should be avoided

The SEC notes the importance of avoiding dense pages of text. It recommends using a dual column design, because white space relieves the eye and encourages the investor to read the document. The SEC recommends using pictures, charts and graphs as long as they are clear and not misleading. Also, the SEC notes that a question and answer format to answer common questions of investors is most helpful. In addition, drafters should use personal pronouns such as "we" and "you" instead of "the company" or "the shareholder" in order to communicate directly with the readers and engage their attention. The SEC has definitely taken a step in the right direction, and hopefully the use of these simple stylistic strategies will help to make disclosure more effective and reduce any potential liability.[490]

VIII. CHANGES TO REGULATION S

Regulation S ("Reg S"), which was adopted by the SEC in 1990, contains a general statement that the registration requirements of Section 5 of the 1933 Act do not apply to offers or sales of securities that occur outside the United States. In addition, Reg S provides two safe harbors from registration requirements of the 1933 Act. The first safe harbor is available to the issuers, underwriters, and other market participants involved in the initial distribution process of securities. The second safe harbor applies to offshore resales by people not involved in the distribution process. The principle behind Reg S is that offshore sales of securities do not require the strict reporting requirements that are applicable to domestic sales of securities. In recent years, however, the SEC has become aware of several abusive practices occurring under Reg S

[490/] For more information about Plain English, see Div. of Corp. In., Before & After Plain English Examples and Sample Analyses, Apr. 4, 1998; and see also the SEC's draft of "A Plain English Handbook: How to Create Clear SEC Disclosure Documents." The draft may be found online at the SEC's Web site at http://www.sec.gov. You may also request a hard copy of this draft by calling the Office of Investor Education and Assistance at 1-800-SEC-0330. In addition, for helpful writing hints, see Elements of Style by William Strunk, Jr. and E.B. White (Macmillian, 3d rev. ed. 1981).

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where securities are placed offshore temporarily in order to evade registration requirements.[491] Often, issuers rely upon Reg S to sell securities outside of the U.S. to avoid the SEC's strict reporting requirements, and after a short waiting period, the securities are resold back into the U.S.

In an effort to eliminate the abusive practices occurring with offshore sales of securities, the SEC has recently adopted a set of amendments to Reg S which affect offshore sales of equity securities of U.S. issuers.[492] The Reg S amendments:

- classify equity securities, including convertible securities, placed offshore by domestic issuers under Regulation S as "restricted securities" within the meaning of Rule 144;

- align the Regulation S restricted period (renamed the "distribution compliance period") for these equity securities with the Rule 144 holding periods by lengthening it from 40 days to one year, the period during which persons relying on the Regulation S safe harbor may not sell these equity securities to U.S. persons (unless pursuant to registration or exemption);

- impose certification, legending, and other requirements, now only applicable to sales of equity securities by non-reporting issuers, on all domestic U.S. issuers' equity securities sold under Regulation S;

- require purchasers of these equity securities to agree not to engage in hedging transactions with regard to such securities unless such transactions are in compliance with the Securities Act;

- make clear that offshore resales under Rule 901 or 904 of equity securities of these issuers that are "restricted securities," as defined in Rule 144, will not affect the restricted status of those securities[493]; and

- Require issuers to report information on Reg S sales occurring after January 1, 1999 on Form 10-Q or Form 10-K, not on Form 8-K within 15 days of the sale as previously had been the case.

While these amendments are welcomed by many who believe the abuses of Reg S need to be eliminated, the Federal Regulation of Securities Committee of the Business Law Section of the American Bar Association has a different view. The members of the Committee have recognized

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491/ See SEC Rel. No. 33-7190 (Feb. 20, 1997) (discussing the problematic practices that have occurred since the adoption Regulation S).

492/ See Securities Act Rel. No. 7505 (Feb. 17, 1998).

493/ Id.

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the abusive practices cited by the SEC, but they emphasized that they believed that most of the abuses cited did not involve truly offshore transactions, but, rather "were essentially domestic transactions with only a superficial and tenuous claim to offshore status."[494] The Committee argued that the proposed changes to Reg S were too restrictive and not warranted by the perceived abusive practices. Only time will tell if the SEC will be successful in its attempt to curb the excessive abuse that has occurred under the former Reg S.

IX. MANAGEMENT MISCONDUCT AND GOVERNMENT INVESTIGATIONS

Incidences of management misconduct and the possibility or inception of government investigations of alleged wrongdoing present unique disclosure problems and raise complex issues regarding materiality, causation, the federalization of state corporate law and self-incrimination.[495] An August 1988 SEC Interpretive Release warned issuers involved in the "Pentagate" government contracting scandal that, because investors may consider questionable conduct and related government investigations material information, these events could trigger line-item disclosure obligations under the federal securities laws.[496]

Several judicial decisions hold that certain corporate improprieties, previously considered immaterial "qualitative" events for disclosure purposes, may in fact have a potentially adverse quantitative impact on the financial condition of the issuer. The Supreme Court's rejection in Basic of a "constructive immateriality" concept in the mergers context makes a public policy rationale for declaring managerial misconduct per se immaterial susceptible to challenge. Although an issuer has no general duty to disclose, these cases indicate that issuers should seriously consider disclosing corporate misconduct and government investigations thereof (i) pursuant to certain line-item disclosure requirements, (ii) within the ambit of the MD&A if there is a reasonable probability that such developments may adversely affect the issuer's results of operations, or (iii) if required to keep other disclosures from being misleading.[497] Specifically, if a

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494/ ABA and NYSBA Reflect on Regulation S Proposals, Federal Securities Law Reports, May 14, 1997, at 7.

495/ For a more complete discussion of materiality and disclosure of "qualitative" information, see George Branch & James Rubright, Integrity of Management Disclosures Under the Federal Securities Laws, 37 Bus. Law. 1447 (1982). See also John F. Olson, Qualitative Materiality — Should Management's Personal Problems Be Disclosed to Shareholders?, Insights, Sept. 1987, at 3.

496/ Exch. Act Rel. No. 25951 (Aug. 2, 1988).

497/ Note that the Private Securities Litigation Reform Act of 1995 requires that independent auditors look for and assess management's response to indications of potential illegality. See Harvey L. Pitt, Karl A. Groskaufmanis, and Vasiliki B. Tsaganos, Director Duties to Uncover and Respond to Management Misconduct, Insights, June 1997, at 5. Where a corporation does not have a proven track record of responding to indications of potential illegality, the auditors may not be able to conclude that the company took appropriate and prompt action in response to then-existing indications of possible illegal actions. Such a result obviously would lead to drastic consequences. See, also, Karl A. Groskaufmanis, Matt T. Morley and Michael J. Rivera, To Tell or Not to Tell: Reassessing Disclosure of Uncharged Misconduct, Insights, June 1999 at 9. While there is no affirmative duty to disclose in MD&A uncharged misconduct,

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significant portion of an issuer's earnings result from questionable management activity or if the company's financial viability depends on the continuance of that activity, any discussion of those earnings or the issuer's future prospects could be rendered misleading without disclosure of the improper practices.

Since 1991, "beneficial ownership" under §16 of the Exchange Act has been determined by reference to the same definition under Section 13(d), namely, a person or group that has or shares voting or disposition powers. Using this definition, 1998 decision imposed §16(b) to recapture liability upon a financial advisor who became a member of a "group" by entering into an agreement with certain statutory "insiders" to maximize the value the statutory insiders would receive under a bankruptcy plan of reorganization. The advisors bought and sold stock of the issue within a six month period believing they were into insiders and, indeed, filed a Schedule 13D disclosing all the relevant information. The court, however, found that the advisors became members of a statutory insider "group" because the agreement granted them a right of first refusal over stock held by the insiders and also provided the advisors with a share of the profits from appreciation in the insiders' stock.

A. The 1988 SEC Interpretive Release

In August 1988, the SEC issued an Interpretive Release (the "1988 Release") outlining the disclosure obligations of companies affected by the government's well-publicized inquiry into the "Pentagate" defense contract procurement scandal.[498] Although the Release was prompted by and appeared to be limited to the "Pentagate" probe, commentators agreed that the SEC policy statements applied to all manners of management wrongdoing and government investigations thereof.[499]

The SEC emphasized in the 1988 Release that for the MD&A, traditional registration and reporting line-items[500] and transactional filings such as tender offers and

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management must consider the likelihood of a charge and the potential effect on the financial situation of the company.

[498/] Exch. Act Rel. No. 25951 (Aug. 2, 1988).

[499/] See Reactions to the SEC Release on Disclosure Obligations Arising from the Defense Procurement Inquiry, Insights, Oct. 1988, at 2.

[500/] These line-items include SEC disclosure rules relating to the description of a company's business (Regulation S-K Item 101), of pending legal proceedings (Regulation S-K Item 103), of legal proceedings involving directors, nominees, executive officers, promoters and control persons (Regulation S-K Item 401), and of possible loss contingencies (Article 5-02 of Regulation S-X and FASB #5). With regard to Item 401 of Regulation S-K, the Commission has published proposed amendments to expand the types of legal proceedings required to be disclosed in Commission filings and to increase to ten years (expanding the current five-year provision) the reporting period for such legal proceedings disclosure. Disclosure Concerning Legal Proceedings Involving Management, Promoters, Control Persons and Others, Securities Act Rel. Nos. 33-7106, 34-34923, IC-20670 (Nov. 1, 1994). See United States of America v. Yeaman, Fed. Sec. L. Rep. (CCH) ¶90,668 (3d Cir. 1999) (Defendant Yeaman was found guilty of failure to disclose in SEC and NASD filings that he previously had been found to have violated securities laws, even though he was not a named party, but simply the "subject of" the proceeding).

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proxy documents require disclosure of government inquiries if an issuer reasonably expects the investigation to have a material impact on the company's business practices or financial condition. According to the SEC, Securities Act Rule 408 and Exchange Act Rule 12b-20 mandate disclosure of alleged misconduct if such disclosure is necessary to keep these filings from being materially misleading. In addition, the SEC indicated that registrants must disclose government inquiries of alleged wrongdoing in the MD&A which could cause a significant change in the relationship between costs and revenues or where the uncertainty caused by an investigation could make historical financial information unpredictable of future operating results or financial condition. The SEC also suggested that the antifraud provisions could create liability for misstatements and omissions regarding such inquiries made outside of SEC filings.[501]

According to the 1988 Release, the SEC adopted the Basic materiality analysis for the MD&A by requiring that issuers consider disclosing the possible consequences of a government inquiry "if in light of the associated probabilities and magnitudes, the effects may be material."[502] As noted above, however, the SEC's 1989 MD&A Release specifically rejects this standard and suggests a standard which requires a minimum threshold probability of "more likely than not" before management must disclose information in the MD&A.

Companies subject to a government inquiry may suffer contract cancellations, suspension of contract payments, termination of further government business, or alteration of procedures for obtaining government contracts. Even if not subject to an inquiry, investigations may materially impact companies from additional expenditures incurred or policies changed in connection with defense contract procurement. Given the nature of defense contracting and the dependence of many companies on these contracts, the magnitude of these consequences can be so great that issuers may have difficulty

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In addition, an issuer is subject to the accounting, record keeping and internal control provisions of the Foreign Corrupt Practices Act (§ 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act). See SEC v. Sundstrand Corporation, No. 90-C20149 (N.D. Ill., May 21, 1990), Lit. Rel. No. 12489 (May 25, 1990), where the Northern District of Illinois entered a final order enforcing the SEC's consent order whereby Sundstrand is permanently enjoined from violating § 13(b)(2)(A) and (B). Pursuant to this order, Sundstrand agreed to appoint a committee to investigate the company's alleged concealment of millions of dollars in overcharges to the Department of Defense, as well as millions of dollars taken as federal income tax write-offs, which were all taken through improper accounting practices. Finally, the court ordered Sundstrand to file with the SEC a report on Form 8-K, to publicly disclose the committee's findings and recommendations.

501/ This was demonstrated by Copley Pharmaceutical, Inc. Securities Litigation, Fed. Sec. L. Rep. (CCH) ¶98,695 (D. Mass. 1995) (allegations of bribery rendered a Section 10(b) claim against a pharmaceutical company's officers as to the company's statement that it believed it was in material compliance with FDA Standards sufficiently particular under Fed. R. Civ. P. 9(b)). The antifraud provisions, however, impose no affirmative duty to disclose material events unless a company is trading in its own securities or needs to correct prior statements that were inaccurate when made. See Wander & Pallesen, supra note 15.

502/ Exch. Act Rel. No. 25951, at 62,126.

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claiming that government inquiries are not material. Therefore, if management cannot determine that these consequences are not reasonably likely to occur, the issuer will have to disclose the investigation in its MD&A.

B. Immateriality Cases

1. Gaines v. Haughton

The Ninth Circuit's decision in Gaines v. Haughton[503] is a landmark for the proposition that management misconduct is immaterial as a matter of law. In Gaines, the court ruled that Lockheed was not required to disclose in a proxy statement payments of "massive" bribes by directors to foreign officials because, absent evidence of kick-backs or other self-dealing, such misconduct was immaterial as a matter of law. The court distinguished acts involving self-dealing which it found presumptively material for §14(a) purposes, and merely offensive corporate behavior or mismanagement, which it ruled immaterial for federal securities law purposes.

The Ninth Circuit reasoned that the nondisclosure of the bribes did not cause any identifiable pecuniary loss to the company, other than the waste of the amounts of the bribes themselves. The court stated that mismanagement and waste of corporate assets are more appropriately redressed through state law breach of fiduciary duty claims. The court refused to boot-strap such state corporate law claims into a federal securities law claim[504] and held that absent self-dealing, illegal foreign payments were immaterial as a matter of law.[505]

2. Weill v. Dominion Resources, Inc.

In Weill v. Dominion Resources, Inc.,[506] a federal district court in Virginia held that certain alleged nondisclosures amounted to no more than

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[503] 645 F.2d 761 (9th Cir. 1981), cert. denied, 454 U.S. 1145 (1982).

[504] Id. at fn.33 (citing Sante Fe Indus., Inc. v. Green, 430 U.S. 462 (1977) (no implied cause of action exists under Rule 10b-5 for claims of breach of fiduciary duty typically regulated by state law)).

[505] See U.S. v. Matthews, 787 F.2d 38 (2d Cir. 1986) (absent self-dealing, mismanagement is not material for federal securities law purposes); See also Warner Communications, Inc. v. Murdoch, 581 F. Supp. 1482 (D. Del. 1984) (securities laws do not require parties to publicly admit the culpability of their actions); Amalgamated Clothing and Textile Workers Union, AFL-CIO v. J. P. Stevens & Co., 475 F. Supp. 328 (S.D.N.Y. 1979) (the proxy statement rules do not require management to accuse itself of antisocial or illegal policies), vacated as moot, 638 F.2d 7 (2d Cir. 1980).

[506] Fed. Sec. L. Rep. (CCH) ¶98,714 (E.D.Va. 1994).

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mere corporate mismanagement, and were immaterial omissions under federal securities law. The court further expounded upon the policy reasons for holding management misconduct immaterial as a matter of law. In discussing materiality, the court quoted from the U.S. Supreme Court case of TSC Industries, Inc. v. Northway, Inc.,[507] stating:

> [I]f the standard of materiality is unnecessarily low, not only may the corporation and its management be subjected to liability for insignificant omissions or misstatements, but also management's fear of exposing itself to substantial liability may cause it simply to bury the shareholders in an avalanche of trivial information - a result that is hardly conducive to informed decision making.[508]

3. Charter Medical Corp. v. Cardin

In Charter Medical Corp. v. Cardin,[509] the Fourth Circuit determined that management misconduct was immaterial and need not be disclosed. In this case, Charter alleged that the controlling shareholders and executive officers of Psych Systems, Inc. defrauded Charter by failing to disclose prior to the acquisition of Psych Systems that the president of Psych had been involved in a fraudulent scheme to inflate sales reported in the annual financial statements. Psych's auditors discovered the scheme and corrected the financial statements prior to their public release. Thereafter, Psych acted to isolate the president from the financial affairs of the company. Psych never advised Charter of the president's attempted indiscretion. However, Charter was aware of Psych's poor financial condition. Hence, the alleged omissions pertained only to the president's character.

Charter argued that the president's history of questionable behavior was material in a 1933 Act Section 12(2) context because Charter regarded the president as a key employee and wished to retain him following the proposed merger. In an unpublished opinion the district court granted the defendant's motion for summary judgment and the Fourth Circuit affirmed. Charter maintained that the Fourth Circuit's decision conflicted with other circuit court decisions involving the disclosure of management misconduct. In its writ for certiorari, Charter

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507/ 436 U.S. 438 (1976).

508/ Weill, Fed. Sec. L. Rep. (CCH) ¶98,714, at 92, 339 (citing TSC Industries, 426 U.S. at 448).

509/ 850 F.2d 688 (4th Cir. 1988), cert. denied, 488 U.S. 982 (1988). For a discussion of the facts of the case see The SEC Today Vol. 88-210 (Nov. 1, 1988), and The SEC Today Vol. 88-222 (Nov. 18, 1988).

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requested that the Supreme Court clarify materiality standards for management misconduct as it did for merger negotiations in Basic.

Contrary to the plaintiff's allegations, the Fourth Circuit's decision is consistent with prior case law in this area. The information allegedly omitted by Psych did not impact the company's economic condition. The information pertained solely to the quality of the president's character. Consequently, this fact situation would not have been helpful to the Supreme Court in settling the current controversy about the disclosure of management misconduct that has a potentially direct quantitative impact upon an issuer. The Supreme Court denied certiorari.

4. Citron v. Daniell

The Connecticut district court ruled that a company's proxy statement disclosures that the government was investigating its practice of bribing government officials to win defense contracts was sufficient to warn investors that these proceedings could affect its stock price.[510] The court dismissed as "absurd" the plaintiffs' allegations that the company (United Technologies, Inc.), which designed and built jet engines, should have disclosed the bribes in its annual reports. The court stated that it "would be unreasonable to require board members to tell the world they are thieves, unless, of course, they have been charged and/or convicted."[511]

5. Greenstone v. Cambex Corporation

In Greenstone v. Cambex Corporation,[512] a federal district court in Massachusetts held that the defendant, Cambex, did not have a duty to disclose material information about its illegal business practices. Cambex, which engaged in the development, lease, and sale of computer enhancement products, apparently had violated terms of a lease agreement with IBM by removing components of machines owned by IBM Credit Corporation and selling or leasing them to Cambex's customers. The plaintiff asserted that Cambex's press releases and SEC filings were false and misleading, because they did not disclose that Cambex's illegal practices were the source of revenues described in the press releases and filings. The court agreed that information about Cambex's improper activities was material, but, citing Roeder, held that Cambex had no

510/ See Citron v. Daniell, 796 F. Supp. 649 (D. Conn. 1992).

511/ Id. at 654.

512/ Fed. Sec. L. Rep. (CCH) ¶96,904 (D. Mass. 1991).

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affirmative duty to disclose this information merely because it was material.

6. U.S. v. Crop Growers

The recent case U.S. v. Crop Growers Corp. similarly follows the reasoning of Citron and Greenstone in finding no duty to disclose untried criminal activities in SEC filings.[513] In Crop Growers, company executives were indicted on numerous counts of illegal federal election activities, and the conspiracy and concealment of such alleged crimes. The 18 count indictment charged the executives with 10 separate counts of failing to disclose the illegal activities in SEC filings. The court dismissed the 10 counts, focusing on the lack of a duty to disclose untried activities and due process. "A fortiori, where a statute or regulation imposes no duty whatever to disclose information, due process concerns require that criminal liability not be based on omission of such information."[514]

7. Anderson v. Abbott Laboratories

In Anderson v. Abbott Laboratories, another district court recently adopted the new materiality standard and ruled that the failure of a pharmaceutical company ("Abbott") to disclose specific details of an ongoing FDA investigation and the receipt of an FDA warning letter was not material.[515] The court reasoned that Abbott's omission is only material when the disclosure of the FDA's investigation would be viewed by the reasonable investor as significantly altering the total mix of information available about Abbott.[516] In this case, the court determined that the history of monitoring , negotiations and inspections between Abbott and the FDA rendered the nondisclosure of yet another FDA investigation inconsequential.[517] Furthermore, the court noted that their determination of non-materiality was affirmed by the lack of market reaction to the eventual disclosure of another FDA investigation.[518] The court concluded

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513/ U.S. v. Crop Growers, 945 F. Supp. 335 (D.D.C. 1997).

514/ Id. at 345.

515 See Anderson v. Abbott Laboratories, et al., Fed. Sec. L. Rep. (CCH) ¶91,340 (N.D. IL 2001).

516 See Id. pg.95,948.

517 See Id.

518 See Id.

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that if reasonable investors believed the FDA investigation and warning letter altered the total mix of information available about Abbott, there would have been a greater market reaction.[519]

C. Materiality Cases and the Duty to Disclose

1. Roeder v. Alpha Industries, Inc.

Other courts have rejected the rigid analysis set forth in Gaines that management misconduct and government investigations are immaterial as a matter of law. The First Circuit in Roeder v. Alpha Industries, Inc.[520] ruled that information regarding the payment of bribes by Alpha Industries to obtain government subcontracts may have been material to investors notwithstanding the absence of allegations of self-dealing. The court rejected the public policy considerations which had compelled the Gaines court to hold incidences of corporate bribery immaterial as a matter of law. Instead, the First Circuit advocated a case-by-case analysis requiring the balancing of all facts and circumstances, an analysis consistent with that adopted by the Supreme Court in Basic in the mergers context.

The court emphasized that it could not dismiss the misconduct as mere "matters of taste" because "illegal payments that are so small as to be relatively insignificant to the corporation's bottom line can still have vast economic implications."[521] The First Circuit noted that Alpha Industries would suffer devastating financial harm if, due to the misconduct, the company was barred from obtaining future government business, which represented 60%-65% of its sales. Apparently, the magnitude of the potential harm was so great that the court determined that the bribes may have been material even before an indictment.

Despite the foregoing, the First Circuit dismissed Roeder's complaint for failing to establish that Alpha Industries had a duty to disclose the bribes, even if material. Roeder's complaint did not allege any inaccurate, incomplete or misleading disclosures, required or voluntary, made by Alpha Industries. There were no corporate insiders trading on

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519 See Id.

520/ 814 F.2d 22 (1st Cir. 1987).

521/ Roeder, 814 F.2d at 26; See also Decker v. Massey - Ferguson, Ltd., 681 F.2d 111 (2d Cir. 1982) (motion for dismissal denied because evidence at trial was required to establish the effect of improper payments on the overall business); SEC v. Jos. Schlitz Brewing Co., 452 F. Supp. 824 (E.D. Wis. 1978) (motion for summary dismissal denied because immaterial payoffs to liquor distributors could economically impact the company's business).

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confidential information. Roeder evidently claimed that Alpha Industries had an affirmative duty to disclose all material information.[522] The First Circuit correctly held that no such general duty to disclose exists. Given the court's expansive materiality analysis, however, it would appear that if Roeder alleged that Alpha Industries' MD&A failed to adequately disclose the alleged misconduct and the potential of an adverse impact on the company's financial condition and operating results, his complaint may have survived a motion to dismiss.[523]

2. In re Craftmatic Securities Litigation

In In re Craftmatic Securities Litigation,[524] the Third Circuit undertook a rather curious analysis to distinguish between "qualitative" and "quantitative" materiality with respect to management misconduct. The plaintiffs in Craftmatic purchased Craftmatic stock for $8.50 per share in an initial public offering made by the company in early 1986. At the time, Craftmatic sold and marketed various furniture products through direct sales and through independent distributors, to which the company supplied advertising, marketing, and promotional services. Craftmatic's prospectus for this offering included: (1) disclosure of the company's plans to use the proceeds of the offering to expand into new products; (2) statements that the company believed that it was in compliance with both consumer protection laws and a recent Consent Order and Assurance of Voluntary Compliance entered into with the Federal Trade Commission; (3) predictions that the requirements of the Consent Order relating to the company's change in sales practices would not have a material adverse effect on its business; and (4) statements that its past success as a leader in direct sales of "custom-fitted" reclining chairs was due primarily to the effectiveness of its advertising, promotion, and marketing programs.

In 1987, Craftmatic experienced a large operating loss, a decrease in sales and advertising commissions, and the failure of two new product lines. The company also entered into consent orders with the states of Washington, Oregon and Pennsylvania regarding its customer sales

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522/ Roeder relied on the fraud on the market theory in support of his argument that issuers have an affirmative duty to disclose all material information to the public. The First Circuit correctly disposed of this proposition by positing that the fraud on the market theory addresses reliance and not an issuer's duty to disclose.

523/ In light of the 1988 and 1989 SEC Interpretive Releases, the SEC apparently would have required that Alpha disclose in its MD&A the investigation into the bribery and its potential effect on the financial condition of the company unless management could show that an indictment or contract loss was not likely to occur.

524/ 890 F.2d 628 (3d Cir. 1989).

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practices in those states. The disclosure of these adverse business developments caused Craftmatic stock price to fall to close to $1 per share. Plaintiffs alleged violations of several provisions of the securities laws, asserting that Craftmatic's prospectus was materially misleading. Plaintiffs claimed that Craftmatic should have disclosed in the prospectus its deceptive and unfair sales practices, its resulting violations of consumer protection laws and the Consent Order, the expenses and risks of the new product lines, and a myriad of information regarding management's incompetence and lack of internal controls.

After discussing Sante Fe Industries v. Green[525] at length, the Third Circuit affirmed the district court's dismissal of those claims pertaining solely to management's failure to sufficiently characterize themselves and their programs as inept. The court stated:

Where the incremental value of disclosure is solely to place potential investors on notice that management is culpable of a breach of faith or incompetence, the failure to disclose does not violate the securities acts.[526]

The court determined that Craftmatic need not have disclosed that its product research was meaningless, its cost and accounting controls were ineffective, and its management was unfocused. The court also dismissed the plaintiffs' claims that Craftmatic should have disclosed that the

525/ 430 U.S. 462 (1977) (absent misrepresentation or deception the failure to disclose a breach of fiduciary duty is not actionable under Rule 10b-5).

526/ In re Craftmatic, 890 F.2d at 640; See also In re Chaus Securities Litig., Fed. Sec. L. Rep. (CCH) ¶95,646 (S.D.N.Y. 1990) (failure to disclose "garden variety mismanagement" is not actionable under the federal securities laws); In re Fleet/Norstar Securities Litig., Fed. Sec. L. Rep. (CCH) ¶96,146 (D.C.R.I. 1991) (allegations that bank failed to disclose inappropriate loan loss reserves and unmanageable lending practices constitute claims of internal corporate mismanagement not actionable under the federal securities laws). In contrast, a district court in the Southern District of Florida determined that a bank's failure to disclose imprudent lending practices violated Rule 10b-5. The defendants in First American Bank and Trust v. Frogel, 726 F. Supp. 1292 (S.D. Fla. 1989), caused First American to engage in risky loan practices and to expand in markets outside the traditional realm of commercial banking. The district court conceded that failure to disclose a breach of fiduciary duty does not constitute a violation of the federal securities laws. Nonetheless, the court held that failure to disclose the "quantitative" consequences of the high risk loans and questionable business practices involved in this case did violate Rule 10b-5.

A 1992 Third Circuit case staked out a position somewhere between Fleet/Norstar and First American. In Shapiro v. UJB Financial Corp., Fed. Sec. L. Rep. (CCH) ¶96,651 (3d Cir. 1992), the court stated that "mere failure to provide adequate reserves (or to perform competently other management tasks) does not implicate the concerns of the federal securities laws and is normally not actionable." Id. at 93,067. However, the court continued: "if a defendant characterizes loan loss reserves as `adequate' or `solid' even though it knows they are inadequate or unstable, it exposes itself to possible liability for securities fraud." Id.

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deceptive and illegal practices would result in charges being brought against the company and the risks associated with Craftmatic's expansion into new product lines. The Third Circuit held that this information was "sufficiently speculative and unreliable to be immaterial as a matter of law."[527]

The court did find, however, that Craftmatic should have disclosed certain other information which the court believed was beyond the general incompetence of management and was therefore material. Specifically, Craftmatic failed to disclose that:

(1) the success of the advertising, promotion, and marketing programs depended on deceptive, illegal practices;

(2) the marketing program violated various consumer protection laws and consent orders between Craftmatic and federal and state governments;

(3) the marketing program resulted in an abnormally high level of consumer complaints; and

(4) despite its entry into consent orders resulting from the company's advertising and marketing activities, Craftmatic misrepresented its chairs as "custom-fitted."[528]

The court held that Craftmatic had a duty to disclose this information in its prospectus. The court found that without such disclosure, statements in the prospectus relating to the success of the marketing program and Craftmatic's assertion that the company was in compliance with consumer protection laws were misleading. The Third Circuit refused to dismiss these claims, holding that a reasonable jury could find the omissions material and misleading under §11(a), §12(2) and Rule 10b-5 of the federal securities laws.

The Third Circuit never addressed whether the company's omissions involved information that would cause a "quantitative" impact on the financial disclosures in the prospectus. The fact that the past success of the promotional program was based on illegal practices did not mean the program could not be equally effective without such practices. Also, the court should have inquired whether the violation of the consumer

527/ Craftmatic, 890 F.2d at 644, see also Ballan v. Wilfred American Educ. Corp., 720 F. Supp. 241 (E.D.N.Y. 1989) (holding that defendants were not obligated to predict as the "likely" outcome of investigations that indictments would follow, with financial disaster in their train).

528/ Craftmatic, 890 F.2d at 640.

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protection laws and the consent orders would result in fines, lost business or disgorgement of past profits. Under the Third Circuit's analysis, almost any statement in Craftmatic's prospectus relating to its business could have been considered misleading. On remand, the district court should inquire whether the omissions were actually "quantitative" information or purely "qualitative" information.

3. In re Par Pharmaceutical, Inc. Securities Litigation

In re Par Pharmaceutical, Inc. Securities Litigation[529] illustrates the application of an issuer's duty not to mislead in the context of a government investigation of bribery. In Par, the Southern District of New York held that the existence of an undisclosed bribery scheme to obtain early FDA approval of new generic drugs could render Par Pharmaceutical's statements regarding FDA approval of their products misleading. From 1986 to 1988 Par Pharmaceutical and its 60% owned subsidiary, Quad Pharmaceutical, allegedly paid several bribes to FDA officials to secure early required approval for its products and to delay approval of competitors' products. During this time, Par Pharmaceutical saturated the company's SEC filings, reports to shareholders and press releases with information regarding the FDA approvals and record sales and earnings. Par not only disclosed the number of approvals received in a given year, but also compared those numbers to competitors' approval rates and to approvals received by both companies in previous years. Further, Par attributed its healthy financial performance to this steady flow of FDA approvals and used its approval rate as evidence for future success.

In June 1988, Congress began an investigation into the FDA generic drug approval process. Par's records were subpoenaed in connection with the investigation in July 1988. Par's Quarterly Report, issued in August 1988, acknowledged the investigation. In an October press release, Par disclosed that Par and Quad were targets of the investigation but the company did not believe this would have an impact on the business. In April 1989, officers of the two companies agreed to plead guilty to bribery charges and, in July 1989, Par and Quad agreed to plead guilty to bribery, facing fines of up to $500,000 each.

The market value of Par's stock, which had traded as high as $27.25 during the class period, fell to $8 in April 1989. Plaintiffs alleged that Par's public touting of its competitive advantage in obtaining quick

529/ 733 F. Supp. 668 (S.D.N.Y. 1990).

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FDA approvals and Par's earning performance were false and misleading and therefore violated Rule 10b-5. Plaintiffs claimed that the company should have disclosed that the approval rate advantage was due to the illegal bribes, not any expertise or business acumen, and that the discovery or termination of the bribery scheme would profoundly harm Par's sales and earnings. The defendants moved to dismiss the complaint.

a. Predictions and Speculations

The district court dismissed the plaintiffs' allegations that Par should have disclosed the consequences associated with the cessation or discovery of the bribery scheme. The court held that failure to disclose such "predictions" cannot support Rule 10b-5 liability because the company did not have an obligation to speculate on the many potential ramifications of this scenario, ranging from minor setbacks to complete ruin. This could, however, be the exact type of information required to be disclosed in an issuer's MD&A by the SEC 1988 Release and SEC 1989 MD&A Release. Given the Third Circuit's similar analysis in Craftmatic, these cases may signify that this is an area where the courts will not impose Rule 10b-5 liability even if the SEC would require a line-item disclosure in the MD&A. Once again, this claim may have survived a motion to dismiss had plaintiffs alleged an inadequate MD&A.

b. Logical Nexus

Curiously, the district court determined that the defendant's statements could be considered misleading as to Par's ability to obtain FDA approval. The court stated that a jury could find that Par's glorification of its FDA approval rate could have conveyed to a reasonable investor "the false impression that Par had a particular expertise in obtaining FDA approvals constituting a legitimate competitive advantage over other companies and that this advantageous expertise was responsible for its success in obtaining FDA approvals."[530]

The district court also rejected the defendants' argument that there was no "logical nexus" between the bribery scheme and Par's earnings, sales or FDA product approval. The court held that, contrary to the defendants' assertion that any connection was pure speculation, one of the questions for the jury was whether Par's earnings, sales, and product

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[530/] Id. at 678.

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approvals did in fact result from the bribery of the FDA officials.[531] Given the FDA approval pattern for Par's products, a jury could probably link the bribery to FDA approvals and resulting increased earnings.[532] Consequently, Par's omissions would meet the standard of "quantitative" materiality, because the loss of the FDA approvals resulted in significantly decreased sales and earnings.

D. Suggested Analysis of Management Misconduct and Government Inquiries

After the Gaines decision it appeared that disclosure issues relating to management integrity were settled. In view of the 1988 SEC Interpretive Release and the Roeder decision, management misconduct and government investigations can no longer be dismissed out-of-hand as immaterial as a matter of law. Instead, issuers must carefully examine these matters to determine whether they could adversely affect the issuer's bottom-line financial performance. If material, issuers must then decide whether they have a duty to disclose management misconduct or government investigations due to a line-item requirement or in order to make other disclosures accurate and complete. Insiders must also disclose any confidential information they have relating to such activities before trading in the company's stock.

The above decisions and the case-by-case analysis adopted therein are consistent with the Supreme Court's decision in Basic, rejecting the constructive immateriality doctrine for preliminary merger negotiations. Several of these cases, however, may contradict the proposition set forth in Santa Fe Industries, Inc., v. Green,[533] that claims of mismanagement involve state law actions which should not be boot-strapped to federal securities laws claims by alleging nondisclosure of the mismanagement.[534] In a rather disingenuous fashion, the Craftmatic court attempted to avoid Santa Fe by requiring the disclosure of the financial consequences of illegal acts rather than of the acts themselves, side-stepping the issue of what constitutes "quantitative" versus "qualitative" information.

531/ See Greenfield v. Professional Care, Inc., 677 F. Supp. 110 (E.D.N.Y. 1987) (holding that failure to disclose a scheme to defraud the New York medicaid system and the state investigation thereof rendered the company's financial disclosures misleading, because reported earnings were illegally obtained).

532/ The court noted that prior to the inception of the alleged bribery scheme, Par's success in obtaining FDA approval had been limited. During the alleged bribery period, Par's and Quad's rapid approval rate increased dramatically along with earnings and sales. When the alleged bribes stopped, the pace of approvals subsided, accompanied with a drop in earnings and sales.

533/ 430 U.S. 462 (1977).

534/ This contradiction was explicitly noted in Weill v. Dominion Resources, Inc., Fed. Sec. L. Rep. (CCH) ¶98,714 (E.D. Va. 1994).

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Unfortunately, issuers still have few guidelines for gauging materiality and making disclosure decisions regarding management misconduct (whether alleged or actual) and government investigations.[535] From a practical standpoint these incidents should be treated no differently than any other corporate development. Conduct involving self-dealing or other breaches of trust generally should be presumed material. For other questionable activity, facts relating to management wrongdoing should be examined from an economic and financial standpoint to determine whether they meet the criteria of quantitative materiality.

When the duty to disclose government investigations arises outside of the MD&A, issuers should employ the Texas Gulf Sulphur probability/magnitude analysis to determine whether illegal conduct or a government investigation thereof would be considered material. The issuer should focus on whether fines, disgorgement of profits, the loss of a substantial amount of business, or any other quantitative impact on liquidity, capital resources, or results of operations could result from a conviction or consent decree. In deciding whether the information is material, the amount at risk should be tempered by the likelihood of the government's success in obtaining an indictment or conviction.

When determining what to disclose regarding government inquiries in the MD&A, an issuer should first determine whether the inquiry more likely than not will result in sanctions, penalties, or other adverse financial consequences.[536] If such a result is not likely, the inquiry need not be disclosed. If management cannot make such a determination, management should attempt to quantify the impact of such sanctions, penalties, or consequences on the companies' financial condition and operations, as if

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[535] The 1988 Interpretive SEC Release clarifies disclosure obligations of government investigations as they fall within the current rubric of the securities laws, but does not offer any real resolution of the qualitative/quantitative debate. Although case law tends to hint that disclosure of management misconduct and government investigations cannot be completely dismissed, current federal securities laws do not actually compel the disclosure of government investigations. In fact, in 1994, when the SEC proposed amendments to the Securities laws, it did not even indicate that management misconduct should be disclosed. The issue of disclosure of government investigations was never addressed. See Harvey L. Pitt, Karl A. Groskaufmanis and Vasiliki B. Tsaganos, "Director Duties to Uncover and Respond to Management Misconduct," Insights, June 1997, at 8; See also SEC Release No. 33-7106 (Nov. 1, 1994). Note also that the Reform Act now requires an issuer's accountant to report to the issuer any illegal act it detects during the course of its audit and to resign and/or notify the Commission if the issuer ignores the accountant's report. Section 10A of the Exchange Act and Rule 10A-1. See, also, Karl A. Groskaufmanis, Matt T. Morley and Michael J. Rivera, To Tell or Not to Tell: Reassessing Disclosure of Uncharged Misconduct, Insights, June 1999 at 9.

[536] In determining materiality, Bromberg and Lowenfels suggest that issuers distinguish between an informal versus a formal investigation. Alan R. Bromberg & Lewis D. Lowenfels, Disclosure of Government Investigations, Insights, June 1994, at 17, 19. A formal investigation by the SEC, grand jury, or other agency is more likely to be material. Id. However, its materiality also depends on whether the company is a "target" of the investigation or only a "subject." Id. An action is more likely to be taken against a target, and thus, materiality is more probable. Id.

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they were certain to occur. If management believes that a reasonable investor would consider the impact of such potential consequences significant in light of all the circumstances, the MD&A should describe the government investigation.

Finally, issuers should examine both required and voluntary statements which could be rendered misleading by omissions of information relating to management misconduct or potential government inquiries. In light of the Par and Craftmatic decisions, courts will likely treat corporate improprieties and government discovery thereof much the same as any other negative business development. In this regard, issuers should review this type of information in the manner suggested earlier for the disclosure of general business developments and risks.

X. DISCLOSURE OF STOCK ACCUMULATION PROGRAMS AND "GREENMAIL" NEGOTIATIONS IN SCHEDULE 13D

As mergers, acquisitions, and hostile offers return to the landscape, a review of the 13D cases in these areas is appropriate. Several cases, including In re Phillips Petroleum Securities Litigation, suggest that third parties who file a Schedule 13D or otherwise make public statements regarding a takeover target have a duty to "promptly" amend their filings to disclose "greenmail" discussions at inception. The plaintiffs in these cases allege that bidders have disclosure obligations under Rule 13(d) which parallel the line-item disclosure obligations imposed upon targets by Rule 14d-9. These decisions also reveal that a target's management may be liable for aiding and abetting the outsider's fraud if the target fails to disclose the negotiations of its own accord.

These decisions are worth remembering in light of the increased activity in hostile offers. The SEC's victory in SEC v. First City Financial Corp., Ltd.,[537] confirms that the SEC will not tolerate any failure to comply with the Schedule 13D filing requirements in a hostile takeover context. The SEC's enforcement actions against Macmillan, Inc. and Sequa Corporation also illustrate that the SEC will scrupulously review line-item disclosure regarding defensive measures and will vigorously enforce the requirement that investors promptly amend their Schedule 13D filings to disclose material changes in investment intentions.[538]

Since 1991, "beneficial ownership" under §16 of the Exchange Act has been determined by reference to the same definition under Section 13(d), namely, a person or group that has or shares voting or disposition powers. Using this definition, a 1998 decision imposed §16(b) recapture liability upon a financial advisor who became a member of a "group" by entering into

537/ 890 F.2d 1215 (D.C. Cir. 1989).

538/ The SEC's concern regarding line-item disclosure is further evidenced by the March 6, 1989 Release proposing amendments to Schedules 13D, 14D-1, 14B and 13E-3 to require disclosure regarding "substantial equity participants" in filing persons involved in control transactions. See Exch. Act Rel. No. 26599 (Mar. 6, 1989). Although the SEC sought comments on this proposal, no further action was taken.

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an agreement with certain statutory "insiders" to maximize the value the statutory insiders would receive under a bankruptcy plan of reorganization. The advisors bought and sold stock of the issuer within a six month period believing they were not insiders and, indeed, filed a Schedule 13D disclosing all the relevant information. The court, however, found that the advisors became members of a statutory insider "group" because the agreement granted them a right of first refusal over stock held by the insiders and also provided the advisors with a share of the profits from appreciation in the insiders' stock.

A. Disclosure of "Greenmail" Negotiations

1. In re Phillips Petroleum Securities Litigation

a. The Third Circuit Opinion: Reckless Statements

The Third Circuit in In re Phillips Petroleum Securities Litigation[539] concluded that T. Boone Pickens' Mesa Partnership may have defrauded shareholders of Phillips Petroleum by agreeing to a buy-out proposal after Mesa had specifically stated in public and in a Schedule 13D that it would not sell its shares back to Phillips "except on an equal basis with all other stockholders". Judge Sirica vacated the lower court's summary judgment order, declaring that a jury could reasonably find that Mesa's "equal basis" statements were reckless when made. The court also held that there existed a genuine issue of material fact as to whether Mesa had any intention from the outset to honor such statements.

On October 22, 1984 Mesa announced a 5.7% stake in Phillips and launched a hostile tender offer for the remaining shares. Pickens then appeared on the nationally televised MacNeil/Lehrer News Hour denying his reputation as a "greenmailer" and affirming statements in the Schedule 13D that Mesa would sell out to Phillips only if all shareholders received the same offer.

Phillips countered by pursuing a vigorous legal defense and by engaging in settlement discussions with Mesa beginning December 21, 1984. The evidence showed that on several occasions during the negotiations Mesa rejected settlement proposals favorable to Mesa on the ground that all shareholders would not be treated equally. When Phillips offered a plan of recapitalization cashing out Mesa and providing a preferred exchange offer for all other shareholders, Mesa demanded a valuation opinion by independent advisors that the proposed exchange offer gave shareholders value equal to the cash price to be paid Mesa for

[539/] 881 F.2d 1236 (3d Cir. 1989).

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its shares. On December 23, 1984, Phillips and Mesa agreed to a recapitalization plan which required that Mesa sell its shares to Phillips for cash prior to completion of the plan.

The district court rejected the plaintiffs' claim that Mesa defrauded Phillips shareholders by agreeing to the recapitalization plan and the Mesa buy-out after having made the "equal basis" statements. Specifically, the district court ruled that plaintiffs could not establish scienter because nothing in the record indicated that the equal basis statements made by Mesa were untrue when made. The district court held that "so long as the statements regarding equal value basis were an accurate reflection of the present intent of [Mesa] when made, the statements are not actionable under Section 10(b)."[540] The court also rejected the plaintiffs' promissory estoppel claim that they reasonably relied on the continuing applicability of Mesa's earlier statements of intent that were never publicly updated.

The Third Circuit agreed with the district court that Mesa's statement of intent with respect to "equal basis" need have been true only when made and that a subsequent change of intent would not, by itself, give rise to a cause of action under Rule 10b-5. Judge Sirica also found that the record established that Mesa had promptly announced and disseminated its change of intent as required by Section 13(d). However, the Third Circuit vacated the district court's order of summary judgment based upon its conclusion that Mesa's equal basis statements may have been "reckless" and an "extreme departure from ordinary care," satisfying plaintiffs' burden of establishing scienter. The court noted:

> Even though they needed only be true when made, such unequivocal statements [providing no contingency for changing circumstances] presented an obvious danger of misleading the public — because they can be read as a statement by [Mesa] that, no matter what happened, it would not change its intentions.[541]

The Third Circuit also determined that the record contained circumstantial evidence supporting the plaintiffs' allegations that Mesa had no intention from the outset to honor the equal treatment statements. Since a jury could reasonably conclude that the proposed recapitalization was an insufficient basis to cause Mesa to change its intent, the district

540/ In re Phillips Petroleum Securities Litig., 697 F. Supp. 1344, 1352 (D. Del. 1988).

541/ In re Phillips Petroleum Securities Litig., 881 F.2d at 1246.

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court's entry of summary judgment for failure to address evidence of scienter was incorrect and vacated.

b. The District Court on Remand: Materiality and Causation

On remand, Mesa again moved for summary judgment, claiming that the "equal basis" statements were not material and that the alleged misrepresentations did not proximately cause plaintiffs' injury. Mesa quoted the Third Circuit's statement that "reliance upon a mere expression of future intention cannot be 'reasonable,' because such expressions do not constitute a sufficiently definite promise."[542] Mesa also urged that because the "equal basis" statements were inherently subject to change and constituted an insignificant portion of Mesa's tender offer announcement, they were immaterial as a matter of law.[543] According to Mesa, the stock price movement was due to shareholders' concerns about the anticipated tender offer and not the "equal basis" statements.

The district court, however, found several factors that could support a jury determination that the statements were material. The court noted that (1) Mesa's general intentions were subject to Schedule 13D disclosure requirements, (2) the one-page press release announcing the tender offer included reference to the "equal basis" statements, (3) Pickens discussed and explained the "equal basis" statements in the MacNeil/Lehrer interview, and (4) due to Pickens' reputation as a greenmailer, the "equal basis" statements lent credibility to the tender offer. Consequently, the evidence was sufficient to create a question of fact as to the materiality of the statements in relation to Mesa's attempted takeover.

The district court also rejected Mesa's defense that the plaintiffs had failed to establish proximate cause. Because Mesa's alleged material misrepresentations were disseminated in a well developed and open securities market, the plaintiffs were entitled to a rebuttable presumption of reliance, encompassing both transaction and loss causation. Mesa had failed to rebut this "fraud on the market" presumption by showing (i) that the market did not respond to the misrepresentation, (ii) that the price difference was not a result of the fraud, (iii) that the plaintiff knew the representation was false, or (iv) that plaintiff would have made the purchase regardless of the undisclosed information.

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[542] In re Phillips Petroleum Securities Litig., 738 F. Supp. 825, 831-32 (D. Del. 1990).

[543] Id. at 832.

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2. Lou v. Belzberg

A federal court in New York has held that, as a matter of law, a Schedule 13D could not be considered misleading for failing to disclose a "greenmail" motive for the purchase of the shares arising out of the First City Financial/Ashland incident.[544] Contrary to the other cases discussed herein, Lou v. Belzberg[545] suggests that if the Schedule 13D discloses that the stockholder may dispose of shares of stock, the possibility of selling those shares back to the issuer at a profit is an obvious conclusion that need not be explicitly stated.

On March 25, 1986, after informing Ashland that it had acquired a 9% stake in the company, First City sent a letter to Ashland's Chairman stating that First City was "prepared" to acquire all of the outstanding stock of Ashland for $60 per share. That same day, Ashland's announcement of First City's holdings increased Ashland's stock price per share by $3.25 to $52. Ashland immediately rejected First City's offer and initiated defensive measures, including intensive efforts to obtain passage of a state anti-takeover statute.

First City filed a Schedule 13D on March 26 stating that (1) it had acquired 9.2% of Ashland's common stock, (2) it had requested a meeting with Ashland to discuss a possible acquisition, and (3) it intended to propose at the meeting a price of $60 per share to acquire all of Ashland's common stock, pending Ashland board of director approval. The March 25 letter to Ashland was attached as an exhibit to the Schedule 13D. First City also stated that depending on Ashland's receptivity to its offer and other available market opportunities "it may increase or decrease or continue to hold or to dispose of its position in the Issuer and may seek to obtain representation on the Issuer's board of directors."[546]

On March 27, First City filed under the Hart-Scott-Rodino Act seeking antitrust clearance to acquire more than 50% of Ashland's stock. By March 31, Ashland had proposed, as of a "restructuring" plan, to purchase First City's shares for $51 per share, $.50 per share less than the current market price. First City agreed, entering into a ten-year standstill agreement not to purchase any voting shares of Ashland. The next day

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[544] See SEC v. First City Financial Corp., 890 F.2d 1215 (D.C. Cir. 1989), discussed infra Section X.B.I.

[545] 728 F. Supp. 1010 (S.D.N.Y. 1990).

[546] Id. at 1013.

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Ashland's stock fell slightly to $49.75 per share. The transaction was concluded by April 2, when First City amended its Schedule 13D.

Plaintiffs sued under Rule 10b-5, alleging that First City's Schedule 13D was materially false and misleading because First City never intended to acquire all of the Ashland stock, but rather intended to "greenmail" Ashland into buying back its stock at a premium. Plaintiffs also alleged that First City implied in its Schedule 13D that it could obtain financing for the acquisition, when in fact it knew it could not. Defendants moved for summary judgment.

The court granted summary judgment with respect to plaintiffs' claims of a "greenmail" motive, finding that First City had complied with the requirements of Schedule 13D and as a matter of law made no material misrepresentation or omissions with respect to its holdings in Ashland. The court noted that First City adequately disclosed accurate information regarding its 9.2% position in Ashland, its proposal to acquire all of the Ashland's stock for $60 per share, and that it might increase, decrease, or dispose entirely of its holdings in Ashland. The court stated that it was self-evident that First City might sell its shares at a profit. Schedule 13D did not require First City to disclose this potential outcome in such pejorative terms as "greenmail." This conclusion may be at odds with other cases, which seem to require more specific disclosure of intent in Schedule 13D filings.

Curiously, the court concluded that First City may have misled investors about its preparedness to finance the acquisition of all of Ashland's stock. Despite clear and unequivocal disclaimers in the Schedule 13D stating that First City had not secured financing for the transaction, the court held that there existed triable issues of fact regarding First City's intent to misrepresent its ability to consummate the proposed acquisition. It is unclear what more First City could have disclosed to convey that its financing was conditional. Regardless, the court dismissed plaintiffs' claim with leave to amend because the complaint had not been pled with sufficient particularity.

3. Kamerman v. Steinberg

The federal court in New York reaffirmed its decision in Belzberg about the disclosure of "greenmail" intentions in a Schedule 13D by granting the defendants motion for summary judgment in Kamerman v.

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Steinberg,[547] a case arising out of Saul Steinberg's attempted takeover of the Walt Disney Corporation and the subsequent sale of his Disney holdings back to the company at a substantial premium. Citing Belzberg, the Kamerman court held that Steinberg's Schedule 13D filings sufficiently disclosed the possibility of a sale to the company because Steinberg had reserved the right to sell all or some of his shares in the 13D.[548] The plaintiffs failed to adequately support their allegations that defendants' intention at the time of the filing of the Schedule 13Ds was to "greenmail" Disney.

The events began on March 28, 1984 when defendants filed a Schedule 13D disclosing that they had acquired 6.3% of Disney's common stock, stating that their purpose was for "investment" but that they also reserve the right to dispose of all or a portion of such Securities on terms and at prices determined by them . . . [and that they] reserve the right at any time to cease being passive investors if in their judgment such action becomes necessary or desirable to protect or enhance the value of their investment.[549]

Defendants filed three amendments to this Schedule 13D, each showing an increase in their holdings of Disney stock but no change in their stated purpose of such holdings. On April 25, a fourth amendment was filed indicating that defendants were seeking permission under the Hart-Scott-Rodino Act to acquire up to 5,467,000 additional shares of Disney common stock. One week later, defendants purchased 1,000,000 additional shares of Disney stock, increasing their holdings from 9.3% to 12.2% of the company's common stock.

Meanwhile, Disney began to take action. On May 17, 1984, the company announced the purchase of Arvida Corporation, a Florida real estate company, for 2.6 to 3.8 million shares of Disney stock. Defendants responded by amending their Schedule 13D on May 25, indicating that they would no longer remain passive investors, but would consider courses of action to take control of Disney. Disney, in turn, announced its agreement to acquire Gibson Greetings, Inc.

547/ 744 F. Supp. 59 (S.D.N.Y. 1990). For a full discussion of the facts of this case, see Kamerman v. Steinberg, 681 F. Supp. 206 (S.D.N.Y. 1988).

548/ Kamerman, 744 F. Supp. at 60.

549/ Kamerman, 681 F. Supp. at 209.

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On June 8, defendants initiated a tender offer for 49% of Disney's stock at $67.50 per share, or $72.50 per share if Disney endorsed the tender offer and canceled the Gibson Greetings acquisition. By June 11, Disney had agreed to repurchase defendants' stock for $70.83 per share plus reimbursement of $28 million in expenses. Defendants filed their final Schedule 13D on June 13, 1984. After six years of litigation and a settlement with the class of plaintiffs who purchased Disney stock after May 24, 1984,[550] the defendants moved for summary judgment of the Kamerman class action for plaintiffs who had purchased their Disney stock between March 28 and May 24, 1984.

In granting the defendants' motion for summary judgment, the court distinguished the situations in Belzberg and Kamerman from that in Seagoing.[551] In Seagoing, the court found that the defendants' motives were not passive at the time the Schedule 13D was filed. To the contrary, the court found in Kamerman that plaintiffs failed to demonstrate that Steinberg's motives were not that of a passive investor when he filed the 13Ds in question.

The court stated that most of Steinberg's actions, both during and after the class period, supported the contention that Steinberg was merely "keeping his options open" and pursuing the most profitable avenues. These actions, including the block purchase of the 1,000,000 shares, could have indicated an intent to take control of Disney as much as an intent to force the company to repurchase the shares at a premium. The court concluded that it was unreasonable to use hindsight to infer from an end result that Steinberg's intention from the beginning was to reach that end result.

4. Seagoing Uniform Corporation v. Texaco

In Seagoing Uniform Corporation v. Texaco,[552] the district court refused to dismiss a claim by a Texaco shareholder alleging that the Bass brothers of Texas violated Section 13(d) by failing to disclose in a Schedule 13D their true speculative intentions in acquiring Texaco stock. On January 18, 1984, just days after Texaco announced its acquisition of Getty Oil, the Bass investor group filed a Schedule 13D disclosing their ownership of Texaco stock and stating that their purchase was "simply for

550/ See Brown v. Steinberg, Fed. Sec. L. Rep. (CCH) ¶95,493 (S.D.N.Y. 1990).

551/ See infra notes 425-426 and accompanying text (discussing Seagoing).

552/ 705 F. Supp. 918 (S.D.N.Y. 1989).

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investment purposes." The plaintiff alleged that the Bass group actually intended to "greenmail" Texaco.

The plaintiff submitted that the Bass group had met with Texaco's chairman and chief executive officer to discuss a buy-back deal as early as May 1982, when they owned slightly less than 5% of Texaco stock. The Bass group allegedly acquired additional Texaco shares, and triggered the Schedule 13D filing requirement, solely to drive up the price of Texaco stock and pressure Texaco management to repurchase their stock. The plaintiff also asserted that the Bass defendants continued negotiations with Texaco senior officers regarding the sale of their stock after the Schedule 13D filing and several amendments thereto.

The plaintiff maintained that the Bass group's false and misleading Schedule 13D induced plaintiff to purchase Texaco stock at an artificially inflated price. The plaintiff also alleged that Texaco aided and abetted the Bass group's fraud by issuing a press release implying that the Basses were merely passive investors, even though Texaco had knowledge to the contrary.

The district court rejected the Bass group's defense that because the parties had not reached an agreement in principle, the negotiations were not material and need not have been disclosed. The court determined that the negotiations may have been material under the flexible standard adopted by the Supreme Court in Basic. The court also noted that, regardless of whether the discussions were material and whether a duty to disclose ever arose, the Bass investors had "a duty to speak the full truth" when it undertook to say anything. The court ruled that a jury could find that the Bass group's failure to disclose the negotiations in the Schedule 13D, and Texaco's failure to disclose them in its press release, constituted a failure to reveal the full truth actionable under Rule 10b-5.[553]

5. Fry v. Trump

In Fry v. Trump,[554] the district court refused to dismiss a claim that Donald Trump defrauded shareholders of Bally Manufacturing Company by filing a false and misleading Schedule 13D which failed to disclose that Trump allegedly intended to "greenmail" the Company. On November 24,

[553] No private cause of action for damages exists under Section 13(d). However, the court ruled that the plaintiff could rely on Section 10(b) because it had alleged that both the Bass group and Texaco had acted with scienter and that it had reasonably relied upon the alleged misrepresentations.

[554] 681 F. Supp. 252 (D.N.J. 1988).

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1986, Trump's Schedule 13D disclosed that he had acquired 9.9% of Bally "for the purpose of making a significant investment in the company." Trump also allegedly made various false public statements denying that he was a "greenmailer" and claimed he was looking out for the interests of all Bally shareholders.

In response to Trump's Schedule 13D filing, Bally management feverishly erected defensive measures and, as a stalling tactic, arranged meetings with Trump to discuss a friendly takeover. Bally subsequently signed a contract to purchase the Golden Nugget, and Trump sued to enjoin the transaction as an illegal entrenchment device. Throughout these maneuvers, Trump and Bally allegedly continued negotiations to resolve their dispute. On February 23, 1987 the parties announced that Bally would buy out Trump at a premium, and that Trump had agreed to drop his legal claims and had executed a ten-year standstill agreement.

Bally shareholders sued both the Bally directors and Trump, alleging that the repurchase transaction constituted a breach of fiduciary duty, waste of corporate assets and illegal payment of "greenmail." The district court found that the plaintiffs stated a valid claim against the Bally directors and also against Trump for aiding and abetting the directors' breach of fiduciary duty.

The court also refused to dismiss the plaintiffs' claim that Trump violated Rule 10b-5 by making misleading public statements that he was not a "greenmailer" while he was actually engaged in repurchase negotiations. Finally, the court ruled that the Bally directors may have aided and abetted Trump's Rule 10b-5 violation by agreeing to repurchase his shares without first disclosing the negotiations.

The court declined to determine whether Trump had an initial duty to disclose the Bally negotiations, without more. The court questioned whether the rationale of the Supreme Court's decision in Basic, that preliminary merger negotiations need not be disclosed, applies to repurchase negotiations. The court did determine that even if Trump had no initial duty to reveal the negotiations, he was not entitled to intentionally mislead shareholders by making false statements with respect thereto.

The district court also ruled that even if Trump's initial Schedule 13D and public denials of "greenmail" were accurate when made, he had a duty to update such statements once they "became materially misleading in light of subsequent events," that is, once he entered into repurchase

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negotiations.[555] The court did not elaborate whether this duty to update arose under Section 13d or was a broader obligation under Rule 10b-5. Section 13d may have imposed upon Trump an obligation to amend his Schedule 13D to disclose the repurchase negotiations. However, the court's suggestion that Rule 10b-5 imposes a general duty to update is ill-founded.

B. Disclosure of Stock Accumulation Programs

1. SEC v. First City Financial Corporation, Ltd.

The decision by the Court of Appeals for the District of Columbia in SEC v. First City Financial Corporation, Ltd.[556] represents a major victory for the SEC in its efforts to enforce the Section 13(d) filing requirements. The SEC charged that First City, a Canadian company controlled by the Belzberg family and its president, Marc Belzberg, deliberately violated Section 13(d) by failing to disclose an informal "put-call" agreement with Bear Stearns which pushed First City's beneficial ownership of shares of Ashland Oil Company above 5%. The court rejected the defense of First City and Belzberg that Bear Sterns had acquired the Ashland shares for its own account and without direction of First City.

In February 1986, First City began accumulating shares of Ashland stock after a New York stockbroker had advised Marc Belzberg that Ashland was a sensational opportunity, well-suited for the "Sam Belzberg Effect." By February 28, First City had accumulated 1.4 million shares, or just over 4.9% of all Ashland stock, largely through secret nominee accounts. On March 4, Belzberg telephoned Alan Greenberg of Bear Stearns and discussed Ashland. This phone discussion was the centerpiece of the litigation. The SEC claimed, and Alan Greenberg testified, that Belzberg instructed Bear Stearns to buy Ashland shares for First City's account. Belzberg, on the other hand, maintained that he only suggested Bear Stearns buy for its own account.

Immediately after the fateful phone conversation Bear Stearns purchased 20,500 Ashland shares. If purchased for First City, those shares would have pushed First City's ownership of Ashland stock over 5% and triggered the 10 day filing period of Section 13(d). Between

555/ Id. at 258 (citing Greenfield v. Heublein, Inc., 742 F.2d 751 (3d Cir. 1984)).

556/ 890 F.2d 1215 (D.C. Cir. 1989).

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March 4 and 14, Bear Stearns purchased an additional 330,700 Ashland shares.

On March 17, Belzberg called Greenberg and arranged a written put/call agreement for 330,700 Ashland shares accumulated by Bear Stearns. When delivered to Belzberg several days later, the "strike price" which Bear Stearns was charging First City was $43.96 per share, almost $500,000 below the market price of $45.37 per share. After First City's SEC compliance officer advised Belzberg that the below-market strike price created an inference that First City was the beneficial owner of the shares before March 17, Belzberg called Greenberg and arranged for a strike price of $40.00 per share, still almost $450,000 below the market price.

Between March 17 and 25, Bear Stearns bought another 890,100 Ashland shares for First City by using several put and call agreements. After these purchases, Belzberg proposed a "friendly" takeover of the company which Ashland rejected. On March 25, Ashland issued a press release disclosing that First City held between 8% and 9% of Ashland's stock. The next day First City filed a Schedule 13D indicating ownership of 9% of Ashland stock and disclosing its intent to launch a tender offer for all remaining shares at $60 per share. On March 31, Ashland bought out First City at $51 per share, resulting in a profit of $15.4 million for First City.

The case turned on the question whether the put/call agreement between First City and Bear Stearns was entered into on March 4, (the date of the Belzberg-Greenberg phone call) as the SEC claimed, or on March 17 (the date the formal document was delivered) as First City argued. If the agreement was entered into on March 4, First City should have filed a Schedule 13D by March 14, almost two weeks before its initial filing on March 26. The court concluded that the circumstantial evidence showed an informal agreement on March 4.

The court found compelling and inexplicable the $500,000 discount strike price. The court also noted that First City launched a full-scale takeover less than two weeks after the March 4 call and that First City had utilized similar put/call arrangements with Bear Stearns only months earlier in another takeover attempt. The court rejected Belzberg's explanation of the discount strike price that Bear Stearns was acting like "Santa Claus" by offering a "bit of a break" to gain more First City business. The court also affirmed the district court's order that First City disgorge $2.7 million of its profit on the Ashland stock.

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2. SEC v. Evans

In SEC v. Evans[557] the SEC charged that three former executives of Macmillan, Inc. violated Section 13(d) by failing to disclose in a Schedule 13D that purchases of Macmillan shares by the company's ESOP were executed, in part, to further a recapitalization plan intended to deter the threat of a hostile takeover. The three individuals consented to an order enjoining future violations without admitting or denying the SEC charges.

On May 27, 1987, the three executives allegedly began to develop a plan of recapitalization of Macmillan, anticipating a takeover bid for the company. As a of this plan, the executives allegedly caused the Macmillan ESOP to purchase 1.2 million shares, over 5% of Macmillan stock. The ESOP filed a timely Schedule 13D which stated that the purpose of the ESOP stock purchases was to further the purpose of the Macmillan ESOP to allow employee ownership of the company. The SEC maintained that the failure to disclose the proposed recapitalization and that "a purpose" of the ESOP acquisition was to further the recapitalization violated Section 13(d). As a warning to companies establishing ESOPs as takeover defenses, the SEC stated:

> The Commission wishes to emphasize that where disclosure is made or is required concerning the purchase of securities in an Employee Stock Ownership Plan, the person making the disclosure must carefully consider the need to disclose fully the purposes of the transaction and any plans or proposals served by the transaction, including, where applicable, any anti-takeover or other defensive purposes, plans or proposals. In this regard, consideration must be given to the appropriate disclosure under Section 13(d) of the Exchange Act where a reporting person has any plans or proposals which relate to or would result in any "actions which may impede the acquisition of control of the issuer by an person."[558]

557/ Fed. Sec. L. Rep. (CCH) ¶94,802 (D.C.D.C. 1989).

558/ Id. at 94,305. See Missouri Portland Cement Co. v. H.K. Porter Co., 535 F.2d 388, 394 (8th Cir. 1976) (holding that an acquiror who tendered an offer to increase its holdings to 49.2% if the outstanding stock, despite a statement that the shares "may give Porter effective working control of Missouri," clearly had a control purpose that should have been disclosed); but see, Azurite Corp. Ltd. v. Amster & Co., Fed. Sec. L. Rep. (CCH) ¶98,666 (2d Cir. 1995). In Azurite, the Second Circuit stated that plans to wage a proxy contest for control of a company need not be disclosed under Item 4 of Schedule 13D unless they are sufficiently "fixed." The scope of the category of fixed plans is limited: the court explained that there is

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3. In the Matter of Sequa Corporation

The SEC's action In the Matter of Sequa Corporation[559] illustrates the SEC's enforcement policy regarding the Schedule 13D filing requirements in a hostile takeover context. On October 15, 1987 Sequa Corporation filed a Schedule 13D disclosing that it had obtained a 12.3% toe hold in Atlantic Research Corporation. The filing included standard "investment purposes" language and reserved Sequa's option to increase or decrease its holdings and to seek control of Atlantic based upon various factors and conditions, including economic, money and stock market conditions. After the "Black Monday" stock market break on October 19, 1987, two entities offered to sell to Sequa blocks of Atlantic Research stock. On October 22, 1987, Sequa executed agreements to acquire approximately 6.1% of Atlantic Research shares, bringing its aggregate holdings to almost 18.3%.

By October 28, 1987, Sequa had determined to acquire at least a 20% interest in Atlantic Research to enable it to use the equity method of accounting for the investment. On November 2, 1987, however, Atlantic Research officials rejected Sequa's request that the company amend its "poison pill" to enable Sequa to acquire 20%-21% of the company without triggering the rights plan. Later that evening, Sequa announced a tender offer for all shares of Atlantic Research common stock. The next morning Sequa filed a first amendment to its Schedule 13D to reflect its October 22, 1987 purchases of Atlantic Research shares.

The SEC determined that Sequa's twelve day delay in amending the Schedule 13D to disclose the October 22 purchases was not "prompt" and violated Section 13(d). The SEC confirmed that whether an amendment is prompt is to be determined "based on all of the facts and circumstances surrounding both prior disclosures by the filing person and the material changes which trigger the obligation to amend."[560]

The SEC concluded that Sequa should have amended its Schedule 13D once the company had determined to increase its holdings of Atlantic Research to 20%. Curiously, the SEC also indicated that Sequa had a duty to amend its Schedule 13D even earlier, after the October 19 market

no requirement to make predictions of future behavior or to disclose tentative plans, so that a course of action need not be disclosed unless it is "decided upon."

559/ Administrative Proceeding File No. 3-7196, SEC Docket Vol. 43, No. 13, at 1433 (May 19, 1989).

560/ SEC Docket Vol. 43, No. 13, at 1435 (citing In re Cooper Laboratories, Inc., Exch. Act Rel. No. 22,171, Fed. Sec. L. Rep. (CCH) ¶83,788 (June 26, 1985)).

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collapse, to reflect that Sequa no longer considered viable certain of the alternatives set forth in Item 4 of the filing. This suggests that investors which utilize broad "buy or sell" boiler plate language in their 13Ds must amend their filings if, due to significant market developments, they lose their flexibility to buy or sell shares or take other action described in the traditional "laundry list."

4. IBS Financial Corp. v. Seidman & Associates, L.L.C.

A district court in New Jersey clarified exactly who must comply with the reporting requirements of 13D concerning beneficial ownership. When partnerships or other entities file statements complying with the disclosure requirements for 13D, they must include in those statements certain disclosures about each person in control of the partnership or entity. In IBS Financial Corp. v. Seidman & Associates, L.L.C.,[561] the court held that although certain entities may have had majority equity interests in an LLC, they were not deemed to have "control" for the purposes of 13D reporting requirements. The court held that where an individual manager has exclusive authority over the finances and general operations of an LLC, that manager controls the LLC even if he does not hold a majority equity interest in the LLC. Therefore, disclosures need only be made by the individual manager in control and not the entities holding the majority equity interest.[562]

C. Summary of Schedule 13D Cases

None of the private actions discussed above, other than the two cases arising out of the Belzberg/Ashland incident, is a final decision on the merits. However, the fact that the plaintiffs' claims in these cases survived motions to dismiss or motions for summary judgment reflects greater scrutiny of the conduct and public statements of those engaged in hostile takeovers. The SEC proceedings against the Belzbergs in First City and against Macmillan in Evans serve notice that the SEC intends to enforce both the timely filing obligations and the line-item disclosure requirements of Schedule 13D.

These decisions and the SEC's enforcement action against Sequa Corporation are instructive for investors who contemplate an aggressive posture with their investments to avoid the overly-broad "investment purposes" language/statements previously used in

[561] Fed. Sec. L. Rep. (CCH) ¶99,455 (D.N.J. 1997).

[562] Id. at 96,998.

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response to Item 4 (that investor may buy or sell stock as conditions warrant).[563] Despite the district courts' holdings in Belzberg and Kamerman, other cases suggest that general statements of this nature may require amendment as a transaction progresses. To avoid misleading investors and to eliminate obligations to amend filings (when, for example, one of the many options contained in an Item 4 response becomes unavailable) investors should carefully tailor their disclosure to specific factual circumstances. Moreover, Item 4 disclosure should be constantly reviewed for continued accuracy.

XI. DISCLOSURE OBLIGATIONS CONCERNING ENVIRONMENTAL LIABILITY

In the 1990's, the SEC has more closely scrutinized companies that fail to adequately disclose actual and contingent environmental liabilities and attendant compliance costs.[564] It has thus become increasingly important for companies to understand the SEC's position with regard to disclosure obligations concerning environmental liability.

In the disclosure of environmental liabilities, three requirements under Regulation S-K have direct applicability: (i) Item 101, relating to the description of the reporting company's business; (ii) Item 103, relating to disclosure of legal proceedings; and (iii) Item 303, relating to Management's Discussion and Analysis of Financial Condition and Results of Operations (this requires, for example, disclosure of potential "Superfund" obligations).

In 1993, the Staff of the Commission issued Staff Accounting Bulletin No. 92 ("SAB 92"), which provides guidance to accounting and disclosure obligations relating particularly to contingent environmental liability. In 1996, the Association of Certified Public Accountants (AICPA) issued its Statement of Position (SOP 96-1) which provides even more guidance with respect to accounting for environmental liabilities.

A. Levine v. NL Industries, Inc.

In Levine v. NL Industries, Inc.,[565] the district court examined an issuer's duty to disclose non-compliance with environmental laws in its Annual Report. The court

[563] For a recent analysis of Item 4 disclosure, see Albert J. Li, The Meaning of Item Four of Schedule 13D of the Securities Exchange Act of 1934: A New Framework and Analysis, The Business Lawyer, May 1997, at 851.

[564] For example, SEC Commissioner Richard Y. Roberts has stated that the SEC intends to increase its focus on the adequacy of environmental disclosures when reviewing filings. See e.g., The SEC Today Vol. 93-70 (April 14, 1993). Commissioner Roberts has also revealed that, in addition to the SEC's issuance of Staff Accounting Bulletin No. 92, the SEC intends to pursue a formal memorandum of understanding with the EPA regarding disclosure of environmental contingencies. See 25 Sec. Reg. & L. Rep. (BNA) 659 (May 7, 1993). The EPA currently provides the SEC with a list of parties designated "potentially responsible parties". See The SEC Today Vol. 90-96 (May 17, 1990). Commissioner Roberts has delivered many speeches on this subject.

[565] 717 F. Supp. 252 (S.D.N.Y. 1989), aff'd, 926 F.2d 199 (2d Cir. 1991).

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rejected the plaintiff's allegations that NL Industries was required to disclose in its Form 10-K certain violations of emissions standards at the Fernald Uranium Processing Facility owned by the Department of Energy and operated by an NL Industries subsidiary.

The Fernald Facility accounted for no more than 0.2% of NL's annual gross income and the operating contract required the Department of Energy to indemnify NL in the event of loss or liability related to compliance with environmental laws. The plaintiff had purchased his NL stock in 1982 for $22-1/8 per share. Immediately prior to NL's 1984 announcements regarding the violations of emission standards at the Fernald Facility, NL's stock was trading at around $10 per share. By 1986, when the State of Ohio filed an action for clean-up costs and penalties, NL's stock price remained between $13 and $14 per share.

The court determined that the Form 10-K line-items requiring disclosure of environmental matters[566] and pending legal matters[567] did not obligate disclosure by NL of the particular violations at the Fernald Facility. Because the Department of Energy was ultimately responsible for environmental liabilities under the operating contract, the costs of compliance with environmental laws could not have impacted NL's capital expenditures, earnings, or competitive position. Furthermore, NL was not aware of any legal proceedings contemplated with respect to the environmental violations, and thus the information could not be disclosed as a pending legal proceeding. The court dismissed Levine's claim, stating that he had failed to show that NL had a duty to disclose the omitted information.

On appeal, the Second Circuit affirmed the lower court's dismissal, focusing on the immateriality of the allegedly omitted information.[568] The Second Circuit found that NL's shareholders could not plausibly suffer financially from NL's alleged failure to disclose the violations at the Fernald Facility due to the Department of Energy indemnity, and, therefore, information relating to such violations was immaterial.[569] The Second Circuit cautioned, however, that the Form 10-K line-item requiring disclosure of environmental matters would require the disclosure of the cost of failing to comply with environmental regulations, as well as the cost of complying with such regulations, and that the district court's opinion in Levine should not be interpreted otherwise. Apparently, NL would have had a duty to disclose the costs related to the Fernald

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566/ 17 C.F.R. § 229.101(c)(1)(xii) requires disclosure "as to material effects that compliance with Federal, State and local provisions . . . relating to the protection of the environment, may have upon the capital expenditures, earnings and competitive position of the registrant and its subsidiaries."

567/ 17 C.F.R. § 229.103 requires disclosure of "any material pending legal proceedings" including information about "any such proceeding known to be contemplated by governmental authorities."

568/ Levine v. NL Indus., Inc., 926 F.2d 199 (2d Cir. 1991).

569/ This finding is clearly supported by the lack of market reaction to the eventual announcements of the violations and the State of Ohio actions.

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Facility violations in its Form 10-K if such costs had been material, and if NL had not had the Department of Energy indemnity.

B. SAB 92

In 1993, the SEC published SAB 92, which answers a series of specific questions pertaining to accounting and disclosure obligations by public companies of their contingent environmental liabilities, among other matters. Given the growing importance of environmental disclosures, it is crucial that companies understand SAB 92, which has also influenced the narrative disclosure for environmental contingencies and obligations.

The first question addressed by SAB 92 is whether it is appropriate to offset in the balance sheet a claim for recovery that is probable of realization against a probable contingent liability and report the difference as a net amount in the company's balance sheet. The interpretive response: "not ordinarily" appropriate. The staff stated that in order to most fairly present potential consequences of the contingent claim on the company's resources, there should be separate presentation of gross liability from any related claim for recovery in the balance sheet.

The second question concerns a situation where the reporting company is jointly and severally liable as a potentially responsible party ("PRP"), but there is a reasonable basis for apportionment of costs among the other PRPs. The issue is whether the reporting company must recognize a liability with respect to costs apportioned to the other responsible parties. The interpretive response is no; however, if it is probable that the other parties will not fully pay costs apportioned to them, the reporting company should include the registrant's best estimate, before consideration of potential recoveries from other parties, of the additional costs that the registrant expects to pay. Registrants should also discuss the solvency of one or more parties if it is in doubt or the responsibility for the site if it is disputed.

The third question deals with how uncertainties (e.g., estimates regarding the extent of liability and amounts of related costs) affect the recognition and measurement of liability. The response states that the measurement of liability should be based on currently available facts, existing technology, and presently enacted laws and regulations, and should take into consideration the likely effects of inflation and other societal and economic factors. If management can only estimate a range of liability, then the lower limit of the range should be recognized even if the upper limit of the range is uncertain.

For question four, the SEC states that an environmental liability may be discounted to reflect the time value of money if the aggregate amount of the obligation and the time and amount of payments are fixed or reliably determinable for a specific site. Further, the rate used to discount the cash payments should be the rate that will produce an amount at which the environmental liability could be settled in an arms-length transaction with a third party. If the liability is recognized on a discounted basis, the

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notes to the financial statements should discuss in detail the basis and amount of discounting.

The fifth question outlines the financial statement disclosures that should be furnished with respect to recorded and unrecorded product or environmental liabilities. Examples of disclosures that may be necessary include:

(i) Circumstances affecting the reliability and precision of loss estimates;

(ii) The extent to which unasserted claims are reflected in any accrual or may affect the magnitude of the contingency;

(iii) Uncertainties with respect to joint and several liabilities that may affect the magnitude of the contingency;

(iv) Disclosure of the nature and terms of cost-sharing arrangements with other potentially responsible parties;

(v) The extent to which disclosed but unrecognized contingent losses are expected to be recoverable through insurance, indemnification arrangements, or other sources, with disclosure of any material limitation of that recovery;

(vi) Uncertainties regarding the legal sufficiency of insurance claims or solvency of insurance carriers;

(vii) The time frame over which the accrued or presently unrecognized amounts may be paid out; and

(viii) Material components of the accruals and significant assumptions underlying estimates.

Question six discusses disclosures outside of the financial statements. The response advises that registrants should consider the requirements of Regulation S-K and S-B (governing small business) Items 101, 103, and 303. The response also refers to the 1979 and 1989 interpretive releases.[570] Disclosures made pursuant to these provisions should be sufficiently specific to enable a reader to understand the scope of the contingency. Disaggregated disclosure that describes accrued and reasonably likely losses with respect to particular claims may be necessary if they are individually material.

In question seven, the staff indicates that material liabilities for site restoration, post closure, and monetary commitments, or other exit costs that may occur on the sale,

570/ See Securities Act Release No. 6130 (Sept. 27, 1979) and Financial Reporting Release No. 36 (May 18, 1989).

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disposal, or abandonment of a property should be disclosed in the notes to the financial statements. Such disclosures should generally include the nature of the costs involved, the total anticipated cost, the total costs accrued to date, the balance sheet classification of accrued amounts, and the range and amount of reasonably possible additional losses. In addition, the reporting company should disclose liability for remediation of environmental damage to a previously disposed of asset unless the likelihood of liability is remote.

Finally, the staff recognizes that where a reporting company expects to incur site restoration costs, post-closure and monitoring costs, or other environmental exit costs at the end of the useful life of an asset, these costs can be accrued over the useful life of the asset. The accrual of the liability would be recognized as an expense.

C. SOP 96-1

In an effort to clarify the standards for reporting and disclosing environmental liabilities, the Association of Certified Public Accountants (AICPA) issued its Statement of Position (SOP) 96-1, which provides guidance on accounting issues related to the recognition, measurement, display, and disclosure of environmental remediation liabilities.[571] SOP 96-1 became effective for fiscal years beginning after December 15, 1996, and applies to all companies that prepare financial statements in accordance with generally accepted accounting principles. The SOP identifies certain stages of a remediation effort as benchmarks that should be considered when determining that an environmental liability is probable, reasonably estimable, and therefore should be disclosed.[572] These benchmarks include:

- the identification and verification of a company as a potentially responsible party (PRP);
- the receipt of a unilateral administrative order;
- participation as a PRP in the remedial investigation/ feasibility study;
- the completion of a feasibility study;
- the issuance of a record of decision; and
- remediation design through operation and maintenance.

571/ For a comprehensive account of the events leading up to this Statement of Position, see Howard B. Epstein and Aaldert Ten Veen, Position Statement Clarifies Liability Disclosures, The National Law Journal, Mar. 17, 1997, at B18.

572/ The scope of SOP 96-1 is limited to environmental remediation liabilities resulting from an assertion or threat of assertion of litigation, a claim, or an assessment.

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Once a company has determined that it is probable that an environmental remediation liability has been incurred, the liability should be estimated by using the available information. The estimation of liability should include the company's allocable share of the liability for a site and the company's share, if any, of the amount related to the site that will not be paid by other PRPs or the government. In addition, SOP 96-1 requires that the entity also include in the estimate the incremental direct costs of the remediation effort[573] and the costs of compensation and benefits for those employees who are expected to devote a significant amount of time directly to the remediation effort.

D. Conclusion

As our planet becomes increasingly aware of the importance of environmental issues, so too must companies understand their social responsibilities with respect to the environment. And as the SEC intensifies its scrutiny of reporting companies' disclosure obligations regarding environmental liabilities, among other matters, so too must companies understand their disclosure obligations under securities law. While the effects of SOP 96-1 may still currently be uncertain, by 1998, we should be able to judge its effects by examining the annual financial statements of companies who prepare their statements in accordance with generally accepted accounting principles.

XII. T + 3

Adopted in 1995, Rule 15c6-1[574] establishes that the standard settlement time for most broker-dealer trades is three business days after the trade or "T + 3."[575] When Rule 15c6-1 was first proposed, commentators expressed concern that settlement within "T + 3" would not be feasible because of the amount of time it would take to print and deliver prospectuses.[576] Two proposals to simplify prospectus delivery were submitted to the commission; the "Four Firms" proposal and the Securities Industry Association ("SIA") approach.[577]

573/ These incremental direct costs would include: the cost of completing the remedial investigation/ feasibility study; fees of law firms for work related to determining the extent of required remedial actions; fees of engineering and consulting firms for site investigations and developments of remedial action plans; and the costs of post-remediation monitoring required by the remedial action plan.

574/ 17 C.F.R. § 240.

575/ SEC Release No. 33-7168; 34-35705 (May 11, 1995) (the "FD Adopting Release").

576/ The SEC noted that prospectus delivery concerns should be alleviated as electronic delivery becomes more prevalent.

577/ The Four Firms include CS First Boston Corporation, Goldman Sachs & Co., Lehman Brothers, Inc., and Morgan Stanley & Co.

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A. The Four Firms Proposal

The Four Firms proposal was based on the view that most of the prospectus could be printed before pricing to facilitate delivery within T + 3, if certain modifications were made to existing SEC rules. Six of the key modifications are summarized below.

1. Reordering of Prospectuses

The SEC's Rule revision allows issuers to present information that becomes available or is likely to change at the time of pricing to be included together either in the beginning of the prospectus after the front cover page in a "pricing-related information" section or wrapped around the prospectus inside the front and back cover pages.[578] The "Pricing-Related Information" section would include among other things: the use of proceeds; capitalization; pro forma financial information; dilution; selling shareholder information; and shares eligible for future sale. If the "pricing-related" information is included after the front cover page of the prospectus, the summary and risk factor sections may appear immediately following the "pricing-related" section. In addition, some information[579] which would normally be required to appear on the cover page may be placed elsewhere in the prospectus.

2. Changes in Offering, Size, or Price

An issuer is permitted to register securities by specifying only the title of the class being registered and the proposed maximum offering price. However, the issuer is still required to specify in the prospectus the amount of securities being offered and, if the issuer is not a reporting company, a bona fide estimate of the range of the maximum offering price. The aggregate dollar amount associated with each class of securities must be disclosed in the registration fee table. If the issuer registers more than the required number of shares in the offering, the excess securities may be carried forward to subsequent registrations of the same class of securities.

Where the size of an offering increases subsequent to pricing, the issuer may use an abbreviated registration statement to register additional securities, provided that the additional shares represent no more than a

578/ To ensure that investors continue to easily locate the "Risk Factors" section of the prospectus, the SEC also requires that the cover page of the prospectus identify the page number at which that section appears in the prospectus and that the risk factors section be labeled as "Risk Factors."

579/ This information would include disclosure regarding the availability of Exchange Act Information, the nature of reports given to security holders, undertakings with respect to information incorporated by reference, and the enforceability of civil liabilities against foreign persons.

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20% increase over the shares previously registered. This abbreviated registration statement includes the facing page, a statement incorporating by reference the contents of the prior filing, all required consents and opinions, and the signature page. It may also include any price-related information with respect to the offering that was omitted from the earlier registration statement pursuant to Rule 430A. The abbreviated registration statement must be filed prior to the time sales are made and confirmation is given, and the statement is effective upon filing.[580]

Where the size or the price of an offering declared effective under Rule 430A do not in the aggregate deviate more than 20% from the price set forth in the registration fee table of the effective filing, a post-effective amendment is not required. On the other hand, where there is a change in offering size or deviation from the price range beyond the 20% threshold, a post-effective amendment is required only if such change materially alters the previous disclosure. The release does, however, indicate that "issuers continue to be responsible for evaluating the effect of a volume change or price deviation on the accuracy and completeness of disclosure made to investors."[581]

3. Manual Signatures and Incorporating by Reference Opinions and Consents

The SEC now permits duplicate or facsimile signatures to be used in lieu of manual signatures for any registration filed under the Exchange Act. If facsimile or duplicate signatures are used, the registrant must maintain the manually signed version for five years and provide it to the SEC upon request.

4. Rule 430A Pricing Period

Rule 430A previously provided that a registration could be declared effective without pricing information if the missing information was contained in a supplemental prospectus filed five days after the effective date of the registration statement. The SEC extended the "pricing" period to 15 days, principally to reduce the likelihood that a post-effective amendment would have to be filed. The SEC, however, has

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580/ Abbreviated filing is allowed even where pricing occurs after the SEC offices have closed. Electronic filers may file via Edgar and others may file by fax, between 5:30 and 10:30 p.m. Eastern time. Payment may be made after banking hours by instructing a bank to wire the payment amount no later than the close of the next business day after filing and providing certain certifications to the SEC with the filing. See the FD Adopting Release, supra note 448.

581/ See Footnote 32 to the FD Adopting Release, supra note 448.

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proposed to amend Rule 430A to allow smaller companies, including small business issuers to delay pricing information for up to one year after the effective date of the registration statement.[582] While such a proposal may seem "somewhat innocuous," some believe that the proposal should be reconsidered, because it provides issuers with a way to avoid important safeguards of the Securities Act registration process.[583]

5. Acceleration Request

The SEC now permits requests for acceleration of effectiveness to be transmitted either via facsimile or orally. A letter indicating that the registrant and managing underwriter intend to request oral acceleration must be submitted to the commission prior to the oral acceleration request.[584]

6. T + 4 for Firm Commitment Offerings Priced After the Close of the Market

Firm commitment offerings priced after 4:30 p.m. Eastern time where the securities are sold by an issuer to an underwriter or a broker-dealer participating in an offering are governed by a "T + 4" settlement time frame. The T + 4 period also applies to a secondary offering where the issuer and managing underwriter agree in writing that such a settlement period will apply. In addition, the Commission has provided an "override" provision to T + 3 for the sale of all securities subject to a firm commitment offering upon agreement by the managing underwriter and the issuer. The Commission has stressed, however, that the override provision is "not intended to dilute the presumption in favor of application of the T + 3 settlement cycle in connection with firm commitment offerings." Instead, the override provision is intended to be used only in those circumstances when T + 3 settlement is not feasible.

B. SIA Proposal

As adopted by the Commission, the SIA approach provides for incremental prospectus delivery. For offerings registered on forms other than S-3 or F-3, prospectus delivery is accomplished by delivery of a preliminary prospectus, a term sheet, if

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582/ See SEC Rel. No. 33-7393 (Feb. 20, 1997).

583/ See Jesse M. Brill, More on The Rule 144 (and Reg S and 430A) Proposals, The Corporate Counsel, March-April 1997, at 1 (discussing the possible negative effects of the Rule 430A proposal).

584/ The letter should also indicate that the registrant and the managing underwriter are aware of their obligations under the Securities Act.

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necessary, and a confirmation. The term sheet provides all information material to investors that is not disclosed in the preliminary prospectus. The preliminary prospectus and term sheet, taken together, may not materially differ from the disclosure included in the effective registration statement. The term sheet must be filed with the Commission within two business days after the earlier of the pricing date or first use.[585]

For registrants using short-form registration, delivery may be accomplished by delivery of a preliminary prospectus, an abbreviated term sheet, and a confirmation. The abbreviated term sheet must include, unless described in the preliminary prospectus or incorporated by reference, a description of the securities (as required by Item 202 of Regulation S-K) and information regarding material changes (as required by Item 11 of Form S-3). Offering-specific information usually contained in the final prospectus, such as use of proceeds and plan of distribution, need not be physically delivered to investors and instead is only required to appear in the prospectus supplement filed with the Commission.

It is unclear how comfortable underwriters will be in delivering abbreviated prospectuses or term sheets to investors or in deviating significantly from the current ordering of information contained in a prospectus. Our own experience has been that few issuers have availed themselves of abbreviated prospectus delivery.[586]

XIII. FREE RIDING INTERPRETATION

The SEC on December 7, 1994 approved certain rule changes to the NASD "free-riding" interpretation of the NASD Manual of Rules of Fair Practice,[587] and a further amendment effective in August 1998 changed the definition of who could participate in a hot issue. Some of the key changes to the interpretation include the following:

A. Stand-by Arrangements

The prior interpretation restricted sales to "stand-by" purchasers in certain instances by disallowing persons restricted under the prior interpretation from having a beneficial interest in a "stand-by" account. The new interpretation now provides that securities purchased pursuant to a "stand-by" arrangement (i.e., an agreement to purchase

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585/ One author has noted that while a term sheet may be effective to quickly update pricing information, "it may be the less attractive alternative where the form of prospectus included in the registration statement at the time of effectiveness has been significantly modified compared to the preliminary prospectus delivered to investors." Nicholas Grabar, Memorandum Regarding Compliance with Prospectus Delivery Requirements in a T + 3 Settlement Environment, May 17, 1995.

586/ Financial printers whom we contacted have indicated that they have not had any problems meeting a "T + 3" deadline. Additionally they have indicated that issuers and underwriters alike have not wanted to be "first on the block" to deliver term sheets or abbreviated prospectuses.

587/ SEC Release No. 34-35059 (December 7, 1994) (the "NASD Release").

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securities not purchased during the offering) are not subject to the provisions of the interpretation if: (1) the "stand-by" is disclosed in the prospectus; (2) the "stand-by" arrangement is the subject of a formal written agreement; (3) the managing underwriter represents in writing that it was unable to find any other purchasers for the securities; and (4) the securities purchased are restricted from sale or transfer for a period of three months.[588]

B. Definition of Immediate Family

The old interpretation restricted immediate family members or persons associated with broker/dealers, persons having a connection to the offering, and individuals related to banks, insurance companies and other institutional type accounts from participating in "hot issue" distributions. The amendment to the interpretation then was changed to provide that:

> the prohibition shall not apply to sales to a member of the immediate family of a person associated with a member who is not supported directly or indirectly to a material extent by such person if the sale is by a broker/dealer other than that employing the restricted person and the restricted person has no ability to control the allocation of the hot issue.[589]

With the May 18, 1998 approval by the SEC of this interpretation, effective August 17, 1998, the definition of who may participate in a "hot issue" has changed.[590]

- Hot issues may not be sold to any person who owns or has contributed capital to a broker-dealer, including certain members of immediate family, as well as accounts in which such persons have a beneficial interest.

- A holding company that owns a broker-dealer may not purchase hot issues.

This latest NASD Release does not appear to include a non-broker-dealer "sister company" or certain "passive owners" of broker-dealers with less than 10% ownership or capital interest if (a) the hot issue is purchased from another broker-dealer or (b) the broker-dealer's securities are listed on an exchange or traded in NASDAQ.

588/ See the NASD Release, supra note 460.

589/ Id.

590/ SEC Releases No. 34-40001 (May 18, 1998) (the "latest NASD Release").

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C. Venture Capital Investors

The NASD concluded that venture capital investors should be allowed to purchase a hot issue to maintain their percentage ownership in an entity, notwithstanding that the venture capital investor may be a restricted person, or that such person may have a beneficial interest in a venture capital account. The new interpretation therefore provides that venture capital investors may purchase hot issues without implicating the interpretation's restrictions if:

(a) there is one year of pre-existing ownership in the entity;

(b) there is no increase in the investor's percentage ownership above that held for three months prior to the filing of registration statement in connection with the initial public offering;

(c) there is a lack of special terms in connection with the purchase; and

(d) [the] Venture Capital Investor shall not assign, sell, pledge, hypothecate or otherwise dispose of the securities for a period of three months following the effective date of the registration statement in connection with the offering.[591]

The NASD has recently warned its members of abusing this exception, reminding members that such "flipping" or "spinning" practices violates their obligations under the "Free-Riding and Withholding Interpretation" of the NASD rules.[592] The "flip" and "spin" occur when an investment bank allocates shares of a "hot" IPO to the personal account of potential future customers, providing for a quick profit. Such activities have recently drawn media attention and debate.[593]

[591/] Id.

[592/] See Securities Offerings: NASD Sends Members Warning Concerning Allocation of Hot IPOs, Securities Regulation and Law Report, vol. 29, no. 47, p. 1687 (Dec. 5, 1997).

[593/] See The Spin Desk: Underwriters Set Aside IPO Stock for Officials of Potential Customers -- Coincidentally or Otherwise, Work Follows for the Investment Bank, The Wall Street Journal, November 12, 1997 and SEC, NASD Begin Probes of IPO "Spin" Accounts, The Wall Street Journal, November 13, 1997.

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D. Definition of Public Offering

The NASD concluded that the definition of "public offering" implicated private placements of securities which do not present the abuses that the interpretation was designed to guard against. The amended interpretation therefore provides that private placements are not within the purview of the interpretation. Specifically, the amended interpretation defines a public offering as "any primary or secondary distribution of securities made pursuant to a registration statement or offering circular . . . of any kind whatsoever except any offering made pursuant to an exemption under §4(1), 4(2) or 4(6) of the Securities Act of 1933, as amended, or pursuant to Rule 504 . . . or Rule 506."[594]

E. The NASD's "Hot Issues" Rule and Private Investment Funds

The NASD promulgated Rule IM-2110-1 to regulate the broker-dealers' allocation of hot issues to their customers.[595] These customers may include private investment funds, and as a result, the rule may have a significant impact on these funds. The rule itself only applies to members of the NASD, and it basically states that a broker-dealer may not allocate hot issues to a fund if the fund has any beneficial owners who are "restricted persons" as defined in the rule, unless two conditions are satisfied: 1.) The fund's operating agreement must contain a carve-out that allocates profits and losses from the hot issue to non-restricted investors only; and 2.) the broker-dealer must obtain a written opinion of an attorney attesting to the carve-out from the fund.[596]

F. History of Rule Filings Regarding Hot Equity Offerings

In October of 1999, the NASDR filed with the SEC an initial proposal to create Rule 2790, "Trading in Hot Equity Offerings", to replace the Free-Riding and Withholding Interpretation, IM-2110-1.[597] The purpose of the initial proposal was to prohibit NASD member firms from withholding securities in a bona fide public offering for the firm's benefit.[598] After NASDR reviewed comments received on the proposal, the National Association of Securities Dealers Inc. Board of Governors approved changes to the rule proposal on August 17, 2000.[599] These approved changes not only restrict

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594/ Id.

595 See Frederick L. White, "The NASD's 'Hot Issues' Rule as it Applies to Private Investment Funds," The Investment Lawyer, Volume 7, No.3 (March 2000).

596 See id.

597 See http://www.NASDR.com, File No. SR-NASD-99-60. The proposal requires the approval of the SEC before it may become effective.

598 See "NASD Board OKs Revised Proposal on Industry Insiders' Trading in IPOs", Securities Regulation and Law Report, Vol. 32, No. 33, pg. 1139, August 21, 2000.

599 See id.

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industry insiders from investing in "hot issues", but they prohibit the industry insiders from investing in any initial public offering "for their own benefit at the expense of public customers."[600] In sum, the proposed changes broadened the rule's coverage to prohibit investment advisers, portfolio managers and hedge fund managers from buying stock in *any* IPO from brokerages.[601]

As a result, a second amendment to the proposed rule was filed with the SEC on October 10, 2000.[602] The text of the broader proposed rule, subject to certain exemptions in section (c), generally states:

(a) General Prohibitions

(1) A member or a person associated with a member may not sell, or cause to be sold, a *new issue* to any account in which a restricted person has a beneficial interest, except as otherwise permitted herein.

(2) A member or a person associated with a member may not purchase a *new issue* in any account in which such member or person associated with a member has a beneficial interest, except as otherwise permitted herein.

(3) A member may not continue to hold *new issues* acquired by the member as an underwriter, selling group member, or otherwise, except as otherwise permitted herein.

(b) Preconditions for Sale

Before selling a *new issue* to any account, a member must in good faith have obtained within the twelve months prior to such sale, a representation from the account holder(s), or a person authorized to represent the beneficial owners of the account, that the account is eligible to purchase *new issues* in compliance with this rule.

(c) General Exemptions

The general prohibitions in paragraph (a) do not apply to sales and purchases by:

(1) An investment company registered under the Investment Company Act of 1940; or

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600 Id.

601 See id.

602 See http://www.NASDR.com, File No. SR-NASD-99-60.

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(2) Certain funds as stipulated in the proposal.[603]

On November 28, 2000, the SEC published for comment the second amendment to the NASD's proposed Rule 2790 with the intent that such rule replace the Free-Riding and Withholding Interpretation. The differences between the new proposed rule and the Interpretation are summarized best as follows:

- It applies to most initial equity public offerings and not just those that are hot issues. The proposal exempts all secondary offerings, as well as initial offerings of certain types of securities.

- It requires a broker-dealer to maintain and update (at least annually) a verification from every account to which it sells hot issues certifying that no "restricted person" has a beneficial interest in the account.

- It eliminates the exemption for sales of hot issues to persons in a manner consistent with their "normal investment history."

- It restricts only those financial institution personnel who have "the authority to make investment decisions" for the account.

- It permits hedge fund managers and other portfolio managers to invest in new issues through the funds they manage (*i.e.*, in proportion to their beneficial interest in the fund/portfolio) but prohibits such persons from purchasing initial public offering securities for their personal accounts.

- It attempts to clarify the restrictions on sales to direct and indirect owners of broker-dealers by focusing on the SEC's concept of ownership set forth in Form BD. The proposed rule also permits certain publicly traded affiliates of broker-dealers to purchase equity securities in an initial public offering, providing such purchases are for the benefit of the public shareholders.

- It liberalizes certain limited exemptions (*e.g.*, for issuer-directed sales) that permit sales to otherwise restricted persons.[604]

[603] See id.

[604] See Dennis C. Hensley and Barbara J. Endres, "NASD Proposes to Overhaul Its Free Riding and Withholding Interpretation," INSIGHTS, Volume 15, Number 1, pgs. 2-8 (January 2001).

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By Maryann A. Waryjas and Mark Wood

Treading Water

A year-plus of lower stock prices has put the options of many corporate managers and employees "under water." With current price below the exercise price, companies feel the need to reprice these options to retain the incentive they promise. But institutions don't like repricing; after all, their share values are lower, too. Maryann Waryjas and Mark Wood provide a primer for companies on how to reprice options to minimize accounting complications and deal with SEC rules involving tender offers.

> Institutional investors are **strongly opposed** to repricings, and companies are concerned about the corporate governance issues surrounding them.

With stock prices plummeting during the last year, many of the stock options issued by companies to incentivize and compensate employees are now "under water" or worth less than their exercise prices. Recognizing that underwater options neither properly compensate employees nor create an incentive to stay, some companies have implemented option repricings in efforts to keep employees from jumping ship and to reward them for their perseverance and loyalty.

Option repricings take many forms, from simply reducing exercise prices of outstanding options to offering employees the opportunity to exchange current options for new ones with lower exercise prices. The structure of a company's option repricing is likely to be driven by a number of factors, including stockholder concerns, accounting considerations, and securities laws issues.

Simple option repricings are no longer common. Institutional investors are strongly opposed to repricings, leaving companies concerned about governance issues. Stockholders, with no relief from falling prices, have shown concern over the dilutive effects of repricings. And, importantly, neither stockholders nor boards of directors want to bestow an undeserved benefit on executive officers — likely to be the people responsible for the stock's falling price.

Three Choices

Sensitive to these concerns, companies determined to reprice options have three choices: Reduce the total number of shares for which repriced options are exercisable, lengthen the vesting schedule of repriced options, or change the tax status of repriced options (i.e., from incentive stock options to a nonqualified stock options). Companies also may choose to incentivize and compensate their rank-and-file employees by repricing their options, but not executive officers and directors, seen as more accountable for the company's performance.

Because accounting treatment can be significantly adverse, repricings often are designed to minimize or avoid certain types of accounting treatment. Ordinarily, an option granted with a fair market value exercise price results in no compensation expense for the company. However, repriced options can be costly under Financial Accounting Standards Board Interpretation No. 44, namely "Accounting for Certain Transactions Involving Stock Compensation: An Interpretation of APB Opinion No. 25," which applies to all options repriced since December 15, 1998.

According to the rule, an option that is repriced followed by the stock price rising above the exercise price is subject to variable account-

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ing. The company incurs a compensation expense based on the difference between the stock price and the exercise price, as measured in each accounting period, until the option is exercised or canceled or expires.

Further, under FASB 44, new options at a lower exercise price that replace canceled options are viewed as a repricing, leaving the new options subject to variable accounting. However, to be considered a repricing, the new options must be granted within six months before or after the cancellation.

Companies have several alternatives for structuring repricings to minimize or avoid variable accounting:

- Companies canceling old options and issuing new ones with lower exercise prices can minimize the adverse accounting treatment by shortening the vesting schedule and/or the life of new options. For example, Amazon.com, Inc., issued new options that begin vesting in six months and expire in approximately 30 months.

- Companies may issue new options without canceling old ones. The new options should not be subject to variable accounting, but the company will have twice as many options outstanding, resulting in much greater potential dilution.

- Companies may issue new options that expire six months and one day after a stock price target is achieved, without canceling old options, to fill the gap between the exercise price of the old ones and the current stock price. As long as the new options do not expire until at least six months and one day after the stock price target is achieved, the new options should not be subject to variable accounting, and the company will have twice as many options outstanding only until the new options expire.

- Companies may issue restricted stock to replace canceled options. Restricted stock is not subject to variable accounting, but the company will incur a fixed compensation expense, taken over the vesting period of the restricted stock, based on the difference between the

More Repricings This Year

Investors, especially institutions, are inclined to react negatively to company initiatives to reprice or exchange underwater executive and employee stock options. Their reasoning is understandable: Our shares are worth less than they were before — why should the company bail out its employees?

Companies argue that options are a critical incentive to attract and keep top managers, software development wizards, scientists, and other key employees. The issue appears to be especially intense in technology businesses.

Shareholder activists have viewed the issue variously in recent years. A couple of years ago, the State of Wisconsin Investment Board (SWIB) mounted a strong campaign to deter certain companies from reissuing options, submitting proposals and holding meetings with executives. SWIB is still against repricing, but works more closely with companies now to negotiate satisfactory settlements.

In fact, only one proposal was filed this year, asking Sprint to get shareholder approval of any repricing plan. Most popular actions by companies involve restricted stock awards, option exchange programs, and canceling underwater options to later issue new ones.

Indeed, the pickup in repricing activity in 2001 is substantial, according to The Investor Responsibility Research Center. IRRC scrutinizes 10-Q reports, proxy statements, and 10-year option repricing tables to discover the companies taking actions. In 2000, some 31 companies did some form of repricing, says Drew Hambly, senior research analyst at IRRC. In contrast, the number has nearly doubled to 59 companies so far this year, he reports.

Of these, 20 were out-and-out repricing of underwater options, while 39 involved restricted stock or cancellation followed six months and a day later by the issuing of new options as a way to circumvent the new Financial Accounting Standards Board (FASB) rule involving variable accounting.

What Some Companies Did

At least a half-dozen companies asked their shareholders this year to approve restricted stock grants, including Coca-Cola. Restricted stock doesn't have a stated/or minimal exercise price, which essentially enables the owner to be compensated even when the price doesn't rise. Holders also have voting rights and receive dividends. IRRC expects restricted stock to grow as an incentive pay tool.

Union Planters, according to IRRC, allowed about 185 executives to exchange their underwater options for restricted stock with a fair market value equal to the present value of the surrendered options.

Several companies have chosen to cancel underwater options, wait six months and one day, and then issue new options as a way around variable accounting treatment. One such company is Colonial Bancorp, IRRC reports. It canceled options carrying an exercise price above $13 a share, granting new options. IRRC says that close to all the 866,000 options eligible under the exchange program were surrendered by employees.

Hartmarx got over 80% shareholder approval to an option surrender program involving 1.6 million shares. No promise of future stock awards was made, and the company indicated that it would not grant any options before the six months and a day period was up, avoiding the variable accounting rules, IRRC says.

As part of its turnaround plan, Priceline.com allowed employees to surrender nearly 8.5 million underwater stock options. The company canceled the shares to free up a sufficient number for future grants. IRRC says the firm "committed to issue" some 4.6 million new options six months and a day after the cancellation.

IRRC's Hambly says that institutions will be "far from thrilled" about the pickup in activity once they realize the extent it grew in 2001. He believes that institutions didn't file resolutions this year because of the low number of companies repricing in 2000. With the number like to be more than doubled once companies report their actions in 10-Q reports due August 15, institutions will probably become more aggressive in their activism, according to Hambly.

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To avoid SEC issues and take advantage of the newly granted exemptive order, companies repricing options by implementing option exchanges will have to **comply** with the issuer tender offer rules.

stock price on the date of grant and any purchase price paid.

- Companies may implement option exchanges, provided employees agree to surrender their underwater options today and the company agrees to grant them new options in six months and one day at a new exercise price. The new options should not be subject to variable accounting. This is the approach taken by many companies, including Ariba, Commerce One, FutureLink, i2 Technologies, Lante, TIBCO Software, and Wireless Facilities.

When Repricings Become Tender Offers

Does exchanging options or issuing new ones constitute a tender offer? If so, it is subject to the issuer tender offer rules under Section 13(e) of the Securities Exchange Act of 1934, as amended, and all related substantive and procedural rules. A Schedule TO, requiring disclosure about the company and offering, must be filed with the Securities and Exchange Commission simultaneously with the offering's commencement. Once filed, the SEC may elect to review the TO, and the offer must remain open for at least 20 business days. Satisfying the tender offer rules is time-consuming and burdensome, and does not fit the compensatory purposes of an option exchange.

Before the SEC officially weighed in on this issue, companies reached opposite conclusions as to whether their option exchanges constituted issuer tender offers. An eight-factor test set forth in Wellman v. Dickinson, 475 F. Supp. 783 (S.D.N.Y. 1979), which focuses primarily on whether stockholders are pressured to tender their securities, is generally used to determine if a tender offer exists. However, this test is not particularly helpful in analyzing option exchanges, because it is designed to deal with typical tender offers made to public stockholders. In contrast to these typical tender offers, option exchanges are not intended to pressure stockholders to participate and are offered to a limited universe of stockholders, namely employees who hold options.

In addition, there is little threat of abusive practices surrounding option exchanges, and employees generally have greater access to information about the company in making their investment decisions. Nonetheless, some companies, including Lante Corporation and Amazon.com, Inc., concluded that their option exchanges were issuer tender offers subject to the tender offer rules. Other companies, including Sprint, apparently came to the opposite conclusion, determining that their option exchanges were not issuer tender offers.

The SEC has ruled on the debate, responding to several recent option exchanges and differing views on the question. Initially, the commission indicated informally to counsel of certain companies that their exchanges would likely constitute issuer tender offers, considering the large number of option holds that would be affected. In March 2001, when granting exemptive relief from two of the issuer tender offer rules (discussed below), the SEC stated explicitly that "these exchange offers as commonly structured are subject to the issuer tender offer rule."

Therefore, to avoid SEC issues and take advantage of the newly granted exemptive order, companies repricing options by implementing option exchanges will have to comply with the issuer tender offer rules.

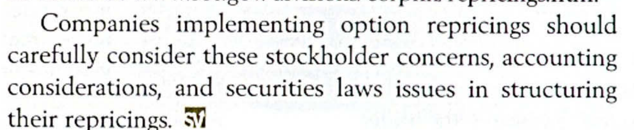
The SEC issued an order exempting option exchanges from two of the tender offer rules — the "all holders" and "best price" rules [Rules 13e-4(f)(8)(i) and (ii)]. In its finding, the SEC stated that option exchanges do not present the concerns regarding discriminatory treatment that these rules were meant to address. Indeed, according to the commission, the all holders and best price rules would most interfere with option exchanges as companies typically desire to structure them.

The all holders rule requires that a tender offer be open to all holders of a particular class of securities. In the context of an exchange, the all holders rule would prohibit a company from excluding directors or executive officers from its option exchange, even if the company believes those persons should be held accountable for the fall in the stock price precipitating the need for the exchange.

The best price rule prohibits a company from offering different consideration to different securities holders. In the context of an exchange, the best price rule would prohibit a company from issuing one employee new options with an exercise price of $3 per share and another employee new options with an exercise price of $5 per share, even if the options surrendered for cancellation by these employees had different exercise prices.

Through the SEC's exemptive order, these limitations are eliminated, allowing companies to structure their option exchanges in ways consistent with their compensation policies and practices so long as certain other requirements are met. The order and an explanation of the exemption can be found at www.sec.gov/divisions/corpfin/repricings.htm.

Companies implementing option repricings should carefully consider these stockholder concerns, accounting considerations, and securities laws issues in structuring their repricings. SV



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2001 Proxy Season Review

(as of June 30, 2001)

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IRRC'S 2001 PROXY SEASON REVIEW

(through June 30, 2001)

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Shareholders Keep the Heat on Executive Compensation

IRRC's analysis of voting results obtained as of June 30, 2001, suggests that traditional corporate governance issues continue to garner steady levels of support from shareholders (see Tables 1 and 2). But, the media's intense focus on the executive compensation might have paid off this proxy season for shareholder proponents who submitted resolutions aimed at reigning in management pay packages.

■ **Eighteen resolutions asking companies either to restrict their executive compensation, to discontinue their executive bonuses, to record option expenses in income statements, to refrain from exercising options after a downsizing, to institute a performance-based compensation system, to link pay to performance, to disclose more information about executive compensation or to freeze executive pay during a downsizing came to shareholder votes in 2001.**

IRRC has obtained voting results for 13 of these proposals, and average support for these stands at 13.5 percent of the votes cast for or against. Last year, a total of 16 similar proposals garnered average support of 8.5 percent of the votes cast.

The average level of support for the 13 proposals aimed at restricting executive compensation was somewhat skewed by the very high vote that a proposal at Luby's received. That resolution received support from 49.7 percent of the votes cast at the company's January 12 annual meeting. Without the Luby's vote, average support in 2001 for "restrict executive compensation" types of proposals stands at 10.4 percent of the votes cast, which is still about two percentage points higher than it was in 2000.

The proposal at Luby's asked the company to link executive pay to performance by amending the terms of the cash investment bonus plans so that no bonus payment would be paid to the CEO from those plans for a fiscal year if either 1) earnings per share; 2) the total sales; 3) the year-end market price of Luby's common shares do not exceed those respective amounts for the prior fiscal year. The board says it adopted an executive bonus plan for fiscal 2000 that provided for the payment of cash bonuses determined by achievement of goals based upon earnings per share and comparable store shares and upon achievement of strategic objectives. While no bonuses were paid under such a plan for fiscal 2000, former President and CEO Barry J.C. Parker received cash bonuses of $93,500 in 1999 and $132,000 in 1998. The company argued against the shareholder resolution, saying that the proposed terms would improperly inhibit its flexibility in providing compensation arrangements needed to attract a new CEO. Nevertheless, the proposals received just short of majority support.

"I think the issue of executive pay is catching on, and institutional investors specifically are getting more involved," says Scott Klinger, co-director of Responsible Wealth, a national network of businesspeople, investors and affluent Americans that each year submits shareholder proposals specifically aimed at curbing executive compensation. He points to the voting results at Raytheon as an example of how institutional investors' support for these types of proposals is growing. A resolution that Responsible Wealth submitted asking the company to link CEO pay to employee satisfaction received greater support from the Class B shares than it did from Class A shares. Class B shares were more widely held by institutional investors, while Class A shares generally were held by individual investors. (In April 2001, shareholders approved

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a management proposal to reclassify its Class A and Class B common shares into a single new class of common stock.)

After the downturn in the stock market last year, Klinger says he expected to see a corresponding decline in executive pay, but he did not. "The longer this goes on, the more resentment builds," he says. While acknowledging that the popularity of executive pay proposals is on the rise, Ken Bertsch, director of corporate governance for TIAA-CREF, says the issue is a "very touchy one that is difficult to get your hands around." He adds that "institutional investors are somewhat wary to take the lead on the issue; union funds are in a better position to critique executive pay." Bertsch is quick to note that one institutional investor, the State of Wisconsin Investment Board, did take the lead on the issue in 1998 when it introduced a number of proposals asking companies to refrain from repricing stock options.

Pointing to a proposal on executive compensation at Sprint that received 46.6 percent of the votes cast, Brandon Rees, a research analyst with the AFL-CIO predicts, "I think we'll see more proposals on executive compensation next year, and possibly majority votes." The Sprint proposal, sponsored by the New York State Common Retirement Fund, asked the company's board to adopt a policy that the company would not reprice (or cancel and regrant) to a lower exercise price any stock option already granted to any employee or director without prior common shareholder approval. Rees also acknowledges that some companies now are more willing to make concessions in this area. "Proposals are being successfully negotiated with companies that have been prior bad actors."

Many of the proposals related to executive compensation that were submitted to companies by shareholders at the beginning of the proxy season (including proposals asking companies to restrict executive compensation, to allow shareholders to vote on future golden parachutes, to grant performance-based stock options and to prohibit the repricing of underwater options) never appeared in the companies' proxy statements. Although companies were deluged with a total of 90 proposals related to executive compensation, just 43 proposals actually came to a shareholder vote. Those that were not considered by shareholders were either omitted from the proxy statements by the companies under SEC rules, withdrawn by the proponents or otherwise did not come to a vote.

"Companies seem especially aggressive in trying to get these thrown out," explains Klinger. "Companies respond so differently to proposals on this topic than they do to proposals on social issues," he adds. "I think it is because executive compensation proposals relate to the core of how companies are organized. It is almost as if management sees the resolutions as statements accusing them of not earning their keep." Francis Byrd, special assistant for pension policy for the New York City Pension Funds, says that regardless of how many proposals made it into the proxy statements, the high profile that the issue has achieved "helps to educate shareholders on the issue and helps to align pay with performance, as opposed to pay for pay's sake."

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■ **Twelve shareholder proposals asking companies to allow a shareholder vote on future golden parachutes came to a vote in the 2001 proxy season.**

IRRC has obtained the voting results for seven of these. The seven proposals garnered average support of 36.8 percent of the votes cast. Last year, a total of seven proposals came to a vote, and those proposals received average support from 30.8 percent of the votes cast.

■ **Union funds submitted another type of executive compensation proposal to a large number of companies last proxy season—asking companies to grant performance-based stock options—but most were later withdrawn**.

In 2001, a total of 11 such proposals came to a shareholder vote. IRRC has obtained the voting results for seven of these. Average support this proxy season slipped slightly to 23.8 percent of the votes cast. In 2000, only one proposal came to a shareholder vote, and it received 24.2 percent of the votes cast. In 1999, four proposals were considered by shareholders, and they garnered average support of 26.3 percent of the votes cast.

■ **This year, only two proposals asking companies to prohibit the repricing of underwater options came to a vote.**

The proposal at Sprint received 46.6 percent of the votes cast. At press time, the vote on the other repricing proposal, which was submitted by the LongView Collective Investment Fund to Earthgrains, had not taken place yet. In 2000, the one proposal that came to a shareholder vote garnered 11.2 percent of the votes cast. In 1999, the three proposals considered by shareholders received the average support of 30.7 percent of the votes cast.

Shareholder interest in curbing repricings could be renewed next year now that it appears as if many companies will continue to "reprice" by using the six-months-and-one-day loophole left by the Financial Accounting Standards Board when it set the rule imposing charges on repriced options.

The bigger picture

As of June 30, 2001, IRRC had tracked 486 governance proposals that were submitted by shareholders, of which 302 have been or will be voted on. Of the total submitted, 103 proposals were omitted from proxy statements under SEC rules, 42 were withdrawn by the proponents and 39 did not otherwise come to a vote. In all of 2000, IRRC tracked 607 proposals submitted by shareholders. Of this total, 262 came to a vote. The building trade union funds submitted a large number of proposals in 2000, but most were withdrawn after talks with the companies. For instance, 57 of their proposals asking companies to allow shareholder nominees on the proxy statements were either withdrawn or omitted under SEC rules. In addition, 31 of their proposals asking companies to elect their directors every three years were either withdrawn or omitted.

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Other Hot Topics

In addition to executive compensation, several other governance issues grabbed shareholders' attention in 2001.

■ **Activists Bart Naylor and Richard Dee submitted a total of 27 proposals asking companies to nominate at least two candidates for each open board seat**.

Of that total, 18 came to a shareholder vote. IRRC has obtained voting results for nine proposals. These nine garnered average support of 5.8 percent of the votes cast.

Naylor contends that the election of directors is the "most important act of the enlightened investor, yet the one most in need of reform." Last year, Naylor submitted a proposal to several companies requesting that shareholders be permitted to nominate at least two candidates for each open board seat. The SEC ruled that proposal was excludable under Rule 14a(i-8), which provides that a proposal may be omitted from a proxy statement if it "relates to an election for membership on the company's board of directors."

At the same time, a proposal asking the company to nominate two candidates, submitted by activist Richard Dee, survived challenges at the SEC. Dee filed his proposal at six companies last year; it came to a vote at four companies and received an average vote of 8.1 percent.

In the supporting statement of Naylor's revised proposal, which he submitted in 2001, he points out that shareholders who are unhappy with the current slate of directors but do not wish to go through the expensive and time-consuming task of running an independent candidate are left with no options other than withholding votes. "Even directors of near-bankrupt companies enjoy re-election with 90 percent plus pluralities. The 'real' selection [of directors] comes through the nominating committee, a process too often influenced, if not controlled, by the very management the board is expected to scrutinize critically," said Naylor.

■ **Another innovative proposal that began appearing on proxy statements last year appeared again this year. Activist Mark Latham and his associates submitted two resolutions in 2001 that asked companies to hire a proxy advisory firm for one year, to be chosen by shareowner vote.**

Latham says this arrangement would give individual investors access to the same voting information that institutional investors now pay to receive. The proposal specifies that in order to insulate advisor selection from influence by company management, any proxy advisory firm could put itself on the ballot by paying an entry fee and declaring the price (no more than $8,000) for its advisory service for the coming year. The winning candidate would be paid its declared price by the company, and expected to make voting advice freely available to all company shareholders for the subsequent year. The decision of whether to hire proxy advisory firms in later years would be left open, and could be decided by future shareowner votes. The proposal garnered 2.4 percent of the votes cast at Gillette and 4.0 percent of the votes cast at KB Home.

In 2000, Mark Latham submitted 12 proposals asking companies to hire proxy monitoring firms, but only two made it into the proxy statements. Ultimately, the proposal received 4.4 percent of the votes cast at Washington Mutual and 8.9 percent of the votes cast at Whole Foods Market.

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The SEC granted no-action relief to the other companies based on rule 14a-8(i-8) (pertaining to the election of directors). The companies argued successfully that the proposal would allow a proxy advisory firm to provide advice on all matters put forth for a shareholder vote, including the election of directors.

Latham revised the proposal with rule 14a-8(i-8) in mind for 2001. The new version of the proposal specifies that the proxy advisory firm will give advice on all matters, except on those matters relating to the election of directors.

■ **Another topic, which gained notoriety in 2000 through a high profile proposal at International Business Machines—employee pension plans—appeared on proxy statements again in 2001.**

Of the 11 shareholder proposals related to companies' pension funds that were submitted to companies in 2001, three were targeted at IBM. Of these 11, just three actually came to a vote—at Boeing, IBM and Qwest Communications. Many of the proposals that did not appear in the proxy statements were allowed to be omitted because the SEC said they pertained to the company's ordinary business. A proposal asking Boeing to provide a pension choice received 9 percent of the votes cast. Another asking IBM to reverse its pension changes garnered 14.7 percent of the votes cast. That proposal requested that the company adopt a policy that all employees, regardless of age, will receive the same long-promised retiree medical insurance and pension choice as employees who are within five years of retirement. The proposal also asked that the company's portable cash-balance plan provide a monthly annuity equal to that expected under the old pension plan or a lump sum that is equivalent.

In 2000, IBM employee James Leas submitted a pension-related proposal that appeared in a lot of headlines. His resolution to IBM essentially asked the company to reverse the effects of its cash-balance conversion. Forty-six members of Congress sent a letter to SEC Chairman Arthur Levitt arguing for its inclusion in the company's proxy statement. Shortly thereafter, IBM was not granted the no-action it sought. Ultimately, the proposal received 28.2 percent of the votes cast.

Old Standbys

Some of the shareholder proposals that traditionally have garnered a great deal of shareholder support continued to do so in 2001.

■ **Poison pill proposals are still the most popular type of governance resolution, garnering more shareholder support than any other type of shareholder proposal**.

IRRC has obtained voting results for 13 of the 23 poison pill proposals that have come to a vote so far in 2001. Average support for the 13 stands at 58.4 of the votes cast. Last year, IRRC tracked 26 such proposals, and average support for those was 57.5 percent of the votes cast. This year's average is skewed slightly by the vote at Navistar International, which stood at 84.5 percent. That pill proposal, which was submitted by Gamco Investors, asked the company to redeem its poison pill unless the pill was approved by a majority of outstanding shares. Gamco said the board should redeem the pill or put it to a shareholder vote in order to improve shareholder value. Navistar's shares have underperformed the S&P 500 index by more than 30 percent in the past year.

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Gamco is Navistar's second largest shareholder and controls 8.6 percent of the total voting power. Navistar also was targeted with a vote-no campaign by Providence Capital.

■ **Shareholder resolutions asking companies to eliminate their supermajority voting requirements are a close second to poison pill proposals in terms of popularity.**

Twelve such proposals were submitted by shareholders in 2001. IRRC has obtained voting results for seven of these. Average support for the seven proposals is 56.7 percent of the votes cast, up from 54.6 percent in 2000, when IRRC tracked a total of seven proposals to eliminate the supermajority voting requirement.

■ **Proposals asking companies to adopt confidential voting gained support in 2001**.

Of the seven confidential voting proposals that came to a shareholder vote in 2001, IRRC has voting results for five. Average support for the five proposals stands at 54 percent of the votes cast. Last year support for the five proposals that were considered by shareholders stood at 52.2 percent of the votes cast.

■ **As usual, classified board proposals continue to receive strong levels of support. Forty proposals dealing with this issue came to shareholder votes in 2001**.

Average support for 29 such resolutions for which IRRC had obtained a vote as of June 30 climbed to 53.2 percent of the votes cast in 2001, up from 52.7 percent of the votes cast in 2000 when IRRC tracked 54 such proposals. In 2001, a proposal at Baker Hughes received the highest level of support so far (76 percent of the votes cast), followed by the resolution at Airborne (71.4 percent of the votes cast).

■ **Support for proposals that call for a majority of independent directors remains steady.**

Eight such proposals came to a shareholder vote in 2001. IRRC has obtained voting results for five of these. Average support for the five proposals stands at 26.5 percent. Last year, IRRC tracked 12 of this type of resolution, and they garnered average support of 26.9 percent of the votes cast.

■ **This year, several board independence proposals were allowed to be omitted under SEC rules because "the company would lack the power or authority to implement the proposal."**

This decision sparked the ire of institutional investors. Martin Dunn, associate director for the Division of Corporation Finance, met with the Council of Institutional Investors on March 27 and explained that, since 1977, a total of 27 proposals on board independence were challenged as being "beyond the power of the board to effectuate." Of that total, 15 appeared in the proxy statements and 12 did not. Basically, Dunn said that there had been no change of policy regarding these types of proposals and that whether they are allowed to be excluded or not depends on how they are worded. He said the proposals should be focused on nominating independent directors, not on "ensuring" that a board or a committee is comprised entirely of independent directors. For example, he recommended a proposal request that, to the extent possible, the board nominate candidates who are independent.

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Both Dunn and Division of Corporation Finance Director David Martin assured council members that these recent decisions did not represent a change in policy, and that they still view board independence as an important issue.

Majority votes

IRRC tracked 43 shareholder proposals through June, 2001 that received majority votes (see Table 2 on page 10). They represent 25 percent of the proposals for which IRRC has obtained voting results so far that is about the same proportion of proposals that had received majority votes at the same stage in 2000. In all of 2000, shareholder proposals to at least 64 companies received majority votes. *Note that IRRC still is in the process of collecting voting results from companies.*

■ **Nearly half (22) of the proposals receiving majority votes so far are those asking companies to repeal their classified boards.**

Shareholder activist Evelyn Y. Davis scored majority votes on a substantial number of classified board proposals. Davis' proposals at Bristol-Myers Squibb, Federated Department Stores, Lucent Technologies, May Department Stores and Merck all registered high support. Her proposal at Bristol-Myers has received majority support since 1997, and her resolution at Federated garnered a majority vote in 1998. At May Department Stores, her proposal registered a majority vote in 2000, and at Merck it garnered majority votes in 1999 and again in 2000.

A few union funds also scored majority votes on classified board proposals. Proposals submitted by the American Federation of State, County and Municipal Employees received majority votes at Baxter International and at Great Lakes Chemical. The union fund submitted similar proposals to both of those companies in 2000, and those proposals also received majority votes.

Another union-sponsored proposal, this one submitted by the International Brotherhood of Teamsters to Airborne, received a majority vote. In 2000, a similar proposal submitted to Airborne by the Teamsters garnered 74.3 percent of the votes cast. Shareholder proponent John Chevedden submitted a classified board proposal to Airborne in 1999 and it received 70.0 percent of the votes cast.

A classified board proposal submitted by the LongView Collective Investment Fund to Cooper Tire & Rubber received 53.5 percent of the votes cast. In 1999, a similar proposal submitted by the New York City Police Retirement System garnered 52.7 percent of the votes cast.

This year at FirstEnergy, a classified board proposal received a majority vote, but still did not garner enough support to pass under the company's voting requirements.

■ **Shareholder proposals on poison pills also were popular, with 10 scoring majority votes.**

Shareholder activist John Chevedden was the leader of the pack on this issue. His proposals at Actuant, Airborne, Allegheny Energy and Northrop Grumman all received majority votes. A similar proposal submitted by Chevedden to Northrop Grumman in 1999 received 64.8 percent of the votes cast.

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■ **In the 2001 proxy season, more than one shareholder proposal registered a majority vote at quite a few companies**.

At Airborne and at Southwest Airlines, three shareholder proposals garnered majority votes. At Alaska Air Group, Allegheny Energy, FirstEnergy, Luby's and Northrop Grumman two shareholder proposals at each company received majority support.

Responses to majority votes

Companies vary in the way they respond to majority votes on shareholder proposals. Some companies adopt the recommendations contained in the proposals, others adopt different governance reforms, and still others choose not to make any changes. In recent years, companies that have elected not to institute any changes have sparked the ire of institutional investors who have responding by launching "vote-no" campaigns.

■ **In 2000 and 2001, the New York City pension funds targeted with vote-no campaigns companies that had ignored majority votes.**

In 2001, the funds targeted Freeport McMoran Copper & Gold and Louisiana-Pacific with this type of campaign. The Service Employees' International Union also launched a vote-no campaign at Eastman Kodak.

At Freeport McMoran, the New York City pension fund reports that an average of 19.5 percent of the company's shareholders withheld votes from management's slate of five directors. At Louisiana-Pacific, an average of 7.1 percent of the shares were withheld from management's slate of four directors. These two companies were chosen as targets for vote-no campaigns because the New York City funds felt "their performance was subpar, and they have demonstrated an intransigence with respect to meeting requests that shareholders have put to them," said Byrd. In 2000, a classified board proposal submitted by Nycers to Freeport McMoran Copper & Gold received 50.7 percent of the votes cast. In 1999, the New York City Teachers' Retirement System submitted a proposal asking Louisiana-Pacific to adopt a policy allowing shareholders the right to act by written consent. That resolution passed, receiving 67.7 percent of the votes cast.

■ **In 2000, Nycers launched vote-no campaigns at Cooper Tire & Rubber, Great Lakes Chemical and Louisiana-Pacific, companies that had not responded to fund proposals that in the past had received majority votes.**

The pension fund reported that approximately 27 percent of the shareholders at Great Lakes Chemical withheld votes for management's slate of two directors. At Cooper Tire & Rubber, an average of 13 percent of the shareholders withheld votes for management's three nominees. Shareholders at Louisiana-Pacific withheld approximately 15 percent of the votes from management's slate. What should be done in response to companies that consistently ignore majority shareholder votes is something that many institutional investors are looking into, says Byrd. "We will be exploring all possible options with respect to those companies that are recalcitrant," he says.

■ **More than 16 percent of shares voted at Eastman Kodak's May 9, 2001, annual meeting were withheld from two of the directors targeted by the Service Employees International Union's (SEIU) "vote no" campaign.**

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SEIU had sent out letters to large investors urging them to withhold votes from directors who have not acted in response to union-sponsored shareholder proposals that have received majority votes for several years. The Service Employees' fund launched the campaign after the company failed to take action on a classified board proposal that SEIU had filed several years in a row. In 2000, the SEIU proposal received 60.7 percent of the votes cast. In 1999, the proposal received 53.2 percent of the votes cast, and in 1997, it received 50.3 percent of the votes cast. In 1998, Kodak's management did not make a voting recommendation against the proposal in the proxy statement, and the resolution garnered 71.4 percent of the votes cast. A classified board proposal did not appear on the company's 2001 proxy ballot. "At a time when most directors are elected with 98 percent pluralities, this vote should send a stern message on corporate democracy," said Steve Abrecht, executive director of the SEIU Master Trust pension funds.

Table 1 - Voting Trend for Significant U.S. Governance Shareholder Resolutions

	2000		2001*	
Proposal Type (no. still pending in 2001)	# of proposals	Average Voting Support+	# of proposals	Average Voting Support+
Redeem or vote on poison pill (10)	24	57.8%	23	58.4%
Eliminate supermajority vote (5)	7	54.6%	12	56.7%
Repeal classified board (11)	54	52.7%	40	53.2%
Confidential voting (2)	5	52.2%	7	54.0%
Vote on future golden parachutes (5)	7	30.8%	12	36.8%
Provide for cumulative voting(6)	24	28.3%	18	32.7%
Director independence (3)	12	26.9%	8	26.5%
Independent nominating committee (3)	3	24.2%	4	29.2%
Increase board diversity (3)	5	19.9%	5	12.2%
Separate CEO & chairman (2)	2	19.0%	4	14.2%
Sell company/spin off/hire investment banker (34)	29	18.4%	44	13.4%
No repricing underwater stock options(1)	1	11.2%	2	46.6%
Disclose executive compensation (2)	5	9.6%	2	0%
Restrict executive compensation** (5)	16	8.5%	18	13.5%
Independent compensation committee (2)	0	-	2	-
Performance-based stock options (4)	0	24.2%	11	23.8%

*based on voting results obtained through June 30, 2001
+"for" vote as a percentage of shares voted for and against, including abstentions
**includes proposals to restrict executive pay, cap executive pay, and link executive pay to performance

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Table 2 -Governance-Related Shareholder Proposals Receiving Majority Votes*				
Company	Issue	Proponent	Support (%)	Passed?
Airborne	repeal classified board	Teamsters	75.4	Yes
Alaska Air Group	repeal classified board	Smith, G.	70.8	Yes
Allegheny Energy	repeal classified board	Gilberts	54.3	Yes
Baker Hughes	repeal classified board	Gilberts & Mathis, H.	76.0	Yes
Baxter International	repeal classified board	AFSCME	62.2	Yes
Boise Cascade	repeal classified board	Rowe, G.	56.8	Yes
Bristol-Myers Squibb	repeal classified board	Davis, E.	56.2	Yes
Cooper Tire & Rubber	repeal classified board	LongView Fund	53.5	Yes
Federated Dept. Stores	repeal classified board	Davis, E.	71.0	Yes
FirstEnergy	repeal classified board	Chevedden, J.	52.9	No
Freeport McMoran Copper & Gold	repeal classified board	Mathis, H.	54.5	Yes
Goodyear Tire & Rub	repeal classified board	NYC Teachers	62.4	No
Great Lakes Chemical	repeal classified board	AFSCME	55.3	Yes
KeyCorp	repeal classified board	Armstrong, G.	54.8	Yes
Luby's	repeal classified board	Greenberg, L.	59.2	Yes
Lucent Technologies	repeal classified board	Davis, E.	54.2	Yes
May Department Stores	repeal classified board	Davis, E.	54.6	Yes
Merck	repeal classified board	Davis, E.	51.3	Yes
Sempra Energy	repeal classified board	Rossi Family	52.4	Yes
Southwest Airlines	repeal classified board	Greenwood, L.	57.6	Yes
U.S. Bancorp	repeal classified board	Armstrong, G.	52.1	Yes
Wisconsin Energy	repeal classified board	NYCERS	55.5	Yes
Actuant	redeem/vote on poison pill	Chevedden, J.	50.4	Yes
Airborne	redeem/vote on poison pill	Chevedden, J.	71.4	Yes
Allegheny Energy	redeem/vote on poison pill	Chevedden, J.	55.9	Yes
Burlington Northern Santa Fe	redeem/vote on poison pill	Naylor, B.	68.9	Yes
McDermott Internat'l	redeem/vote on poison pill	AFSCME	54.8	Yes
Navistar International	redeem/vote on poison pill	Gamco Investors	84.5	Yes
Northrop Grumman	redeem/vote on poison pill	Chevedden, J.	52.4	Yes
Pitney Bowes	redeem/vote on poison pill	AFSCME	53.2	Yes
Profit Recovery Grp Int'l	redeem/vote on poison pill	CREF	64.4	Yes
Southwest Airlines	redeem/vote on poison pill	Gilberts	64.3	Yes
Airborne	adopt confidential voting	Chase, R.	68.7	Yes
Mesa Air Group	adopt confidential voting	Berberian, P.	52.2	No
Union Pacific	adopt confidential voting	Electrical Workers	61.8	Yes
Alaska Air Grp	eliminate supermaj vote requiremt	Chevedden, J.	69.9	Yes
FirstEnergy	eliminate supermaj vote requiremt	Gilberts	56.5	No
Northrop Grumman	eliminate supermaj vote requiremt	McLaughlin, J.	52.9	Yes
PG&E	eliminate supermaj vote requiremt	Rossi, N.	57.3	Yes
Sempra Energy	eliminate supermaj vote requiremt	Chevedden, J.	54.0	Yes
Southwest Airlines	eliminate supermaj vote requiremt	Schlossman, B.	68.8	Yes
Luby's	eliminate takeover provisions	Apenel, A.	62.6	Yes
Bethlehem Steel	eliminate stock buyback program	Greenway Partners	97.6+	Yes

*based on voting results obtained through June 30, 2001
+supported by management

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2001 Votes Rise for Proposals on Burma, Labor

Vote results are all but one of the 138 social policy shareholder proposals that came to votes at U.S. corporate annual meetings this year through June 30, and they reveal that a higher-than-usual number won the support of at least 10 percent of the shares voted. In the last few years, no more than 15-16 social issues proposals gained this much support, but this year, 38 social policy proposals met or exceeded this support level. The 10 percent figure is an important benchmark, because under the shareholder proposal rule administered by the Securities and Exchange Commission, a proposal that earns this level of support may be resubmitted, all things being equal, regardless of how many times it has appeared on the company's proxy statement in the past.

Notably, 10 of these top vote-getting proposals asked companies to take various steps to report on or improve their global labor standards—an issue that until this year had produced few high votes. Indeed, of the three social issue proposals that won more than 20 percent support, one was a resolution asking Unocal to implement key labor standards in its global operations.

Another striking feature of the 2001 proxy season was the relatively high support for proposals that, directly or indirectly, questioned companies about their operations in Burma, where the International Labor Organization and other rights monitoring organizations have raised the alarm about the extensive use of forced labor. Both the labor standards proposal at Unocal, and another proposal at Unocal concerning executive compensation that got double-digit support, made unfavorable mention of the company's operations in Burma. Proposals at three other companies that asked them to report on their business ties to Burma averaged more than 10 percent support.

As in the past two years, proposals calling on companies to increase racial and gender diversity on their board of directors got the highest support levels as a group among social policy resolutions—nearly 19 percent, on average, of the shares voted. The two top vote-getters of the 2001 season were board diversity proposals at American Power Conversion and Bed Bath and Beyond that each garnered more than 27 percent support. The other types of proposals, by issue area, that so far have averaged 10 percent or higher support were those asking companies to expand their equal employment policies domestically or to implement the MacBride code for fair employment in Northern Ireland.

As in past years, the majority of the proposals were filed by religious investors affiliated with the Interfaith Center on Corporate Responsibility, but this year saw increased sponsorship by New York City pension funds, particularly for proposals on monitoring global labor standards. Socially oriented investment management firms and individual shareholders also filed numerous resolutions.

Activity at the SEC: The 2001 proxy season also saw the SEC staff continue a trend of the last several years of tending to give proponents the benefit of the doubt when it decided company requests to omit shareholder resolutions. It allowed companies to exclude only 26 resolutions on technical or substantive grounds under its shareholder proposal rule, which sets out circumstances in which such omissions are permissible. As usual, the majority of the exclusions came under the "ordinary business" clause of the rule, which prevents shareholder votes on mundane management issues. The ordinary business clause stopped in its tracks a new effort to get companies to make more

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disclosure of environmental liabilities, and also prevented shareholders from questioning AT&T about leasing its lines to a channel that broadcasts pornography.

Table 3: Final Status of Social Policy Shareholder Resolutions in 2000 and through June 30, 2001

	Number of Resolutions								Average	
Subject	Proposed[1]		Withdrawn		Omitted[2]		Voted On		Votes	
	2001	2000	**2001**	2000	**2001**	2000	**2001**	2000	**2001**[1]	2000
Banking/Insurance	9	16	6	6	--	5	3	5	4.3	5.3
Board Diversity	10	9	5	4	--	0	5	5	18.9	19.9
Charitable contributions	3	9	1	0	1	3	1	5	2.7	4.6
Energy	8	4	--	0	2	0	6	4	6.9	7.2
Environment: Ceres/misc.	27	12	8	3	4	0	15	19	8.0	6.7
GMOs	11	22	3	8	1	0	7	14	5.9	3.8
Climate change	7	11	2	6	--	0	5	5	9.3	7.5
Equal Employment[3]	26	29	14	14	2	1	9	13	10.6	8.4
Executive Pay & Social Link	16	20	3	6	1	0	12	14	9.6	8.8
Global Labor/Env. Standards	40	27	7	8	6	2	25	17	8.8	8.2
Human Rights	12	9	3	5	1		8	3	9.3	7.2
Military	10	11	1	1	--	0	9	9	5.1	7.0
Northern Ireland	10	8	6	1	--	0	4	6	14.0	16.5
Pharmaceutical Pricing	9	10	2	1	--	0	7	7	7.0	4.7
Political Contributions/Ties	11	12	--	0	2	2	9	9	5.8	4.5
Tobacco	13	14	4	1	--	0	9	12	7.0	5.9
Other issues	10	13	4	0	2	10	4	3	4.7	n.a.
Total	**232**	251	**69**	65	**22**	25	**138**	150	**8.3**	7.5

[1] Excludes resolutions not voted on for other reasons (usually a merger): 1 on equal employment and 2 on global labor standards in 2001; and 3 on the environment, 2 on pharmaceutical pricing, and 1 each on charitable contributions, equal employment, human rights, military topics, Northern Ireland, political contributions/ties and tobacco in 2000. Also excludes proposals omitted on technical grounds.
[2] Excludes proposals omitted on technical grounds.
[3] Includes anti-gay rights proposals: 1 vote, 2 omissions and 1 withdrawal in 2001; and 1 vote in 2000;
[4] Excludes vote for 1 proposal for which vote talliy was not available at press time.

In perhaps the biggest surprise of the SEC proxy season, using another part of the shareholder proposal rule the SEC staff agreed with several companies that some new resolutions on global labor standards could be excluded on grounds that they were "vague and indefinite." The proposals asked the companies to implement global labor standards set out by the International Labor Organization (and, in the case of some of the resolutions), reflected in a social audit program called SA8000. The resolutions did not spell out the standards in detail, and the SEC staff accepted the company argument that shareholders wouldn't have a clear picture of what they were voting on. (Other global labor resolutions, though, did pass muster at the SEC, giving proponents a road map for continuing to press the issue at annual meetings.)

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But in the majority of other cases, the calls went to the proponents. Activists were particularly gratified that the staff was clearly backing away from a position taken in the 1990s that small operations in Burma did not raise a significant social issue that could be pursued in shareholder resolutions. (Details of the SEC decisions appear in the issue categories below.)

Withdrawals: So far this year, 69 resolutions have been withdrawn (compared to 65 for all of 2000). A few withdrawals occurred when shareholders found that they had improperly filed them, but most came about from cooperative agreements. As in past years, the equal employment category produced an especially large number of withdrawals—14 so far this year. Withdrawals also cut into the number of new issues shareholders had to consider this year. They eliminated fledgling campaigns on workplace violence, treatment of disabled employees, sale of mercury thermometers and provision of AIDS drugs in poor countries. And proponents, who had run into trouble with predatory lending resolutions at the SEC last year, rewrote proposals so that they would pass muster, but then managed to work out withdrawal agreements for all but one of the five offered this year.

What follows is a summary, by category, of the leading social issues—based on number of proposals voted on or the support they received—of the 200l proxy season through June 30, including the most interesting votes, withdrawals and decisions at the SEC on whether resolutions could be omitted. Companies at which proposals did well enough to qualify for resubmission next year are highlighted in **bold face**. All vote support levels reported here are thus calculated according to the formula the SEC uses to determine resubmission eligibility: the percentage of shares cast "for" out of the total number of shares cast "for" or "against" (and excluding abstentions). First-year proposals must win at least 3 percent support under this formula to qualify for resubmission an additional year, second-year proposals must get at least 6 percent, and proposals in their third year or more must get at least 10 percent.

Board Diversity

Only five resolutions on board diversity came to votes by June 30, after several withdrawal agreements were negotiated, all of which easily cleared their resubmission thresholds.

Votes: As mentioned earlier, two board diversity proposals—at **American Power Conversion** (filed by Citizens Funds) and **Bed Bath & Beyond** (filed by an Interfaith Center affiliate) —garnered more than 27 percent support. In addition, another Citizens Funds proposal at **Chiron** won 15.5 percent support, an Interfaith Center proposal at **Unocal** won 14.8 percent support, while Tom Gniewek's second-year proposal at **ExxonMobil** got 9.6 percent support.

Withdrawals: As usual, a good proportion of the board diversity proposals were withdrawn. The managements of targets Clarcor, Crown Castle International, EOG Resources, Jefferson-Pilot and Shopko all pledged increased efforts at board diversity.

Activity at the SEC: The only board diversity proposal challenged at the SEC was Gniewek's second-year proposal at ExxonMobil, the only one from a proponent who appeared to be less than persuaded than a diversified board was a worthy goal.

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Table 4: Top Vote-Getting Social Issue Proposals of 2001, as of June 30		
Company	Resolution	% in favor*
American Power Conversion	commit to/report on board diversity	27.5
Bed Bath & Beyond	commit to/report on board diversity	27.2
Unocal	implement ILO standards	23.3
TJX	Implement MacBride principles	16.4
Caterpillar	implement MacBride principles	15.8
McDermott International	report on projects in Burma	15.8
Unocal	link executive pay to social criteria	15.7
Baker Hughes	implement MacBride principles	15.7
Chiron	increase efforts to diversify board	15.5
Kroger	label gene-engineered food/report to shareholders	15.3
Unocal	commit to/report on board diversity	14.8
FleetBoston Financial	link executive pay to social criteria	14.4
MBNA	report on steps to break “glass ceiling”	13.8
AT&T	link executive pay to social criteria	13.5
ExxonMobil	adopt sexual orientation non-discrimination policy	13.0
Emerson Electric	adopt sexual orientation non-discrimination policy	12.8
Allegheny Energy	report on global climate change	12.3
Ball	implement ILO standards and third-party monitoring	12.3
99 Cents Only Stores	implement ILO standards	11.5
Pharmacia	adopt drug price restraint policy	11.5
American Eagle Outfitters	implement ILO standards and third-party monitorin	11.4
American International Group	report on EEO	11.4
Colgate-Palmolive	implement ILO standards and third-party monitoring	11.4
Circuit City	report on EEO	11.1
Johnson Controls	review/report on global standards	11.0
Allstate	endorse Ceres principles	10.6
Alcoa	review/report on global standards	10.6
General Electric	disclose costs of PCB cleanup delay	10.5
Halliburton	report on projects in Burma	10.5
Bank of America	end political donations	10.5
Black & Decker	review/report on global standards	10.5
Gannett	report on EEO	10.5
Ameren	reduce radioactive emissions	10.5
Home Depot	implement ILO standards and third-party monitoring	10.4
Chevron	report on plans to drill in Arctic Natl. Refuge	10.3
Boeing	link executive pay to social criteria	10.3
Caterpillar	implement ILO standards and third-party monitoring	10.0
Xcel Energy	obtain power supply without harming Cree	10.0
out of shares votes “for” or “against”		

ExxonMobil challenged it on grounds that Gniewek had announced at the 2000 annual meeting that he intended to vote against his own resolution. Therefore, the company argued, the 2000 resolution had not been properly moved and was disqualified under the section of the shareholder proposal rule that allows companies to omit repeat proposals

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that had not been formally proposed at the previous annual meeting. The SEC staff rejected the argument without comment.

Energy and Environment

As usual the energy and environment category was the largest, with continuing coordinated campaigns on genetically modified organisms, global warming and the Ceres principles, a new effort on environmental reporting and a variety of other scattered issues. In the energy component, Robin Mills offered a new batch of proposals on renewable alternatives.

Votes: All together, 33 proposals came to votes on a wide array of environmental issues through June 30.

Turning first to ***new campaigns*** this year:

- Robin Mills's proposal at **Constellation Energy Group** (5.8 percent), **Duke Energy** (4.2 percent) and **Progress Energy** (6.3 percent), which asked the utilities to invest in generation from solar and wind power, are eligible for resubmission next year, while IRRC is awaiting the vote tally at Southern.
- Walden Asset Management's proposal asking **Coca-Cola** to increase the recycling, and the recycled content, of its plastic bottles won 5.2 percent support, and its identical proposal at **PepsiCo** won 7.8 percent, according to the preliminary vote count.
- Bruce Herbert's proposal at **Weyerhaeuser** asking it to report more comprehensively on its environmental liabilities squeaked past the 3 percent resubmission threshold, but it still appears vulnerable to omission next year. Weyerhaeuser, alone of the companies that received the Herbert proposal this year, declined to challenge it. At issue are recent studies by the World Resources Institute of U.S. forest product firms that criticized their reporting on the likely impact of environmental regulation on their share prices.

The remaining environmental proposals that came to votes represented ongoing campaigns.

Five proposals came to votes asking companies to endorse the ***Ceres principles*** for environmental conduct and reporting. The proposal, in its second year at **Albertson's** (7.1 percent), **Allstate** (11.1 percent) and **Kmart** (9.6 percent), did well enough for resubmission next year, but failed to clear the third-year resubmission target necessary at Dana and Raytheon.

Of the seven proposals that came to votes regarding genetically modified food, the highest vote-getter by far was a proposal at **Kroger** that asked it to commit to labeling and identifying all products sold under its brands or private labels that may contain genetically engineered organisms, "where feasible, unless long-term safety testing has shown that they are not harmful to humans, animals and the environment," and to report to shareholders. This proposal received the support of 15.3 percent of the shares voted, up substantially from the 3.8 percent support last year for a more stringent proposal from the same proponents that had asked Kroger to label genetically modified food products in an interim step before ending such sales. The higher vote this year may also reflect shareholder concern over the fact that several varieties of Kroger's tortillas and taco shells were included in the U.S. Food and Drug Administration's November 2000 recall of products found to contain protein from StarLink genetically modified corn, which has been approved only for consumption by animals, not humans.

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Beside the proposal at Kroger, first-year proposals concerning genetically engineered food at **Anheuser-Busch** and **Albertson's** may be refiled next year, as can the second-year proposal at **PepsiCo**, but not so the proposals at Coca-Cola, Philip Morris or Hershey Foods.

The debate over drilling for oil in the ***Arctic National Wildlife Refuge***, which has gained new prominence with the Bush administration's energy plan, also featured at **Chevron**'s and **ExxonMobil**'s annual meetings, where Trillium Asset Management asked each company to report on its plans to drill in the Refuge. Based on the vote results, Trillium will be eligible to file the proposal for a third year at Chevron and a second year at Exxon.

On a related issue, proposals asking companies to examine their policies with respect to ***global climate change*** also fared well this year. The five proposals that came to votes were all resubmissions, and all gained more support this year than last. The second-year proposal at **Exxon** asking it to develop renewable energy alternatives got 8.9 percent support, up from 6.1 percent last year. The highest vote in this category came for the proposal at **Allegheny Energy** asking it to report on its greenhouse gas emissions and its financial exposure due to the likely costs of reducing those emissions. It received a "for" vote of 12.4 percent. Similar proposals got 9.6 percent support at **Chevron** and just under 8 percent at **Eastman Chemical** and **Norfolk Southern**.

Of the remaining proposals in the energy and environment area where vote tallies are known, those that are eligible for resubmission in 2002 ask:

- **Ameren** to reduce its radioactive emissions;
- **General Electric** to report on the feasibility of ending its nuclear reactor design and construction business
- **Chevron** to develop a plan for the virtual elimination of dioxin and other bioaccumulative halogenated pollutants at its major facilities.
- **General Electric** to disclose the lobbying, legal and other expenditures it has made in relation to cleaning up PCB contamination
- **Tyco International** to phase out manufacture of products containing polyvinyl chlorides, and
- **Enron** to report on its environmental impact and plans.

A second-year proposal at Weyerhaeuser asking it to report on plans to phase out chlorine bleaching fell short of its resubmission threshold.

Action at the SEC: Many of the environmental issues broached through shareholder resolutions had been tested at the SEC in earlier years. As a result, in the broad environment category, the only issue receiving a serious challenge was the new campaign asking for enhanced assessment of environmental liabilities. The campaign was coordinated by Bruce Herbert of Newground Investments in Seattle, who enlisted members of the Interfaith Center on Corporate Responsibility and the Social Investment Forum to file proposals asking forest products companies to address issues raised in a World Resources Institute report entitled *Coming Clean: Corporate Disclosure of Financially Significant Environmental Risks*.

Herbert was hopeful that because the resolution addressed core financial disclosure questions it would draw support from institutional investors that typically shun voting on social issues proposals except when a direct effect on shareholder value can be identified. But some of the companies argued that for that very reason the proposals were

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not suitable for shareholder consideration. The SEC staff agreed, saying that the companies could omit the proposals as ordinary business questions because they focused on "evaluation of risk." The proposal was omitted at Mead and Potlatch, and a similar proposal at Willamette from an individual was also thrown out.

An energy proposal was omitted when the SEC staff agreed with Duke Energy that the phrasing of a proposal asking it to reduce nitrogen oxide emissions by 80 percent put it in the ordinary business category.

Withdrawals: Before the SEC decisions on the environmental risk proposals were handed down, Caraustar and Georgia-Pacific agreed to provide the information requested, and the resolutions there were withdrawn. Proponents also withdrew the same resolution at Willamette when the adverse SEC decisions came down and they saw they were sure to lose at the SEC.

Resolutions on genetically modified organisms were withdrawn at Dow Chemical, DuPont and Tricon Global Restaurants. None of the companies pledged to abandon GMOs, but all promised to continue considering the issue.

On global warming, activists negotiated a withdrawal agreement with CSX for a second year, and also withdrew a new proposal at Union Pacific. Four of nine Ceres principles proposals were withdrawn when the companies agreed that senior management would attend meetings with the Ceres organization. The four were Aetna, Gap, Home Depot and UAL.

A campaign to get drugstores to stop selling mercury thermometers moved to the shareholder resolution phase where it quickly bore fruit. The two companies that received resolutions for 2001—CVS and Longs—agreed to stop selling the thermometers and the resolutions were withdrawn. Also withdrawn was a new resolution asking Staples to report on how it might increase the recycled contents of its products; the company promised to provide the report.

Equal Employment

Activists continued to press EEO issues, filing 13 proposals asking for EEO reporting, plus resolutions on sexual orientation discrimination, the glass ceiling and policies for the disabled.

Votes: Vote levels in favor of proposals asking companies to report on or expand their equal employment policies were among the highest of any issue this season, averaging 11 percent. All cleared their resubmission thresholds.

Thus, **ExxonMobil** could face for a fourth year, and **Emerson Electric** for a third year, a proposal asking each to expand company EEO policies to bar discrimination on the basis of sexual orientation. The proposals each got 13 percent support. However, a first-time proposal at **AT&T** that took an opposing tack, asking the company to *drop* sexual orientation from its EEO policy, also got enough support—7.4 percent—to be resubmitted next year. The proponents are two individuals affiliated with anti-abortion group Pro-Vita Advisors.

Three proposals filed by religious investors that asked for reports on EEO policies, including breakdowns of employees, by race and sex, in standard job categories, came to votes, obtaining 11.4 percent support at **American International Group**, 11.1 percent at **Circuit City** and 10.5 percent at **Gannett**.

Another three proposals came to votes asking companies to report on the steps they were taking to break the metaphoric "glass ceiling" that bars women and members

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of racial minorities from advancing to top management positions. A second-year proposal from EEO skeptic Tom Gniewek garnered 8.5 percent support at **Du Pont**, while first-year proposals filed in sincerity by religious investors affiliated with the Interfaith Center earned 13.8 percent support at **MBNA** and 7.1 percent at **Merck**.

Withdrawals: Proponents from church groups and social investment funds got enough EEO data from eight of their 14 targets to enable them to withdraw the proposals. The companies were Alltel, Bank of America, Bristol-Myers Squibb, Citigroup, Home Depot, Morgan Stanley Dean Witter, Nextel and Worldcom. The proponents, led by Walden Asset Management, were particularly pleased with the agreement at Home Depot, a target of resolutions on the issue for three years.

Two proposals were withdrawn when Home Depot and American International Group promised to add sexual orientation as an element of their EEO policies. AIG had been the largest financial services company without such a policy. Resolutions asking for reports on steps to break the glass ceiling on women and minority managers were withdrawn at Merrill Lynch and Newell Rubbermaid when the companies agreed to provide the reports.

Calvert kicked off what may eventually be a broad campaign to get companies to disclose more information on policies for the disabled with a single resolution to Diebold. The company agreed to provide the information and the resolution was withdrawn.

Action at the SEC: Individuals once again tried to sponsor resolutions asking companies not to provide benefits to gay partners, and as always saw them shot down as ordinary business issues at the SEC.

One company, EMC, omitted a resolution on EEO reporting from its proxy statement without going to the SEC. The company persuaded the shareholders that the omission had been accidental and promised to meet with them to share information on company diversity. The proponents, led by Walden, who held nearly 2 million shares in the company, were subsequently extremely unhappy when they attended the annual meeting and found that they were unable to ask questions because the company had changed the structure of the meeting to eliminate microphones.

Executive Pay

Shareholders stepped up campaigns raising social issues through the device of tying specific issues to executive pay as Responsible Wealth, a unit of the Boston group United for a Fair Economy, intensified efforts in that area. The issues raised were all over the map.

Votes: Of the 12 such proposals that came to votes by June 30, all did well enough to be resubmitted next year, earning average support of just under 10 percent of the shares voted. The highest vote-getter in this group was the proposal to **Unocal**, where religious investors and Walden Asset Management raised concerns about its extensive operations in Burma and about its "historic and ongoing environmental violations" at a number of oil spills in California. Aided by the support of the California Public Employees' Retirement System, which owns 1.5 million Unocal shares, the proposal gained 15.7 support. One outcome of the proposal is that dialogue has resumed between shareholder proponents and Unocal for the first time since February 1996.

The next highest level of support—14.4 percent—was at **FleetBoston Financial**, where members of Responsible Wealth said the company should tie executive pay to

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improving its poor consumer service record. In December 2000, the Minnesota attorney-general sued the bank for improperly sharing confidential customer information with telemarketers, and *Consumer Reports* in June last year ranked the bank 19th out of 20 national and large regional banks for customer satisfaction.

Proposals asking for an explicit link between executive pay and social criteria also came to votes at **American International Group**, **AT&T**, **Boeing**, **Citigroup**, **ExxonMobil**, **Household International**, **McDonald's**, and **United Technologies**, and a second proposal at **ExxonMobil**, asking it to freeze executive pay during periods of worker layoffs, garnered 9.3 percent support. A Responsible Wealth proposal at **Raytheon**, asking it to tie executive pay to employee job satisfaction, got 6.9 percent support.

Omissions and withdrawals: With the exception of a proposal to Raytheon submitted by an individual shareholder, none of the proposals was challenged at the SEC on substantive grounds. Walden Asset Management and Interfaith Center affiliates withdrew a resolution to Kohl's that asked it to link pay to social performance in promoting human and labor rights through overseas contracting. Walden reported that "the company agreed to extend their 'Terms of Agreement' with vendors to their overall company code governing their top 3,000 executives. Compliance with these standards will be one criterion used by the compensation committee in their annual evaluation of top management for compensation purposes. The filers felt that Kohl's had made an extraordinary effort to respond to the spirit and letter of the shareholder proposal." In addition, Responsible Wealth and an individual shareholder each withdrew shareholder proposals at Coca-Cola asking for a link between executive pay and social criteria.

Global Labor Standards

With a new push from the New York City pension funds, the global labor issue took on even more prominence than it had already had on proxy ballots, nearly overtaking energy/environment as the number one topic. A proliferation of proponents led to a variety of resolutions with somewhat different emphases.

Votes: The 25 proposals that came to votes on global labor issues as of June 30 fell into three main categories:

- proposals filed largely by union groups that asked companies to implement the core conventions of the International Labor Organization,
- proposals filed primarily by the New York City funds that asked companies not only to implement the core ILO standards, but also to engage third-party monitors to verify the extent of implementation, and
- proposals filed largely by religious investors and social investing funds that asked companies to review the global labor practices of their operations or those of their vendors and to report to shareholders.

The ILO, founded in 1919 and loosely affiliated with the United Nations, is a tripartite organization that represents the governments and the national employer and employee associations of 174 member nations. It has drafted 182 conventions concerning labor rights and minimum acceptable labor conditions that it urges its member nations to ratify. The core conventions that so many of this year's labor proposals invoke refer to eight that the ILO considers so fundamental as to constitute basic human rights. These eight conventions bar child labor, forced labor and workplace discrimination and

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require employers to observe equal pay for equal work and to respect workers' rights to freedom of association and collective bargaining.

As noted earlier, the highest vote-getter among the global labor proposals, and indeed among any of the social issues proposals this year, was the one filed by LongView Collective Investment Fund at **Unocal**, asking it to implement the core ILO standards. It garnered the support of 23.4 percent of the shares voted. LongView, which is affiliated with Unite, the U.S. textile workers union, said that it was particularly concerned with the company's operations in Burma. It noted that "Unocal partnered with the Burmese government in a gas field project that hired the Burmese military to provide security and other services. In doing so, the military committed numerous human rights violations, including forced labor." The high vote may be explained by the ILO's decision in November last year to ask its member bodies to review their ties to Burma to ensure that they are not aiding or abetting the use of forced labor, a practice that the ILO notes is widespread and persistent in Burma.

Several of the other global labor proposals earned double-digit support, and the average support for this category of proposals is 8.8 percent, up slightly from last year. With the exception of a first-year proposal at closely held Tyson Foods that garnered only 0.8 percent—the low vote of the season—and third-year proposals at Cooper Industries and Mattel that fell short of their 10 percent resubmission thresholds, all the proposals on global labor standards that came to votes through June 30 may be refiled next year. In addition to the LongView proposal at Unocal, this list consists of:

- An ILO standards proposal from the Teamsters at **Du Pont** (8.3 percent support) and from LongView at **PPG Industries** (9.5 percent);
- Proposals on ILO standards and monitoring sponsored by New York City funds at **Ball** (12.3 percent), **Colgate-Palmolive** (11.4 percent), **Home Depot** (10.4 percent), **Kellogg** (4.6 percent), **Lands' End** (3.0 percent), **Lowe's** (8.8 percent), **Nordstrom** (5.7 percent) and **Philip Morris** (6.2 percent), by the LongView Fund at **American Eagle Outfitters** (11.4 percent), and by religious investors at **Caterpillar** (10.0 percent);
- Proposals from religious investors and SRI funds at **Alcoa** (10.6 percent), **Black & Decker** (10.5 percent), **Delphi Automotive Systems** (7.0 percent), **General Electric** (6.7 percent), **Johnson Controls** (11.1 percent) **Nordstrom** (6.2 percent) and **Wal-Mart** (5.2 percent) that ask the companies to review their global labor standards and how they are implemented and to report back to shareholders;
- Proposals from individual shareholder Aaron Epstein asking **Kmart** and **99 Cents Only Stores** to implement ILO standards.

Activity at the SEC: Many of the recipients of global labor proposals didn't challenge them, perhaps assuming that challenges would be pointless since the SEC staff had allowed most of those resolutions once it changed its stance to permit many employment-related issues in 1998.

A group of companies, however, did go to the SEC, focusing their challenge on section i-3 of the shareholder proposal rule, which allows companies to omit proposals that are vague and indefinite—an exclusion that is not often successfully applied to resolutions from experienced proponents.

Most of the challenges were directed at a proposal written by the New York City pension funds and focused on a whereas clause that noted that "the Council on Economic

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Priorities has established a program of independent monitoring known as the SA8000 Social Accountability Standards." The proposal noted that the SA 8000 standards incorporated five core ILO conventions, which it summarized, and then asserted that "independent monitoring of corporate adherence to these standards is essential if consumer and investor confidence in our company's commitment to human rights is to be maintained." The resolved clause of the proposal asked that "the company commit itself to the full implementation of the aforementioned human rights standards by its international suppliers and in its own international production facilities and commit to a program of outside, independent monitoring of compliance with these standards."

In making the case that the proposal was vague and indefinite, four companies asserted that it did not fairly summarize the SA 8000, so shareholders would be unable to determine what they were voting on. The SEC staff agreed, without elaboration, allowing Revlon, Kohl's, McDonald's and TJX to exclude that resolution. Its stance was not confined to the New York City proposal; it also allowed AnnTaylor Stores to omit a similar proposal from the LongView Fund, which dropped the whereas clause referencing the SA8000 but was otherwise the same as the New York resolution.

But while allowing those omissions, the staff refused to allow Kmart to omit a related proposal, which summarized the ILO principles in the same language used in the omitted resolutions but which had a more straightforward three-part resolved clause asking the company to (1) amend its buying policy to reflect adoption of the ILO principles; (2) establish an independent monitoring process; and (3) report annually. Lacking elaboration from the SEC staff on why it found one type of proposal false and misleading but not another, it is difficult for an outside observer to determine exactly what distinctions it made; one factor may have been that Kmart made less of the false and misleading argument than other companies, insisting unsuccessfully that the proposal was moot.

The only other proposal omitted on substantive grounds was one asking The Gap to report on the child labor practices of its suppliers; the SEC staff agreed that that resolution was moot because the company already made substantial information available.

Withdrawals: While getting caught on some proposals at the SEC, New York City also had some success in working out what it considered highly satisfactory withdrawal agreements. Following the model of agreements reached with Polo Ralph Lauren and Nautica in summer 2000, when it kicked off its global standards campaign, the city pension funds got commitments from Abercrombie & Fitch, Jones Apparel and May Department Stores to align their codes with the ILO conventions and implement a system of outside independent monitoring. LongView Fund reached a similar agreement that led to withdrawal of a proposal to Hasbro, and Calvert withdrew a global labor resolution at Illinois Tool when the company promised to draft new language for its code on discrimination, prison labor and union activity and to post the code in its factories. A New York resolution was withdrawn at Oshkosh B'Gosh when the city was found to hold the wrong class of stock. Religious investors withdrew a proposal at Emerson Electric asking it to review and report on its global labor standards.

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Human Rights

Burma returned as a shareholder issue after a year's absence. Church and social investment groups continued to raise the issue of corporate activity in China, and two resolutions on energy development had international human rights focuses.

Votes: The eight proposals that came to votes garnered support levels of 9.3 percent on average, up from the 7.2 percent in 2000. The two highest vote-getters were first-year proposals by LongView at **McDermott International** (15.9 percent support) and **Halliburton** (10.6 percent) that asked them to report on their projects in Burma. As with its ILO standards proposal at Unocal, LongView noted in these two proposals the widespread use of forced labor in Burma. In addition, a first-year AFL-CIO proposal at **Citigroup** concerning its indirect links to Burma earned 5.2 percent support. At issue was the fact that a Thai subsidiary of Citigroup was among a consortium of banks that financed a private Thai company in building an electric plant that will be the largest customer of natural gas from Burma's controversial Yadana pipeline. The proposal asked Citigroup to explain whether this arrangement falls afoul of the U.S. ban on investing in Burma or on facilitating investment by foreigners there.

Harrington continued its campaign for companies to adopt the China Principles developed by Global Exchange, Amnesty International and the ILO and to persuade companies to participate in a working group on the principles code of conduct. Its first-year proposals at **Hewlett-Packard** and **McDonald's** earned 8.1 percent and 9.3 percent support, respectively. In another China-related campaign, a proposal from individual shareholder Mark Seidenberg asking **General Motors** to adopt precautions against selling to or purchasing from enterprises in China that use forced labor got 6.3 percent support.

Finally, two proposals came to votes concerned with the rights of aboriginal peoples. The Sinsinawa Dominicans' third-year proposal at Occidental Petroleum failed to get enough support for resubmission in 2002. The proposal had asked the company to have an independent firm conduct a risk analysis of Oxy's plans to conduct oil exploration activities in an area of northeast Colombia that the U'wa ethnic group claim as their own. The second proposal, a first-time proposal at electric utility **Xcel Energy**, got 10 percent support. It is asking the company to obtain power supplies from increased efficiencies and renewable resources that do not have undue adverse environmental and social impact upon the Pimicikmak Cree in northern Manitoba, Canada. At issue are Xcel's agreements to purchase electricity from the Manitoba Hydro Electric Board, whose operations have flooded Cree lands.

Withdrawals: Harrington Investments withdrew its China Principles proposals at the Gap, Intel and Target, but details of the withdrawals were not released.

Activity at the SEC: ExxonMobil challenged a second-year resolution that asked it to report on a pipeline project to carry oil from Chad through Cameroon to an offshore port. The company argued that the proposal was moot because it had already reported extensively on the project and the World Bank had given the venture a green light since the 2000 annual meeting. The SEC staff concurred.

Two of the three companies receiving resolutions on corporate activity in Burma tried, without success, to get them omitted. Citigroup, with regard to its loans to the Thai power plant customer of Burmese natural gas, argued that the transaction involved

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Thailand, not Burma, and that the proposal raised ordinary business issues as well as being vague and misleading. The staff did not concur.

The resolution to Halliburton asked the company to report on its projects in Burma and describe steps to avoid the use of forced labor. The company, which has sold the Dresser Rand subsidiary that had done most of its business in Burma, argued that it should be able to exclude the resolution under section (i)(5) of the shareholder proposal rule, which allows omission of resolutions that are "not significantly related" to company business. The SEC staff rejected the (i)(5) argument, though it had allowed companies to rely on that rarely used clause to omit Burma-related proposals in the mid-1990s. This ruling would appear to seal the end of that policy, which proponents had always found mystifying, arguing that it would have knocked out the entire anti-apartheid shareholder campaign if applied to business in South Africa.

Northern Ireland

The New York City-led campaign to get companies to endorse the MacBride principles against religious discrimination in the workplace entered its 17th year.

Votes: Of the four proposals that came to votes through June 30, three—at **Baker Hughes**, **Caterpillar and TJX**—were each supported by approximately 16 percent of the shares voted. In a major turnabout, though, the proposal at Dun & Bradstreet, which has appeared on the ballot every year since 1989 and averaged 14 percent support, got only 8.2 percent support this time around, disqualifying it for resubmission until 2006.

Withdrawals and omissions: No company bothered to challenge the now well-tested resolution. As usual there were withdrawals as more companies agreed to implement the principles.

Political Issues

In the last two years, proponents seeking to use the shareholder resolution as a mechanism for broaching questions about campaign financing have largely turned to other arenas, and most of the 2001 political resolutions emanated from perennial gadfly Evelyn Y. Davis, although Patricia Broderick, a new filer in 2000, returned to the scene this year with proposals asking companies to end all political donations.

Votes: Of the nine proposals that came to votes through June 30, the top vote-getter was Broderick's second-year proposal to **Bank of America**, which received 10.5 percent. Six other proposals did well enough to be resubmitted in 2002: Broderick's proposal at **Duke Energy**, and Davis's proposals to **AT&T** and **Citigroup** asking them to affirm political nonpartisanship, and her proposals to **Ford Motor, Lockheed Martin** and **United Technologies** asking them to disclose their political contributions through advertisements in leading newspapers.

Withdrawals and omissions: There were no withdrawals (Davis rarely negotiates with companies). As in 2000, the SEC staff allowed NiSource to omit a resolution from an individual who wanted it to eliminate its political action committee, underscoring the staff's view that the decision to have such a committee is one left to management.

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