SEC PURSUES CURRENT DISCLOSURE

Shortly after he became Chairman of the SEC, Harvey Pitt stated that the SEC's current disclosure mechanisms were "antiquated." In remarks made to members of the securities bar, Pitt envisioned a system in which public companies would be required to affirmatively disclose "unquestionably material information when it arises and becomes available." In another forum, Pitt called for such disclosures in "real time." On February 13, 2002, the SEC issued a press release that addressed this concept of current disclosure. In the press release, the SEC took the unusual step of announcing its intention to propose rules that, among other things, would greatly expand the scope of events that must be reported on Form 8-K.

The SEC's first detailed regulatory proposal with respect to its current disclosure initiative was issued on April 11, 2002. The proposal calls for accelerated disclosure of transactions in company securities and other events involving directors and executive officers of companies that have a class of securities registered under Section 12 of the Securities Exchange Act. The regulations would, therefore, cover most domestic companies that file reports with the SEC.

Specifically, the proposal seeks accelerated disclosure by companies on a Form 8-K of the following events:

- Directors' and executive officers' transactions in company equity securities, including transactions in derivative securities, such as options, warrants, swap arrangements and futures contracts;
- Directors' and executive officers' entry into, or modification or termination of so-called "10b5-1 plans" or other arrangements that are intended to satisfy the affirmative defense conditions of Rule10b5-1(c) under the Securities Exchange Act relating to insider trading; and
- Loans of money or guarantees of loans by the company or an affiliate of the company for the benefit of directors and executive officers.

Under a new Item 10 of Form 8-K, companies would be required to report, within two business days, most directors' and executive officers' transactions in company equity securities having an aggregate value of $100,000 or more. In addition, the same two-business-day deadline would apply to loans or guarantees for the benefit of directors and executive officers having a value of $100,000 or more. Subject to exceptions for transactions with a value not exceeding $10,000, all other transactions covered by proposed Item 10 would have to be reported by the close of business on the second business day of the week following the week in which the relevant event occurred.

Currently, directors and executive officers are required to file reports with regard to most transactions in company equity securities on either Form 4 or Form 5. Form 4 generally relates to transactions that are subject to the short-swing profit provisions of Section 16(b) of the Securities Exchange Act and are filed 10 days following the month in which the transaction occurs. Form 5 relates to most transactions that are exempt from the short-swing profit provisions and need not be filed until 45 days following the end of the company's fiscal year. Because the Form 4 filing deadline is addressed in the Securities Exchange Act, the SEC has not attempted to change the Form 4 filing deadline,

but stated in the February 13 press release that it would support "a legislative solution that would dramatically shorten" the Form 4 filing deadline. On April 24, 2002, the House of Representatives passed the Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002, which would, if enacted into law, mandate the adoption of a rule by the SEC requiring Section 16 reports to be filed before the end of the next business day after the day on which the transaction occurs. Moreover, the rule would require the disclosure of loans or other extensions of credit to officers and directors.

The entry into 10b5-1 plans or other arrangements is not required to be reported at all, although some companies have issued press releases regarding their executives' entry into such plans, and notations on Forms 144 that a transaction was effected under a 10b5-1 plan are common. Loans and guarantees of the type described in the release are typically covered in the proxy statement for a company's annual meeting of stockholders (assuming a $60,000 threshold amount is reached) and may be disclosed in financial statement footnotes. The SEC's proposed regulation would put the onus on companies to report these events on a much more accelerated basis.

The information required by the proposed disclosure requirement with respect to the specified events is fairly detailed. With regard to transactions in equity securities, information is required involving acquisitions and dispositions of the securities, including information with regard to the number of securities involved and the relevant price. With respect to derivative securities, comprehensive information with regard to the acquisition, exercise, conversion, termination or settlement of a derivative security is required. With regard to 10b5-1 plans or arrangements, information is required with respect to the duration of the plan, the number of securities to be purchased or sold and the name of the counterparty or agent. In addition, with regard to a modification of a 10b5-1 plan or arrangement, a company must disclose if the interval at which securities are to be purchased or sold or the price at which securities are to be purchased or sold has been modified. Finally, with respect to loans or guarantees, information provided must include the dollar amount of the loan, the class of securities pledged as collateral, if any, and whether a pledge is made with or without recourse. Information also must be provided if the loan is forgiven or if the company or an affiliate makes payment on its guarantee or similar arrangement, or if the collateral is foreclosed upon.

The reporting burden for companies subject to the proposed disclosure requirement is formidable, and will result in the need for much more comprehensive information-gathering procedures than are currently in effect for most companies. After the SEC required companies to make disclosures regarding the late filing of Section 16 reports by directors, officers and 10-percent stockholders, many companies instituted detailed monthly reporting procedures under which directors and officers provide information to the company regarding transactions in the company's equity securities on a monthly basis. These procedures will not be sufficient to enable companies to comply with the proposed requirements. Companies will have to institute procedures that will require directors and executive officers to report transactions to the company at the time they occur. Even with such procedures, it is likely that many companies will file late disclosures.

Reporting of 10b5-1 plans and arrangements raises different concerns. In its proposing release, the SEC asked for comments on whether there was a general expectation of privacy with respect to the terms of 10b5-1 plans or arrangements. In practice, there does not appear to be a uniform approach on this issue. While some executives do not voluntarily disclose entry into 10b5-1 plans, others have their entry into such plans widely publicized through press releases, to communicate to the public that the sales are part of an organized program and not intended to be an indication of the executive's views regarding the company's prospects.

The SEC has attempted to address the potential reporting issues under the disclosure requirement in two ways. First, the SEC is proposing the inclusion of language in Form 8-K stating that it is not in the public interest to impose a sanction on a company, even if a violation occurs, if the company demonstrates that it had designed procedures and a system for applying such procedures sufficient to provide reasonable assurances that the events are reported on a timely basis; that at the time of the violation, the company followed the procedures; and that the company made a filing to correct any violation as promptly as reasonably practicable. While this language is helpful, there is a great deal of potential for "20/20 hindsight" here. Suppose that, despite a good-faith effort by a company to establish meaningful procedures, several violations occur. Does this mean that the company's procedures were not "sufficient to provide reasonable assurances"? In its proposing release, the SEC said that repeated violations or "those that otherwise are not isolated" would suggest deficiencies in procedures or their application. But if, for example, the company does institute rigorous reporting procedures, and a director fails to adhere to them, what is the appropriate response? Absent stockholder approval, a company cannot remove a director for failing to advise a company of his or her transactions in company equity securities.

The second way in which the SEC is proposing to address potential reporting problems for companies is to provide that a delinquency in the reporting of the specified events on a Form 8-K will not affect the ability of a company to use Securities Act registration forms (including a Form S-3 for use in a shelf registration), which currently may be used only if the company was timely in filing its annual and periodic reports during the preceding 12 months. In addition, the failure to report an event on a timely basis would not cause a company to fail to satisfy the "current public information" requirement for the use of Rule 144 by affiliates and holders of restricted stock.

The 60-day comment period for the proposed disclosure requirements ends on June 24. Hopefully, a final rule will be fashioned that will better accommodate the difficult reporting burdens placed on companies in this context. A better result would be to defer to a legislative solution that would direct the reporting requirements for transactions not involving the company to the persons best able to provide the disclosures, namely the officers and directors involved in the reportable events.

It is also important to keep in mind that this is only the first step in the SEC's current disclosure initiative. As stated by the SEC in its February 13 press release, additional items under evaluation for inclusion in Form 8-K include, among others, defaults and other events that can trigger acceleration of direct or contingent obligations,

departure of a company's CEO, CFO, COO or president; a definitive agreement that is material to the company; any loss or gain of a material customer or contract; changes in rating agency decisions and other rating agency contacts; waivers of corporate ethics and conduct rules for officers, directors and other key employees; and offerings of equity securities not included in a prospectus filed by the company with the SEC. These items, as well as the other items addressed in the SEC's press release, would result in much more frequent reporting by companies on Form 8-K. In addition, some items, such as disclosure of a material agreement or a loss or gain of a material customer or contract, would involve difficult judgments.

While it is too early to tell what will be encompassed in the final regulations in this area, one thing is clear: there will be dramatic changes and far more effort involved in the preparation of Form 8-K disclosures as a result of the "current disclosure" initiative.

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