

MORGAN LEWIS ON SECURITIES

A NEWSLETTER FROM THE SECURITIES PRACTICE ■ www.morganlewis.com

SPECIAL ISSUE: Focus on Public Companies

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 compa-

nies 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 Rule 10b5-1(c) under the Securities

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HOW TO SURVIVE AND THRIVE AS A PUBLIC COMPANY

Lawyers from Morgan Lewis, accounting professionals from co-host Ernst & Young LLP, officers of public companies, and bankers and analysts from financial services firms gathered in Pittsburgh earlier this year to discuss the challenges faced by public companies today. The Executive Briefing was organized by Marlee S. Myers, the managing partner of Morgan Lewis' Pittsburgh office. Some of the important themes of the briefing are summarized below.

MANAGING A PUBLIC COMPANY IN CHALLENGING ECONOMIC TIMES REQUIRES SOLID BUSINESS AND FINANCIAL STRATEGIES

The first two speakers were the CEO of a "new economy" company that went public at the height of the Internet boom in 1999 and survived the Internet bust of 2001, and the CEO of a traditional metals company that has experienced contracting markets, rising costs and increased competition from foreign imports. Although their companies are in vastly different industries, their survival strategies are remarkably similar.

Glen Meakem, Chairman and CEO of FreeMarkets, Inc., the Pittsburgh-based company that pioneered the e-sourcing industry in 1995 and today leads that industry, shared with the

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EDITOR'S NOTE:

Volatile financial markets and investor skepticism following recent accounting meltdowns have raised new challenges for public companies. MORGAN LEWIS ON SECURITIES presents this Special Issue to highlight the ongoing discussion of these challenges reflected in the pages of this newsletter, and in the day-to-day counsel provided by many of our attorneys. Future issues of this newsletter will continue to address the issues public companies face in navigating this new regulatory landscape.

Morgan Lewis
C O U N S E L O R S A T L A W

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SPECIAL ISSUE: Focus on Public Companies

SEC PURSUES CURRENT DISCLOSURE *(continued from page 1)*

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.



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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

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EMPLOYER STOCK IN 401(k) PLANS

Company stock as a 401(k) investment option has become an increasingly controversial issue — particularly where a company has financial problems or files for bankruptcy. Many firms offer company stock as an investment option under their 401(k) plans.



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It is also common for companies to provide participants with company stock, as opposed to cash, as a matching contribution. Employers have various reasons for

making the matching contribution in company stock: it is less costly than giving cash; it provides the company with a tax deduction in the amount of the contribution it makes; it puts large blocks of shares in the hands of people unlikely or unable to sell, helping to stabilize the stock price; it is thought to align employees' interests with those of management and shareholders; and it may give employees an incentive to make the company successful. Often employers impose restrictions on the sale of company stock contributed or purchased in satisfaction of employer matching or other contribution obligations. Thus, participants are often precluded from selling the company stock until they reach a specified age or satisfy specified service requirements.

LEGAL ACTIONS

For years, attorneys and pundits have predicted that 401(k) plan participants would sue their employers over company stock when times got tough. With the decline in the stock market and the drastic decline in value of several companies' stocks, those lawsuits are now being filed.

While the Enron collapse and its dramatic impact on the Enron 401(k) plan participants has captured front-page headlines, there has, in fact, been a flurry of recent

lawsuits, pitting thousands of employees, former employees and retirees against their current or former companies. In these cases, participants are attacking the common practices of matching 401(k) contributions with company stock and of offering employees the opportunity to invest their own contributions in company stock. The suits challenge commonly held views on the governance of 401(k) plans, particularly the scope of fiduciary responsibility and the protections of section 404(c) of ERISA. Under section 404(c), companies are generally not legally responsible for losses in 401(k) plans so long as they provide a broad range of investment choices to the participants (and do not subject participants to improper influence). However, the protections afforded by section 404(c) and the fiduciary obligations pertaining to investments in company stock have not been thoroughly tested legally until now. The outcome of these suits will determine how the judicial system will view an employer's responsibility for its 401(k) plan.

PROPOSED LEGISLATION

Lawmakers and regulators have jumped into the fray as well. Currently, Congress is debating two major bills offering a variety of fixes, including, among others:

- requiring plans to allow participants to diversify out of employer stock after specified periods;
- requiring advance notice of blackout periods, limiting the duration of such periods and imposing penalties on the sale of company stock by insiders during 401(k) plan blackout periods;
- requiring plan sponsors to provide participants with statements regarding the financial health of the company and the importance of investment diversification;
- expanding the liability, remedial and enforcement provisions under ERISA; and
- increasing the investment education provided to participants.

MINIMIZING THE RISK

What can employers do to minimize their risk pending the outcome of current litigation and proposed legislation? Companies

whose 401(k) plans are heavily invested in company stock will likely not be able to eliminate or substantially reduce the risks associated with those investments. Nevertheless, there are certain steps employers can take to minimize the risks. Here are just a few:

What's the Design? Plan design decisions generally are not subject to fiduciary rules and standards under ERISA. Accordingly, plans that are *designed* to invest in company stock should derive some protection under this doctrine.

Where's the Loyalty? ERISA has always permitted the company officials to wear "two hats," that is, to serve in a fiduciary capacity to a plan despite their duties as corporate officers. Nevertheless, such executives often must walk a fine line in meeting their dual obligations. Nowhere is this inherent conflict more pronounced and the potential exposure to liability greater than in the area of plan investments in company stock.

It may not be practical or desirable in many cases to transfer the fiduciary responsibilities associated with company stock investments to a corporate trustee or other independent fiduciary. However, employers may benefit from reviewing the fiduciary structure and procedures for their plans to clearly identify the roles of the various plan fiduciaries and to obtain a sound understanding of the responsibilities of the in-house fiduciaries in this context.

What's the Problem? What is perhaps most disconcerting about the current brouhaha over company stock in 401(k) plans is that, with certain exceptions, the alleged wrongs do not stem from illegal plan provisions or operations. To the contrary, the plans that are currently the subject of litigation do not appear to be unusual or outside the parameters of permissible design and operation. Still, it would be advisable for employers to review the company stock aspects of their plans to ensure compliance with all applicable legal requirements. These would include ERISA fiduciary rules and, in particular, compliance with the special 404(c) requirements

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Failure to Supervise: Some Lessons from the Past Year

The SEC staff — in both the Enforcement Division and the Office of Compliance Inspections and Examinations (OCIE) — continues to prioritize potential supervisory weaknesses within broker-dealers and investment advisors. The following describes some of the familiar themes that the SEC continues to play.

DUTY TO ENACT AND ENFORCE ADEQUATE POLICIES AND PROCEDURES

In one of the most notable supervision cases of 2001, *In the Matter of Dean Witter Reynolds, Inc. et al.*, the Division of Enforcement suffered a rare defeat when an administrative law judge dismissed an administrative proceeding in its entirety against Dean Witter Reynolds, Inc. and one of its branch managers. The ALJ found that neither the firm nor its branch manager had failed to supervise a registered representative who allegedly

had defrauded four elderly clients, noting that the firm and the supervisor “discharged their duties without reason to believe that its procedures and systems were not being complied with.” The opinion is instructive about the types of duties for which a branch manager potentially is responsible, which include:

- being familiar with the clients and accounts serviced through the branch offices;
- performing a daily review of order tickets and ensuring that tickets are properly completed;
- supervising active accounts on a monthly basis and investigating unusual activity;
- completing supervisory logs confirming completion of all supervisory activities; and
- forwarding evidence of supervisory reviews to the compliance department.

While all registered entities must have written policies and procedures that seek to prevent violations of the federal securities laws, it is not enough to simply publish and disseminate a detailed policy manual if the policies and procedures contained therein are not properly implemented by the supervisors. In one case, *In the Matter of Oechsle International Advisors, L.L.C.*, a Boston investment advisor (Oechsle) agreed to settle administrative proceedings against it for failure to supervise a former portfolio manager who allegedly was scheming to “mark the close” in order to push up the closing price of certain securities. The SEC found that although Oechsle had instituted written policies and procedures, it had failed to adequately implement policies prohibiting manipulative trading. In a separate case involving a broker-dealer and its president, *In the Matter of Roundhill Securities, Inc.*, the SEC found that, although the broker-dealer had recently adopted new supervisory procedures, it and its president allegedly had failed to establish a reasonable system to implement such procedures. In addition, the broker-dealer and president allegedly had “failed to train the compliance and supervisory personnel adequately to be effective in their positions.”

DUTY TO INVESTIGATE RED FLAGS

Some of the cases brought this year by the Division of Enforcement are instructive with regard to the concepts of heeding “red flags” and supervising branch offices. *In the Matter of Western Asset Management Co. et al.* (discussed in detail in the December 2001 issue of *MORGAN LEWIS ON SECURITIES*), two investment advisers settled an administrative action for failure to supervise a portfolio manager who allegedly had defrauded a mutual fund and an offshore fund by causing the funds to overstate their net asset values. Among other things, the SEC found that the fund manager had indica-

Recent Publications

NASDR and NYSE Tackle Research Analysts Practices . . . But Are Their Proposals Workable? Robert C. Mendelson, Steven W. Stone and John V. Ayanian, *Wall Street Lawyer* (May 2002)

Conducting Your Advisory Business on the Web, Steven W. Stone and Jennifer L. Klass, *Compliance Review* (May 2002)

The Current SEC Enforcement Landscape, John F. X. Peloso and Ben A. Indek, *New York Law Journal* (April 17, 2002)

New SEC Guidance on Soft Dollars and Riskless Principal Trades, Steven W. Stone and Jack P. Drogin, *NSCP Currents* (March/April 2002)

SRO Disciplinary Proceedings: How Much Delay Is Unfair? John F.X. Peloso and Ben A. Indek, *New York Law Journal* (February 21, 2002)

Analyze This: NASDR Proposes Tougher Rules on Research Analyst Practices, Steven W. Stone, *Complanet* (February 19, 2002)

Expanding Safe Harbors for Soft Dollars, Steven W. Stone and Jack P. Drogin, *Wall Street Lawyer* (February 2002)

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Variable Life Registration Forms

Get Much-Needed Facelift

Insurance companies and investors alike will welcome the SEC's latest action in the area of insurance products: the adoption of a registration form specifically tailored to variable life insurance. Form N-6 focuses on disclosure of information that is relevant to variable life investors such as premium payments, death benefits, surrenders and loans, and eliminates requirements of the prior registration forms that tended to produce lengthy prospectuses and disclosure of arguably irrelevant information. Like its Form N-4 and Form N-1A counterparts for variable annuities and mutual funds, Form N-6 has a two-part format — a simplified prospectus and a statement of additional information — designed to streamline the presentation of information to investors. Discussed briefly below are some of the highlights of the new form.

A significant feature of the Form N-6 prospectus is a fee table that shows all costs associated with a variable life policy, including cost of insurance charges. Cost of insurance will be presented in two ways: (1) as a range from minimum to maximum; and (2) as the actual charge for a representative policy owner. This presentation will be supplemented with a footnote disclosing that the charge varies, that the "representative" charge is not necessarily the charge an investor will pay, and how the investor can obtain additional information. The fee table also requires maximum charges to be shown, though registrants are free to disclose current charges as well.

Form N-6 does not require hypothetical illustrations, but, if included, they can appear in either the prospectus or SAI and, among other things, must be preceded by a clear and concise explanation, must show values based on three gross rates of return (0%, 6% and some other percentage not to exceed 12%), and must reflect an arithmetic average of the total expenses of all available underlying funds. Financial statements are no longer required in the prospectus. Rather, Form N-6 allows the separate account's statements and the insurer's balance sheets to appear in the SAI with the remainder of the insurer's statements appearing in Part C. Moreover, the insurer's financials can be prepared in accordance with statutory requirements rather than generally accepted accounting principles, provided that the insurer doesn't otherwise prepare financials in accordance with GAAP for its SEC filings or those of its parent.

All new variable life registration statements, or post-effective amendments that are annual updates to effective registration statements, filed on or after December 1, 2002, must comply with Form N-6. The final compliance date for filing amendments to effective registration statements to conform with Form N-6 is December 1, 2003.

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MORGAN LEWIS CALENDAR

June 2002

6 **Portfolio Trading**
Thomas P. Lemke
Glasser Legal Works Fifth Annual Institute on Investment Management Regulation
Sponsored by Glasser Legal Works
New York, NY

6 **Alternative Markets for Execution and Related Compliance Issues**
John V. Ayanian
NRS Annual Symposium on Investment Adviser Trading Practices
Sponsored by National Regulatory Services
New York, NY

10 **Legal & Regulatory Update**
Christian J. Mixter
2002 Corporate Governance Conference: How to Meet Shareholder & Regulatory Demands Through Board and Management Excellence — The New Imperative
Sponsored by CPE Inc.
Washington, DC

13 *Annual ALI-ABA Investment Company Regulation and Compliance Conference*
14 Thomas S. Harman, Co-Chair
Boston, MA

18 **Supervision of Offices**
Thomas L. Taylor III
NRS Suitability for Traditional & Online Brokers Conference
Sponsored by National Regulatory Services
Phoenix, AZ

20 **The Applicability of Suitability Rules to Variable Products**
Paul Huey-Burns
NRS Suitability for Traditional & Online Brokers Conference
Sponsored by National Regulatory Services
Phoenix, AZ

WHEN DOES A COOPERATOR WAIVE GOODBYE TO ITS PRIVILEGES?

The lead article in our December issue reviewed the SEC's October 23, 2001 Cooperation Guidelines. In that article, we noted that both the law and the agency's expressions on the waiver of attorney-client privilege and work-product protection have been somewhat ambivalent. The past few months have seen evolution in both the law and the SEC's views.

On March 27, the Georgia Court of Appeals issued its much-anticipated decision in *McKesson HBOC, Inc. v. Adler*, in which McKesson, joined by the SEC as *amicus curiae*, sought reversal of a trial court ruling that a private plaintiff was entitled to discovery of interview summaries, legal memoranda, and an audit committee report that McKesson had voluntarily shared with the SEC. The court of appeals affirmed the trial judge's ruling that McKesson had waived the attorney-client privilege by turning the materials over to the SEC. However, the appellate court disagreed with the trial judge on McKesson's assertion of the work-product protection, holding that the company had made out colorable claims that the investigative materials were work-product and that the work product protection had not been waived. In reaching this determination, the court noted that the company and the SEC were not adverse to one another, and that the company had entered into a written confidentiality agreement with the SEC. Disappointing both the parties and legions of court-watchers, the appellate court did not make a final ruling on either the application of the work-product doctrine to McKesson's materials or the question of waiver, but instead remanded the case to the trial judge to make findings on both issues.

As we noted in December, the Commission itself has argued, in a subpoena enforcement proceeding entitled *SEC v. USA Detergents et al.*, that if individuals under scrutiny by the SEC cite the results of a company's internal investigation in their defense, the privilege will

have been waived inadvertently. The SEC's effort to enforce a waiver in *USA Detergents* was never ruled on by the court; instead, on March 21, 2002, the Commission announced that it had stipulated to the dismissal of the subpoena enforcement proceeding based, in part, "on an agreement between the parties whereby the Commission staff reviewed the documents that were the subject of that proceeding." *USA Detergents* still stands as a sign that the Commission will argue "waiver" if it believes that the privilege is being used as both a shield and a sword — even if the identities of the parties wielding the sword (individuals under investigation) and the party seeking the protection of the shield (the company) are not the same.

Most recently, on April 23 the SEC issued a ruling in an administrative proceeding that shows that the privilege is in peril even if it is the Division of Enforcement, and not a person under investigation, that creates the circumstances leading to the "waiver." In the underlying proceeding, *In the Matter of Clarke T. Blizzard*, the Division seeks sanctions against Blizzard, a former officer of Shawmut Investment Advisers, for allegedly causing client brokerage commissions to be directed to brokerage firms as compensation for the firms' referrals of new client accounts. In 1996, Fleet Financial Group, which had acquired Shawmut, retained Ropes & Gray (Firm) to conduct an investigation of the matter. As part of the investigation, a Firm attorney interviewed Blizzard, and took notes of the interview. The Firm subsequently prepared a report of its investigation, which it provided to the Division of Enforcement as part of a "Voluntary Disclosure."

During discovery in the *Blizzard* administrative proceeding, the Division gave the respondents a copy of the Firm's Report, which the Division described as "part of its non-privileged investigative file." The Division also told the respondents that it intended to call as a witness the Firm lawyer who had interviewed Blizzard, and

that it might even offer the Report into evidence. Blizzard then served a subpoena on the Firm in which he demanded the interview notes, which the Firm had not provided to the Commission. In its April 23 order, the Commission ruled that the Firm was obliged to turn over the notes, redacted to eliminate any pure opinion work product that they might contain, based on the Firm lawyer's intention to testify as a Division witness and the lawyer's rather unsurprising statement that his testimony would be consistent with his notes. The Commission noted in its opinion that "given [the Firm lawyer's] decision to testify, our decision does not impact" the Firm's statement, made when it originally produced the Report to the Commission, that its client Fleet was not thereby waiving "Fleet's Attorney-Client Privilege, the Attorney Work Product Doctrine or any Other Applicable Privilege."

The *Blizzard* order underscores two points that must be borne in mind by counsel who produce the results of internal investigations to the Commission under the cooperation guidelines. First, whatever materials counsel actually give the Commission — in *Blizzard*, the investigative report — can and often will wind up in the hands of the very person who was being investigated. The Division (by its disclosure of the Report) and the Commission (by its somewhat chilly statement that "[g]iven our disposition of this matter on other grounds, we need not decide whether any waiver of privilege occurred as a result of the Division's . . . disclosure of the Report to Blizzard") appear to be thoroughly indifferent to such a result. Second, if cooperating counsel go the extra mile and agree to testify as witnesses for the Division of Enforcement, even the investigative materials that counsel did not furnish to the Commission are in serious danger of being revealed.

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HOW TO SURVIVE AND THRIVE AS A PUBLIC COMPANY

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attendees his thoughts on how to build and maintain a strong company through turbulent times. He pointed out the contrast between FreeMarkets' stock price performance, which has been extremely volatile, and its revenue and operating earnings performance, which has grown consistently. Meakem identified the following as the elements of his strategy:

- deliver real value to customers,
- lead and develop people,
- adhere to strict character traits and values,
- deliver innovative product and service offerings, and
- follow a strict financial plan.

James Murdy, president and CEO of Allegheny Technologies Incorporated, one of the world's leading specialty materials companies, agreed with Meakem that companies must consistently deliver excellent service and products to their customers. In short, Meakem and Murdy agreed that, to stave off accounting implosions, executives must understand their company's "corporate DNA," must maintain a culture that values ethics, and must adopt financial strategies to maintain a healthy balance sheet, increase productivity and create operational efficiencies.

BOARDS OF DIRECTORS — AND PARTICULARLY AUDIT COMMITTEES — SHOULD PREPARE FOR HEIGHTENED SCRUTINY

Elliot Gerson, Senior Executive Vice President and General Counsel of Rite Aid Corporation, joined Linda Griggs, partner in the Washington, D.C. office of Morgan Lewis, and Kenneth Marceron, partner in the Washington, D.C. office of Ernst & Young LLP, in discussing board responsibilities in this post-Enron era.

The role of audit committees is made difficult by a maze of accounting rules, the complexity of modern business transactions, and the limited time available to board members to review documents and supporting materials, all of which are occurring in an atmosphere of heightened scrutiny. The panelists offered suggestions on a variety of issues.

Off-Balance-Sheet Transactions.

The panel suggested that, when confronted with an off-balance-sheet transaction, audit committee members should consider and identify the economic bases for the transaction and consider its options for discussing the matter with the SEC staff.

Related-Party Transactions.

The panel offered the following suggestions to audit committees regarding related-party transactions (*i.e.*, transactions with a person who might have an interest in a transaction, or who otherwise might not be at arm's length):

- in approving a related-party transaction, obtain adequate evidence to support the reasonableness of the transaction,
- disclose the related-party transaction in detail, and
- continually monitor the transaction to ensure that the terms on which it was undertaken are carried out and that safeguards against conflicts of interest are maintained.

Earnings Restatements.

Audit committees should clearly define with management and outside auditors their expectation that they will be advised of developing issues. If a situation arises that may require a restatement, the audit committee should be involved in the decision-making process and should be satisfied as to the reasons for the restatement.

The panelists provided the following bottom-line advice for audit committees:

- review and understand the company's financial reports,
- ask pertinent questions of management and outside auditors,
- continue to probe until issues are fully vetted and resolved,
- create an environment that promotes full disclosure by management, and
- ensure that disclosures are timely, are sufficiently detailed, and satisfy regulatory requirements.

RESPONDING TO THE DEMANDS OF WALL STREET REQUIRES EFFECTIVE DISCLOSURE PRACTICES

Marlee Myers, Christian Mixer, partner in Morgan Lewis' Washington DC office, Jack Kelly, Managing Director at Goldman Sachs & Co., and Joan Hooper, CFO of FreeMarkets, Inc., discussed the challenges executives face in providing appropriate disclosure of corporate events in an environment where good news is greeted with skepticism and bad news is greeted with panic. Hooper noted that Wall Street demands consistent results, but pointed



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out that companies must strike a balance between managing expectations and satisfying disclosure obligations that often have subjective standards. Kelly noted that the threshold for one such standard — materiality — has become lower in response to the heightened scrutiny of today's marketplace.

The panelists discussed the factors that are relevant to a decision to announce an event prior to the time that regulations would require public disclosure. Although panelists shared different approaches to the timing and content of an announcement, Kelly offered three recommendations from the analyst's perspective:

- be early, even if complete details are unknown,
- define the problem as clearly as possible given the circumstances, and
- be cautious in offering new guidance until complete details are known.

Hooper expressed her concern that immediate disclosure of unfolding events when details are sketchy can send inaccurate signals to the market, resulting in misperceptions about a company's prospects. Hooper noted that, absent an

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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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HOW TO SURVIVE AND THRIVE AS A PUBLIC COMPANY

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immediate disclosure obligation, she prefers to make an announcement when sufficient facts are available to provide the market with a full and adequate explanation. The conference panelists agreed that, regardless of when and how much information is announced, executives should at all times be straightforward in their disclosures.



Frank G. Zarb addresses the luncheon audience at the Executive Briefing sponsored by Morgan Lewis' Pittsburgh office.

IT COMES DOWN TO ETHICS

In many ways, the Executive Briefing concluded on the same theme with which it began: the importance of an ethical environment in a public company. Frank G. Zarb, Chairman of Nasdaq Europe and former Chairman and CEO of The Nasdaq Stock Market, Inc. and NASD, Inc., shared with the attendees insights gleaned from his distinguished 40-year career in the securities and insurance industries and in government. According to Zarb, strong ethics are the keystone to maintaining the integrity of financial markets and the faith of the investing public in business leaders and the corporations they run. Zarb's advice sums up the overarching message of the conference — strong ethics should be the compass by which officers and directors steer their business decisions.

Ashley D. Kozel contributed to this article.

NAVIGATING ACCOUNTING AND FINANCIAL REPORTING PROBLEMS

Morgan Lewis has one of the nation's premier securities practices, including one of the largest contingents of former SEC officials of any law firm in the country. Our lawyers are known for their ability to handle complex matters involving financial disclosure, investigations and litigation.

Morgan Lewis has unique experience in understanding and navigating accounting and financial disclosure issues and the myriad legal problems that — as recent events have shown — can flow from these issues. Our partners who advise clients on disclosure and reporting issues include many who have served in senior positions in the SEC's Office of the Chief Accountant and Division of Corporation Finance and many with years of experience in the private sector. They provide clients with broad and deep experience in helping public companies understand and comply with SEC financial disclosure regulations. Our partners who advise clients in connection with the investigations and litigation that often develop from accounting issues include lawyers who have served in senior positions with the SEC's Division of Enforcement and the Department of Justice, as well as litigators who have long-standing experience defending private and class action lawsuits.

We counsel a wide range of clients on financial disclosure obligations, conduct internal investigations, defend investigations being conducted by the SEC and criminal authorities and defend private and class-action litigation. We seamlessly advise issuers and their officers and directors through all stages of crisis management, from the initial identification of an issue through its final resolution.

Linda L. Griggs and Christian J. Mixer serve as coordinators for this team. Linda may be contacted at 202.739.5245 or lgriggs@morganlewis.com; and Chris may be contacted at 202.739.5575 or cmixer@morganlewis.com.

MORGAN LEWIS NEWS

John Hartigan Ranked Among Most Notable Attorneys in LA

John F. Hartigan was named to the *Los Angeles Business Journal's* list of LA's top 25 attorneys, "Who's Who in Law — LA's Rainmakers." Mr. Hartigan is a partner in the Business and Finance Practice, co-chair of our global securities interdisciplinary initiative and managing partner of the Los Angeles office. The article described him as "one of the most sought-after securities law attorneys on the West Coast," and as a "securities law expert, even among other lawyers."



Northern Virginia Office Expands Securities Litigation Capability With the Addition of Doug Lobel

Partner Douglas P. Lobel, of counsel Joseph F. Yenouskas, and associates David A. Vogel and James Deacon have joined Morgan Lewis, resident in the Northern Virginia office. Their focus is on complex commercial litigation and consumer class actions, including broker-dealer and banking litigation.

Mr. Lobel is an experienced trial lawyer who has represented underwriters and

broker-dealers in securities class actions and arbitrations, public corporations in commercial litigation and corporate internal investigations, corporations and directors in federal grand jury investigations, administrative enforcement actions and civil and criminal cases, and investigations brought by the SEC, the FDIC, and the Department of Justice.

Mr. Lobel can be reached at 703.918.1670 or dlobel@morganlewis.com; Mr. Yenouskas can be reached at 703.918.1767 or jyenouskas@morganlewis.com; Mr. Vogel can be reached at 703.918.1237 or dvogel@morganlewis.com; Mr. Deacon can be reached at 703.918.1233 or jdeacon@morganlewis.com.

Bob Romano Returns to Morgan Lewis

Robert M. Romano will rejoin the firm's Securities Litigation Practice in New York. Mr. Romano, who was a partner at Morgan Lewis from 1987 to 1999, has extensive experience in a variety of securities regulatory litigation matters, including the defense of individuals and companies under investigation by the SEC, the NYSE and the NASDR for securities fraud or other regulatory violations. He has handled numerous matters involving commodities regulatory litigation, including the representation of individuals and firms in investigations and litigation with regulators concerning trading practices and supervision. Mr. Romano also has experience with white-collar criminal defense



matters, including the representation of individuals and companies in investigations by federal and state prosecutors for business-related crimes, and general federal civil litigation.

Before entering private practice, Mr. Romano served as vice president and counsel (litigation) for Merrill Lynch, Pierce, Fenner & Smith, Inc. Prior to that, he was with the Trial Unit of the SEC's Division of Enforcement in Washington, serving as the Deputy Chief Litigation Counsel for his last two years of government service. Prior to his tenure at the SEC, he was an Assistant U.S. Attorney in Newark, New Jersey. He received his undergraduate and law degrees from Georgetown University in 1969 and 1972, respectively.

Mr. Romano can be reached at 212.309.7083 or rromano@morganlewis.com.

Prominent Employment Lawyers — with Securities Industry Focus — Join Morgan Lewis

The Labor and Employment Law Practice is pleased to announce that Michael A. Curley, Samuel S. Shaulson and Samuel Estreicher have joined the practice in the New York office. The three have over 50 years of combined experience in all facets of labor and employment law, with particular experience with the securities industry.

Mr. Curley can be reached at 212.309.6711 or mcurley@morganlewis.com; Mr. Shaulson can be reached at 212.309.6718 or sshaulson@morganlewis.com; Mr. Estreicher can be reached at 212.309.6725 or sestreicher@morganlewis.com.

EMPLOYER STOCK IN 401(K) PLANS

(continued from page 3)

applicable to company stock; securities laws, including registration requirements for plans that permit employees to invest their own contributions in company stock; and Internal Revenue Code requirements pertaining to plans that invest in employer stock. Another increasingly critical element of compliance in this area is full disclosure of investment rights to participants.

What About Blackout Periods?

Blackout periods are a necessary component of plan administration. Indeed, the fiduciary responsibilities under ERISA

mandate that fiduciaries change investment vehicles and service providers if they determine that it is prudent and in the best interests of participants to do so. However, employers can and should carefully design such periods so as to cause the least amount of disruption in plan operation as possible. In this regard, advance notice to participants and a structure that permits participants to adequately prepare their plan portfolios for the inevitable downtime is imperative. The recent spate of lawsuits suggests that fiduciaries should negotiate

for the shortest blackout period consistent with an orderly transition.

It would be fanciful to believe that there will not be significant changes in rules governing company stock in 401(k) plans in the very near future. The precise parameters of the new rules remain to be seen. However, the issues identified above are worthy of the attention of those who wish to minimize their risks in this arena.

Amy R. Promislo co-authored this article. She may be contacted at 215.963.4749 or apromislo@morganlewis.com.

FAILURE TO SUPERVISE

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tions of “red flags,” such as stale pricing of troubled notes and a questionable proposed roll-up transaction, but did not follow up on these irregularities or establish procedures for review. Other cases brought by the Division of Enforcement stemming from the failure to heed “red flags” touched upon soft-dollar payments and commission kickbacks. In one such case, *In the Matter of Howard M. Brenner*, Howard Brenner, the CEO and president of a defunct broker-dealer in New York, agreed to settle an administrative proceeding alleging that he failed to supervise the soft-dollar payments made by two of his operations officers. In that case, Alan Bond, a registered investment adviser, allegedly had concocted an illegal kickback scheme by directing brokerage business to Brenner’s firm in exchange for certain “soft dollar” payments from the firm. Bond sent monthly invoices to the broker-dealer, many of which contained clearly impermissible expenses. Brenner, the direct supervisor of both operations officers, was charged with failure to supervise because, among other things, he allegedly had failed to monitor the payments made by the operations officers on behalf of the broker-dealer, which could have alerted him to the soft-dollar violations.

In a related case, *In the Matter of George M. Lintz*, George Lintz, the CEO and president of a defunct broker-dealer in California, agreed to settle an administrative proceeding alleging that he failed to supervise the commission kickbacks being paid to Alan Bond by the firm’s registered representative, Robert Spruill. Lintz agreed to pay commissions received by Spruill from Bond’s trading paid to an unregistered “dummy” corporation. The commissions amounted to more than \$4 million, of which about \$2.8 million were “kicked back” to Bond. The SEC found that Lintz, who was Spruill’s direct supervisor, should have been cognizant that the request to pay commissions to an unregistered entity raised a “red flag.” The SEC also found other “red flags,” including the fact that Lintz knew that

the “dummy” corporation paid for certain marketing activities benefiting both Spruill and Bond.

DUTY OF HEIGHTENED SUPERVISION FOR PROBLEM BROKERS AND BRANCH OFFICES

The SEC continues to bring cases that highlight the need to increase the level of supervision over brokers with a disciplinary history. One of these cases, *In re Quest Capital Strategies, Inc.*, charged a registered broker-dealer and investment adviser (Quest) and its president with failure to supervise a branch office manager who allegedly had defrauded customers through the sale of unregistered securities relating to a loan program he had created. In that matter, the branch manager was operating in New York, yet was being supervised by the firm’s president located at the firm’s headquarters in California. Although the firm’s president allegedly learned that the branch manager was violating the firm’s compliance directives by borrowing money from customers, he was “content to rely on [the branch manager’s] written and oral assurances that he would discontinue those practices.” Because the firm’s president had been put on notice of the branch manager’s violations, the SEC found that the firm should have placed the branch manager under enhanced supervision. It further found that Quest would not be permitted to maintain branch offices in the future unless it retained a registered principal and conducted semiannual surprise inspections.

CONCLUSION

Recent cases brought by the Division of Enforcement provide

lessons concerning the type and extent of preventive and corrective measures a firm should take to limit supervisory liability. Supervisors should avoid rationalizing transgressions of firm policies and procedures and be sure to follow up appropriately on “red flags.” Regular reviews of customer accounts and familiarity with trading patterns and products being utilized by the brokers in the branch, particularly when a top producer is concerned, will help a branch manager detect violations and will also promote a “pro-compliance” environment. Additionally, supervisors must take extra care with “problem” brokers and be knowledgeable about remote locations in their supervisory purview. These practices, combined, should assist in protecting supervisors (and their firms) from liability.

For more information, contact Thomas L. Taylor III at 213.612.2522 or tltaylor@morganlewis.com; or Robert K. Smith at 202.739.5993 or rksmith@morganlewis.com.

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