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Articles

SEC To Propose New Disclosure Rules

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Introduction

On February 13, 2002, the Securities and Exchange Commission issued a press release announcing that it will *propose* a series of new disclosure rules for public companies. If adopted, the proposed rules will expand and accelerate disclosure to the public of significant company events, particularly when a company's financial condition deteriorates. While Enron Corporation is not specifically mentioned, many of the proposals appear to be targeted at the accounting and corporate disclosure abuses uncovered at Enron. The issuance of this press release is one of the few times the SEC has announced a rule making initiative in advance of the formal proposal of the rule. This unusual step signals the SEC's commitment to promptly correcting perceived weaknesses in the current disclosure system.

While formal adoption of any new rules is months away, in many cases the proposal presents a model of "best practices" under the existing rules. Because some expanded form of disclosure seems inevitable, a company may wish to consider certain interim disclosure steps, which are highlighted below.

Background

The new SEC Chairman, Harvey Pitt, has announced an intention to improve the financial reporting and disclosure system. Under the federal securities laws currently in force, public companies generally do not have an obligation to disclose material events until specifically required by a line item in the reports mandated under the Securities Exchange Act of 1934 (the "Exchange Act"). Until that time, unless the company intends to trade in its own stock or needs to correct an earlier statement, a company may generally defer disclosure of material events. For example, reports on Form 8-K require disclosure of certain significant events, such as an acquisition or disposition of significant assets, a bankruptcy filing, a change in control or a change in accountant. Despite the importance of such events, however, under current disclosure guidelines, companies can defer public disclosure for periods of five to 15 days. With the advent of EDGAR and the ability of public companies to make nearly instantaneous disclosure, Chairman Pitt clearly intends to accelerate the disclosure cycle.

The SEC is moving in a number of areas in addition to the rulemaking initiative described in the press release. For example:

• On December 12, 2001, the SEC staff recommended expanded disclosure of critical accounting policies. (Release No. 34-45149)

• On December 21, 2001, the SEC announced that it would monitor the Annual Report on Form 10-K filed by every Fortune 500 company this year, as part of a program of increased scrutiny of periodic reports.

• On January 22, 2002, the SEC issued a *Statement about Management's Discussion and Analysis of Financial Condition and Results of Operations* (Release No. 34-45321), advising, among other things, that existing SEC regulations require companies to disclose in MD&A any known trends and uncertainties that threaten liquidity.

• In a separate February 13, 2002 press release, Chairman Pitt announced that he had formally requested the New York Stock Exchange and Nasdaq to review their policies of corporate governance and listing standards, including addressing officer and director qualifications and the codes of conduct of public companies.

The Proposed Rules

The February 13 press release targets five areas in which the SEC intends to propose new rules.

Insider Reports

Under present reporting requirements, insiders (officers, directors and 10% shareholders) are required to report their transactions in company stock, but generally have until the tenth day after the end of the month in which a trade is made to report the transaction, a potential delay of up to 40 days. Because these requirements are established by statute in Section 16 of the Exchange Act, the current reporting requirements can be shortened only through
further legislation enacted by Congress. Moreover, when officers and directors sell stock back to the company, the existing rules and regulations of the SEC permit them to delay reporting the transaction up to 45 days after the end of the fiscal year in which the sale took place. This reporting regime has permitted members of management to engage in transactions that dispose of holdings in company stock, but avoid publicly reporting the transaction for weeks or even several months. In the press release, the SEC supports legislation to accelerate insider reporting, and indicates that it is seeking ways to make immediate, direct reporting of securities trading by insiders technologically feasible.

While it promotes legislation to modify the Section 16 reporting scheme (and until the requisite technology is available), the SEC plans to use its existing regulatory authority over public companies to require them to monitor and report trading by their own insiders. According to the press release, the proposed rules would require companies to promptly report transactions by insiders in company securities, including transactions with the company.

Accelerated SEC Filings

The proposed rules will reduce the maximum time allowed for companies to file historic reports by one third. Quarterly Reports on Form 10-Q will be required to be filed within 30 days after the end of the quarter rather than the current 45 days. Annual Reports on Form 10-K will be required to be filed within 60 days after the end of the fiscal year rather than the current 90 days.

Expansion of Significant Event Reporting

The proposed rules would substantially increase the number of items which would trigger disclosure on Form 8-K. Prompt disclosure would now be mandated for an expanded laundry list of "significant" events. The SEC is evaluating the following items for inclusion in a Current Report on Form 8-K, to be filed within two days of the event (or, in some cases, before the opening of business on the next day):

• Changes in rating agency decisions and other rating agency contacts.

• Transactions in the company's securities, including derivative securities, with executive officers and directors.

• Defaults and other events that could trigger acceleration of direct or contingent obligations.

• Transactions that result in material direct or contingent obligations not included in a prospectus filed by the company with the SEC.

• Offerings of equity securities not included in a prospectus filed by the company with the Commission.

• Waivers of corporate ethics and conduct rules for officers, directors and other key employees.

• Material modifications to rights of security holders.

• Departure of the company's CEO, CFO, COO or president (or persons in equivalent positions).

• Notices that reliance on a prior audit is no longer permissible, or that the auditor will not consent to use of its report in a Securities Act of 1933 filing.

• The execution of a definitive agreement that is material to the company (according to the press release, negotiations of agreements would be excluded from this requirement unless and until a definitive agreement is entered into).

• Any loss or gain of a material customer or contract.

• Any material write-offs, restructurings or impairments.

• Any material change in accounting policy or estimate.

• De-listing of the company's securities or movement from one quotation system or exchange to another.

• Any material events regarding the company's employee benefit, retirement and stock ownership plans, including the beginning and end of lock-out periods.

Disclosure on Company Website

The SEC proposes requiring companies to post their Exchange Act reports on company websites, if available, simultaneously with filing the reports with the SEC.

Disclosure of Significant Accounting Policies

The SEC proposes that a company will have to provide a discussion of critical accounting policies in the management's discussion and analysis ("MD&A") section of its Annual Report on Form 10-K. As noted above, the SEC staff has already recommended expanded disclosure of critical accounting policies in a December 12, 2001 Interpretative Release (Release No. 34-45149).

Will the Rules Be Enacted as Proposed and When Will They Become Effective?

The Administrative Procedures Act requires the SEC to publish new rule proposals in the Federal Register and to provide a period of time for public comment before adopting the rules. After considering the public comments to the proposals, the SEC may adopt specific rules. Thereafter, the final rules must be published in the Federal Register for at least 30 days before the rules take effect. In the current environment, it is likely that the SEC will move quickly in the next 60 to 90 days to draft and issue the formal proposals discussed in the February 13, 2002 press release. The public comment process and changes by the SEC staff in response to such comments could add several months before the final rules become effective.

What to Do Now?

Until a modification of the current rules and forms becomes effective, companies should continue to comply with existing reporting requirements.

Companies may wish to consider reporting any of the enumerated significant events promptly in a press release and on Form 8-K under Item 5 (Other Events and Regulation FD Disclosure) or Item 9 (Regulation FD Disclosure). One could view any event in the proposed list as presumptively material.

Companies do not need to file Form 10-Ks and Form 10-Qs under the shortened time schedule until such time as the rules formally change. In recent years, some companies have been making an effort to file their Form 10-Q simultaneously with or as soon as possible after the announcement of quarterly results. If achievable, this is a good practice.

Given the nearly instantaneous flow of information in today's capital markets, the historical reporting deadlines have become outdated (e.g., 15 calendar days to report a bankruptcy filing). Many companies have already been using press releases to announce major events in advance of Exchange Act reporting deadlines and should continue doing so.

Conclusion

The Enron debacle has given further impetus to an overdue overhaul of historical accounting and disclosure practices for public companies. During the next several months, public companies should expect a flurry of expedited rule making and legislation affecting the timing and content of Exchange Act reports and public company disclosure in general. Pending these changes, public companies should consult with their auditors and counsel to make sure that their current disclosure practices are consistent with emerging disclosure trends.

Practice Areas

Corporate