JENNER & BLOCK

# SEC Bulletin

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# Sarbanes-Oxley Compliance Dates Extended

On February 24, the SEC extended the compliance dates for its rules under Section 404 of the Sarbanes-Oxley Act of 2002. These rules require SEC reporting companies to include in their annual reports management's report on the company's internal control over financial reporting and an accompanying attestation by the company's outside accountants. The rules also require reporting companies to evaluate, as of the end of each fiscal period, any change in the company's internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting.

The compliance dates are extended as follows:

- A company that is an "accelerated filer" must begin to include management's report on internal control over financial reporting and the related attestation with its annual report for its first fiscal year ending on or after November 15, 2004 (rather than June 15, 2004, as required by the original rules).

- A non-accelerated filer must begin to comply with these requirements for its first fiscal year ending on or after July 15, 2005 (rather than April 15, 2005, as required by the original rules).

- A foreign private issuer that files its annual report on Form 20-F or Form 40-F must begin to comply with the corresponding requirements in those forms for its first fiscal year ending on or after July 15, 2005.

A reporting company must evaluate changes to internal control over financial reporting beginning with the company's first periodic report due after the first annual report that must include management's report on internal control over financial reporting.

The extended compliance periods also apply to the portion of CEO and CFO certifications required by Exchange Act Rules 13a-14(a) and 15d-14(a) that refers to the certifying officers' responsibility for establishing and maintaining internal control over financial reporting for the company. This language must be provided in the first annual report required to contain management's internal control report and in all periodic reports filed thereafter. The extended compliance dates further apply to the amendments of Exchange Act Rules 13a-15(a) and 15d-15(a) relating to the maintenance of internal control over financial reporting.

The SEC is also extending the compliance period for registered investment companies to comply with the amended portion of the introductory language in paragraph 4 of the certification in Form N-CSR required by Investment Company Act Rule 30a-2(a) that refers to the certifying officers' responsibility for establishing and maintaining internal control over financial reporting for the company, as well as paragraph 4(b) of the certification in Form N-CSR. The amended language must be provided beginning with the first annual report filed on Form N-CSR for a fiscal year ending on or after November 15, 2004. Registered investment companies must comply with the amendment to Investment Company Act Rule 30a-3(a) relating to the maintenance of internal control over financial reporting with respect to fiscal years ending on or after November 15, 2004.

The SEC stated that a longer transition period was appropriate in light of both the substantial time and resources needed by companies to properly implement the rules and the corresponding benefit to investors that would result from companies' proper implementation of the new requirements.

The extended compliance periods do not in any way affect the provisions of other rules and regulations regarding internal controls that are in effect.

When it adopted its rules under Section 404 of the Sarbanes-Oxley Act in June 2003, the SEC expressed its intention to provide a lengthy compliance period for management's report on internal control over financial reporting. The SEC stated that a longer transition period was appropriate in light of both the substantial time and resources needed by companies to properly implement the rules and the corresponding benefit to investors that would result from companies' proper implementation of the new requirements. The SEC further noted that a longer transition period would provide additional time for the Public Company Accounting Oversight Board (the "PCAOB") to consider relevant factors in determining and implementing new standards for registered public accounting firms. The PCAOB held a public roundtable in July 2003 to discuss significant issues associated with the establishment of a new standard and issued a proposed standard on October 7, 2003. The PCAOB received nearly 200 comment letters on the proposals and has completed its review and analysis of the public comment.

In extending the compliance deadlines, the SEC acknowledged comments it received that companies with June, July and August fiscal years would have extreme difficulty implementing a new set of standards that have not yet been finalized. The SEC also expressed its belief that an extension will help limit the cost and disruption of implementing a new disclosure requirement under a standard that will soon be superseded, and that it will provide companies and their auditors with sufficient time to perform additional testing or remediation of controls based on the final standard.

## Recent Decision on Shareholder Letter Campaigns

At issue in a recent case in the U.S. District Court for the Southern District of New York was whether shareholders can send out copies of a company's proxy card when they send letters recommending a vote against management nominee or proposal in a proxy solicitation.

In the case, Highfields Capital Management, a shareholder of The MONY Group, opposed a merger with AXA Financial. Highfields sent a letter to shareholders stating that the proposal was ill-timed; that the share price was too low; that the solution to MONY's underperformance is replacing poor management, rather than putting itself up for sale; and that management self-interest, rather than shareholders' best interest, was driving the sale. The letter further stated that Highfields was exercising its right of appraisal by informing MONY of its appraisal demand and voting against the agreement, and encouraged shareholders to do the same. Highfields distributed this letter and enclosed MONY's proxy card. Highfields did not file its soliciting material in reliance on an exemption provided under Rule 14a-2(b)(1) of the proxy rules.

At the heart of the dispute is the scope of the exemption provided under Rule 14a-2(b)(1). Rule 14a-2(b)(1) exempts from the filing requirements "[a]ny solicitation by or on behalf of any person who does not, at any time during such solicitation seek directly or indirectly, either on its own or another's behalf, the power to act as proxy for a security holder and does not furnish or otherwise request, or act on behalf of a person who furnishes or requests, a form of revocation, abstention, consent or authorization."

MONY asserted that the Rule 14a-2(b)(1) did not apply, arguing that the inclusion of MONY's proxy card with Highfields letter constituted the furnishing of a form of revocation. The court, however, sided with Highfields. The court found persuasive the rationale set forth in an internal SEC staff memo which stated the following, in question and answer format:

> May a person otherwise qualified to rely on the exempt communication provision provide a solicited shareholder with a copy of management's proxy card for the purpose of facilitating the shareholder's revocation of a previous card or vote in favor of a proposal supported by the soliciting party?
>
> Response: Yes, so long as the card is returned directly to management and not to the soliciting party. Rule 14a-2(b)(1) disqualifies from reliance on the exemption persons who seek authority to act as a

proxy or who “furnish or otherwise request, or act on behalf of a person who furnishes or requests, a form of revocation, abstention, consent or authorization.” Providing management’s card does not create any proxy authority in the soliciting party, particularly where the party does not retain possession of the card and therefore de facto discretion whether to present the card at the meeting. Although management’s card will have the effect of a revocation of an earlier dated proxy submitted by the same shareholder, this should not constitute a “form of revocation” envisioned by the rule.

Although management’s card states that it is solicited on behalf of the company, shareholders will not be misled, so long as the disclosure clearly indicates that the solicitation is in opposition to management and that the card is management’s card to be returned to the company and is only being provided as a convenience.

The same result applies where the shareholder provides a photocopy of management’s card rather than the card itself.

### *Counseling Point*

The strategy employed by Highfields could be employed generally in “just vote no” campaigns against management nominated directors. Shareholders of The Walt Disney Company have sent out letters urging other shareholders to join them in a vote against certain directors. These mailings included management’s proxy card. Voting no campaigns have taken on added significance because of a pending set of rules proposed by the SEC in October 2003 which, if adopted, would require public companies to include in their proxy materials stockholder nominations for election as directed if one of two triggering events occurred:

- At least one of the director nominees of the company (for whom the company solicited proxies) received “withhold” votes for more than 35% of the votes cast at an annual meeting held after January 1, 2004 at which directors were elected; or

- A stockholder proposal to Rule 14a-8 requesting application of the proposed new director nomination procedures was submitted for a vote of stockholders at an annual meeting held after January 1, 2004 by a stockholder (or group of stockholders) that held more than 1% of the securities entitled to vote on the proposal for a year or more, and the proposal received more than 50% of the votes cast on that proposal (abstentions and broker non-votes are not included in the calculation).

While these rules are still in the proposal stage, votes at the 2004 annual meeting could trigger security holder nominations if the triggering events are adopted as proposed.

# Significant Amendments to the NASD's Corporate Financing Rule Become Effective This March

Recently adopted changes by the National Association of Securities Dealers (the "NASD") to its Conduct Rule 2710 (the "Corporate Financing Rule") will become effective on March 22, 2004. The changes to the rule significantly alter the NASD's framework for reviewing the underwriting terms and conditions of public securities offerings.[1]

The Corporate Financing Rule is intended to ensure that the underwriting terms and conditions of public securities offerings are fair and reasonable. The NASD reviews the underwriting terms and conditions of many public securities offerings, including all initial public offerings. If the amount of compensation to an NASD member is deemed unfair or unreasonable, the Corporate Financing Rule will prohibit that member from participating in the offering. In addition, the SEC will deny a request for acceleration of the effectiveness of a registration statement if the NASD does not issue an opinion that it has no objections to the offering.

> The amendments help ensure private financing is structured in a manner that avoids a later determination that a potential underwriter has received unfair or unreasonable compensation.

The most significant impact of the rule changes, for issuers and member firms alike, is to provide greater certainty in determining whether securities acquired by a member firm or its related person[2] in private financing activities prior to a public offering will be considered underwriter compensation in connection with the offering. In considering what constitutes underwriting compensation in connection with a public offering, the NASD includes, in addition to underwriting discounts and commissions, any "item of value" received by the underwriter and related persons in connection with or related to the distribution of the public offering. The Corporate Financing Rule amendments create a more objective framework for determining what constitutes an "item of value" and whether an "item of value" must be included in the calculation of underwriting compensation.

The amendments to the Corporate Financing Rule help address the difficulty faced by underwriters, their affiliated and related private equity or venture capital groups, and issuers in ensuring that private financing is structured in a manner that avoids a later determination that a potential underwriter has received unfair or unreasonable compensation under the Corporate Financing Rule. This issue has become increasingly important as it has become more common for NASD member firms to establish private equity and venture capital capabilities, and as the timeframe between rounds of private financing and an initial public offering has become shorter in the case of many issuers.

As amended, the Corporate Financing Rule includes a non-exclusive list of items that will be included in determining the amount of underwriter compensation received. The amended rule also includes a list of items that will not be considered "items of value" under the rule.

The following will be included, together with all other "items of value" received or to be received by the underwriter and related persons in connection with or related to the distribution of a public offering, in the calculation of underwriting compensation under the amended rule:

- the underwriters' discount or commission;
- reimbursement of expenses to or on behalf of the underwriter and related persons;
- fees and expenses of underwriter's counsel (except for reimbursement of "blue sky" fees);
- common or preferred stock, options, warrants, and other equity securities, including debt securities convertible to or exchangeable for equity securities, received: (a) for acting as private placement agent for the issuer; (b) for providing or arranging a loan, credit facility, merger or acquisition services, or any other service for the issuer; (c) as an investment in a private placement made by the issuer; or (d) at the time of the public offering;
- special sales incentive items;

- any right of first refusal provided to any participating member to underwrite or participate in future public offerings, private placement or other financings, which will have a compensation value of 1% of the offering proceeds or that dollar amount contractually agreed to by the issuer and underwriter to waive or terminate the right of first refusal;
- compensation to be received by the underwriter and related persons as a result of the exercise or conversion with twelve months following the effective date of the offering of warrants, options, convertible securities, or similar securities distributed as part of the public offering;
- commissions, expense reimbursements, or other compensation to be received by the underwriter and related persons as a result of the exercise or conversion within twelve months following the effective date of the offering of warrants, options, convertible securities, or similar securities distributed as part of the public offering;
- fees of a qualified independent underwriter; and
- compensation, including expense reimbursements, previously paid to any member in connection with a proposed public offering that was not completed, unless the member does not participate in the revised public offering.

Notwithstanding the above list, the following are identified in the amended rule as items that are <u>not</u> "items of value" and therefore will not be deemed compensation in connection with a public offering:

- expenses customarily borne by an issuer, such as printing costs, SEC, "blue sky" and other registration fees, NASD filing fees, and accountant's fees, whether or not paid through a participating member;
- cash compensation for acting as placement agent for a private placement or for providing a loan, credit facility or for services in connection with a merger or acquisition;
- listed securities purchased in public market transactions;
- securities acquired through any stock bonus, pension, or profit-sharing plan that qualifies under Section 401 of the Internal Revenue Code;
- securities acquired by an investment company registered under the Investment Company Act of 1940;
- non-convertible or non-exchangeable debt securities acquired for a fair price in the ordinary course of business in transactions unrelated to the public offering; and
- derivative instruments entered into for a fair price in the ordinary course of business in a transaction unrelated to the public offering.

The rule amendments specify that debt securities are acquired for a "fair price" if they have been priced by the underwriters and related persons in good faith, on an arms' length basis, in a commercially reasonable manner, and in accordance with pricing methods and models and procedures used in the ordinary course of their business for pricing similar transactions. Generally, a transaction that occurs within the 180-day period before filing the registration statement and up to the time of the offering's effectiveness that is negotiated by personnel in a member's investment banking department would not be considered by the NASD to be "unrelated to the public offering."

Any "items of value" received by an underwriter or related person during the 180-day period before filing the registration statement or other information with the NASD and up to the time of the offering's effectiveness or commencement of sales are deemed to be underwriting compensation unless they were received in a transaction that meets one of the following five exceptions:

- *Purchases and Loans by Certain Entities* – this exception applies to securities received as consideration for certain investments and loans by entities that meet certain capital requirements and criteria that demonstrate their independence from the underwriting function of underwriters;
- *Investment in and Loans to Certain Issuers* – this exception applies to the acquisition of securities of issuers that have significant institutional investor involvement in their corporate governance;[3]
- *Private Placements with Institutional Investors* – this exception applies to venture capital investments or the receipt of securities as compensation for acting as a placement agent in transactions that include significant institutional investor participation;
- *Acquisitions and Conversions to Prevent Dilution* – this exception applies to securities that are acquired

as the result of anti-dilution provisions, such as a qualifying right, preemption, stock-split, pro-rata rights or similar offering, or the conversion of securities that have not been deemed by the NASD to be underwriting compensation; and

- *Purchases Based on a Prior Investment History* – this exception applies to purchases of securities based on a prior investment history in order to prevent dilution of a long-standing equity interest in the issuer.

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[1] Although the amendments to Conduct Rule 2710 become effective on March 22, 2004, the NASD currently applies many aspects of the rule amendments on the basis that they represent the NASD's interpretation of the existing rule. The amendments were approved by the SEC on December 23, 2003.

[2] Under the amended rule, "related persons" consist of underwriter's counsel, financial consultants and advisors, finders, and participating NASD members, and any other persons related to an participating member.

[3] Under the amended rule, an "institutional investor" is any individual or legal person that has at least $50 million invested in securities in the aggregate in its portfolio or under management, including investments held by its wholly owned subsidiaries; provided that no participating members direct or otherwise manage the institutional investor's investments or have an equity interest in the institutional investor, either individually or in the aggregate, that exceeds 5% for a publicly owned entity or 1% for a nonpublic entity.

## Proxy Disclosure Regarding Broker Non-Votes

Recent changes by the New York Stock Exchange (the "NYSE") to the NYSE Listed Company Manual will affect NYSE-listed companies' broker non-vote disclosure for the 2004 proxy season. The SEC's proxy rules require that companies disclose the treatment and effect of abstentions and broker non-votes on the outcome of proposals submitted to a shareholder vote. While the NYSE's rules have historically prohibited an uninstructed broker from voting on non-routine matters, Section 303A.08 of the Listed Company Manual, adopted in June 2003, makes clear that proposals regarding the adoption of new equity compensation plans and material revisions to existing equity compensation plans are non-routine matters on which uninstructed brokers may not vote. This change will require companies to re-characterize proposals regarding equity compensation plans as non-routine in their 2004 Proxy Statements and to specify that a broker non-vote will occur if the beneficial shareholder does not provide instructions to their brokers with regard to such proposals.

Item 21 of Schedule 14A to the Securities Exchange Act of 1934 requires public companies to disclose the method by which shareholder votes will be counted, including the treatment and effect of abstentions and broker non-votes under applicable state law and the company's charter and bylaws.[1] While Item 21 does not refer directly to stock exchange rules on this point, the term "broker non-vote" is a reference to situations in which stock exchange rules limit the right of an uninstructed broker to vote on behalf of a beneficial shareholder.

The NYSE rules have historically granted brokers who hold their customers' shares of record in the broker's name or in street name discretionary voting authority to vote such shares for uncontested director elections and certain other routine matters without receiving instructions from their customers. However, the NYSE prohibited brokers from voting these shares for such non-routine matters as contested proposals, mergers, changes in quorum requirements and issuances of stock or options to insiders in excess of five percent of the number of outstanding shares of such class of stock.[2] When brokers holding shares on behalf of beneficial owners do not receive voting instructions from the beneficial holders with respect to a proposal and the brokers do not have discretionary voting power with respect to such proposal, a "broker non-vote" results. In determining the voting results of a proposal, companies must consider broker non-votes as "shares not entitled to vote" and neither count them for nor against the respective proposal.

In June 2003, the NYSE amended its corporate governance standards to address, among other items, the issue of shareholder approval of equity compensation plans. At this time, the NYSE adopted Section 303A.08, which prevents member organizations from giving a proxy to vote on equity compensation plans unless the beneficial owner of the shares has given voting instructions.[3] As a result of this amendment, proposals relating to equity compensation plans are no longer considered routine matters and, consequently, uninstructed brokers may no longer vote on proposals by companies to adopt new equity compensation plans or to materially revise existing equity compensation plans. This means that for purposes of the SEC disclosure required by Item 21 of Schedule 14A, companies must disclose to their shareholders that the failure to provide instructions to brokers with regard to proposals for equity compensation plans will result in a broker non-vote on the proposal.

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[1] Securities Exchange Act of 1934, Schedule 14A, Item 21.
[2] Carl W. Schneider, *Broker Non-Votes and Abstentions – An Analysis of Legal Issues,* The Corporate Counsel, May-June 1998 (referencing NYSE Rule 452 prior to the June 2003 changes).
[3] Final Rule Text Section 303A.08, Shareholder Approval of Equity Compensation Plans, approved by the SEC on June 30, 2003.

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