

Corporate and Securities Law Developments **NEWSLETTER**

JULY 19, 2002

SEC PROPOSES SIGNIFICANTLY EXPANDED CURRENT REPORTING REQUIREMENTS

On June 12, 2002, the Securities and Exchange Commission (the “SEC” or the “Commission”) announced that it would propose new rules requiring more timely and more broad disclosure in current reports on Form 8-K. The Commission issued the rule proposals on June 25, 2002.¹

I. Background

On February 13, 2002 the Commission announced that it intended to propose a series of initiatives aimed at more robust and timely disclosure by reporting companies. The first two initiatives, related to accelerating filing deadlines for annual and quarterly reports and prompt disclosure of certain securities and related transactions by or with management, were formally proposed in April 2002.² In May 2002 the Commission proposed new rules requiring enhanced disclosure of critical accounting policies.³ The Form 8-K Release is another step in the Commission’s efforts to enhance the corporate disclosure and financial reporting system.

The proposed changes to Form 8-K’s reporting requirements follow a similar proposal in 1998 that was part of the

Commission’s proposed comprehensive reforms of the Securities Act offering system.⁴ The Commission believes that additional and more timely disclosure by companies of significant events can reduce opportunities for deception and manipulation by increasing the amount and timeliness of corporate disclosure of significant events. Therefore, this proposal adds eleven new items requiring current disclosure, moves two items from quarterly and annual reports to current reports and expands disclosure regarding three items that are already in Form 8-K. The proposal also accelerates the filing deadline for all reports on Form 8-K.

II. Description of Proposed Changes

A. New Disclosure Items

The new, enhanced or moved items proposed for Form 8-K relate to the following areas: the business and operations of the issuer; financial information regarding the issuer; the issuer’s securities and their trading market; matters related to accountants; and governance of the issuer.⁵

¹ *Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date*, Securities Act Release No. 33-8106, Exchange Act Release No. 34-46084, 67 Fed. Reg. 42914 (June 25, 2002), available at <http://www.sec.gov/rules/proposed/33-8106.htm> (hereinafter *Form 8-K Release*).

² *See Form 8-K Disclosure of Certain Management Transactions*, Securities Act Release No. 33-8090, Exchange Act Release No. 34-45742, 67 Fed. Reg. 19914 (April 12, 2002), available at <http://www.sec.gov/proposed/33-8090.htm> and *Acceleration of Periodic Report Filing Dates and Disclosure Concerning Website Access to Reports*, Exchange Act Release No. 34-45741, Securities Act Release No. 33-8089, 67 Fed. Reg. 19896 (April 23, 2002), available at <http://www.sec.gov/proposed/33-8089.htm>.

³ *Disclosure in Management’s Discussion and Analysis about the Application of Critical Accounting Policies*, Exchange Act Release No. 34-45907, Securities Act Release No. 33-8098, 67 Fed. Reg. 35620 (May 10, 2002), available at <http://www.sec.gov/proposed/33-8098.htm> (hereinafter *Critical Accounting Policies Release*).

⁴ *See The Regulation of Securities Offerings*, Securities Act Release No. 33-7606A, 63 Fed. Reg. 67174 (December 4, 1998), available at <http://www.sec.gov/rules/proposed/337606a1.txt>.

⁵ The proposal includes a reorganization of Form 8-K, in which there would be eight sections that incorporate the new items with existing items: Registrant’s Business and Operations; Financial Information; Securities and Trading Market; Matters Related to Accountants; Corporate Governance and Management; Regulation FD; Other Events; and Financial Statements and Exhibits. Individual items would be included in each section to identify specific disclosure requirements. *See Form 8-K Release*, §II.C; *see also Form 8-K Release* at Text of Proposed Amendments, Part 249—Forms, Securities Exchange Act of 1934, Form 8-K (to be codified at 17 CFR § 249) (hereinafter *Proposed Form 8-K*).

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1. Business and Operations

Material agreements. The proposed revisions to Form 8-K include two new disclosure requirements with respect to material contracts. Proposed Item 1.01 requires a brief description of any agreement “that is material to the registrant and not made in the ordinary course of the registrant’s business” and proposed Item 8.01(c) requires filing the agreement as an Exhibit to the Form 8-K. Notably, the instructions to this item specify that an “agreement” includes “any letter of intent or other non-binding agreement or any similar document.”⁶ The instructions also make it clear that a filing is required to disclose material amendments to material agreements and assumptions and assignments of material agreements.⁷ Companies would also be required to file the agreement itself as an exhibit to Form 8-K.⁸

The proposal also requires disclosure on Form 8-K when a material agreement not made in the ordinary course of business is terminated.⁹ The disclosure required would include a narrative description of the relationship between the parties (other than with respect to the agreement at issue), the agreement itself, material circumstances surrounding the termination, material termination penalties and management analysis of the termination’s effect. The instructions specify that disclosure would not be required during negotiations or discussions until either the registrant decided to terminate the agreement or the other party has notified the registrant of the termination.¹⁰

Changes in relationship with a customer. Proposed Item 1.03 would require disclosure when a registrant becomes aware that a customer has terminated or reduced the scope of its relationship with the registrant if the termination or reduction equals 10% or more of the registrant’s consolidated revenues during the issuer’s most recent fiscal year. The required disclosure includes management’s analysis of the effect of the change. As with termination of a material agreement, disclosure need not be made during discussions or negotiations.¹¹

2. Financial Information

Material financial obligations. Proposed Item 2.03 would require disclosure whenever the registrant or a third party enters into a transaction or agreement that creates a material, direct or contingent financial obligation for the registrant. The disclosure required includes the nature and amount of the obligation (including a description of the events that may cause the obligation to arise) and management’s analysis of the effect of the obligation on the registrant.

⁶ Proposed Form 8-K at Instruction 1 to Item 1.01.

⁷ *Id.* at Instruction 4 to Item 1.01.

⁸ *Id.* at Item 8.01(c).

⁹ See Proposed Form 8-K at Item 1.02.

¹⁰ *Id.* at Instruction 1 to Item 1.02.

¹¹ *Id.* at Instruction to Item 1.03.

¹² However, a refusal to issue a rating would only have to be disclosed where the company had requested the rating. *Form 8-K Release*, §II.A.

¹³ See Instruction 1 to Item 3.01 of Proposed Form 8-K.

Under proposed Item 2.04, disclosure would also be required when a material contingent obligation is triggered. Triggering events include events of default or acceleration and any event that will result in a previously contingent obligation becoming unconditionally due (or due conditioned only on the passage of time). Disclosure is not required during negotiations or discussions regarding whether a triggering event has occurred, whether it will be waived or whether an agreement curing the triggering event will be implemented.

Exit activities. Proposed Item 2.05 requires disclosure when the board of directors or an officer of the registrant commits to an action that will result in material write-offs or restructuring charges. The required disclosure includes the timing of the commitment, the reasons for the decision, the nature of the asset, the estimated amounts at issue and an analysis of the effect of the action.

Material impairments. Proposed Item 2.06 requires disclosure when the board of directors or an officer of the registrant concludes that a material charge for impairment is required. The required disclosure includes the date the determination is made, a description of the assets subject to impairment and the facts leading to the impairment, the estimated amount of the charge and management’s analysis of the effect on the registrant and any affected segments.

3. Securities and Trading Market

Rating agency decisions. Proposed Item 3.01 requires disclosure when a registrant receives any communication from a rating agency about certain changes or potential changes in ratings on the registrant’s securities. The actions covered by the item would include:

- change or withdrawal of the credit rating assigned to, or outlook on, the registrant or its securities (or securities it has guaranteed);
- refusal to assign a credit rating;
- placing the registrant or its securities on credit watch or similar status; and
- any similar action.

This requirement only extends to those agencies to whom the company provides information, but it generally does not distinguish between solicited and unsolicited ratings from those agencies that receive information from the company.¹² As with other new items, disclosure is not required pending discussions with a rating agency until the agency informs the registrant that it has made a final decision.¹³

Changes in listing or eligibility for listing. Proposed Item 3.02 would require disclosure when a registrant receives notice from a national securities exchange or national securities association that the registrant or its securities do not satisfy the listing requirements of the principal trading market for a class of the registrant's common stock. The disclosure required includes the date of the notice, the listing requirement that the registrant failed to satisfy and the registrant's planned response. Disclosure is also required if the registrant takes definitive action to terminate or move its listing.

Unregistered security sales and modifications of rights of holders. The Commission proposes requiring disclosure of these two matters on Form 8-K under Item 3.03 as soon as they occur, rather than on a quarterly basis as currently required. The proposal changes only the timing of this disclosure, not its substance.

4. Matters Related to Accountants

Reliance on financial statements or related audit report. Proposed Item 4.02 would require disclosure when the entire board of directors (if there is no audit committee), the audit committee or an authorized officer determines that the company's previously issued financial statements cannot be relied upon, or if the company is notified by its current or former auditors that action should be taken to prevent reliance on a previously issued report. The required disclosure would include a description of the events giving rise to the conclusion or notice and a description of management's plans to alleviate the issue. The registrant is also required to submit the disclosure to its independent auditors and file the auditor's response as to whether it agrees or disagrees with the disclosure.

5. Corporate Governance and Management

Any material limitation, restriction or prohibition, including the beginning and end of lock-out periods, regarding the company's employee benefit, retirement and stock ownership plans. Proposed Item 5.04 requires disclosure whenever these limitations described above are imposed. The disclosure must include the period or expected period of the limitation. Disclosure is not required where the company imposes temporary trading "black outs" on officers or directors.

Change in directors or officers. The Commission proposes to significantly expand disclosure regarding changes to the status of the company's officers or directors. Form 8-K currently requires disclosure of such changes only when a director resigns because of a dispute and specifically requests disclosure. Changes in officers and other changes in directors are currently

only required to be disclosed by the annual identification of officers and directors in a registrant's annual report. Proposed Item 5.02 would require current disclosure on Form 8-K of any change in directors or the chief executive officer, president, chief financial officer, chief accounting officer, chief operating officer or similar officer. The required disclosure includes the date of, and reasons for, a departure, as well as the information about new officers and directors normally required in annual proxy statements. The revised disclosure would continue to require the information currently required for directors who resign as a result of a disagreement.

Amendments to articles of incorporation or bylaws; change in fiscal year. Proposed Item 5.03 requires current disclosure whenever any change is adopted to the articles or certificate of incorporation or bylaws of the registrant. The required disclosure includes the date of the change and management's explanation of the change and its effects. The proposed item also carries over the current requirement to disclose changes in a registrant's fiscal year.

B. Filing Deadlines

The proposed rules would substantially accelerate the filing deadline for all filings on Form 8-K. Currently, filings are due either five business or fifteen calendar days after an event, depending on the event. The proposal would require all filings to be made within two business days of the event for all disclosure items.¹⁴ An issuer would be able to extend the filing deadline by two business days if it is not able to file in a timely manner without unreasonable effort or expense by filing a Form 12b-25 with the Commission within one business day after the Form 8-K is otherwise due.¹⁵

The proposed rules would also add a new safe harbor for certain failures to meet the filing deadlines.¹⁶ The safe harbor would require that:

- on the filing due date, the company had sufficient procedures in place for collecting, processing and disclosing information;
- no officer, employee or agent of the company knew or should have known that the Form 8-K was required to be filed; and
- once an executive officer of the company knew that the Form 8-K filing was required (and not later than two business days after knowing of the failure to file), the company filed a Form 8-K with the Commission and that filing indicated the date on which it should have been made.

¹⁴ See Proposed Form 8-K, General Instruction B.1.

¹⁵ See 17 CFR § 240.12b-25; see also Form 8-K Release, §II.E.

¹⁶ The safe harbor would only be available with respect to violations of Section 13(a) or 15(d) of the Exchange Act. Other potential liability under the securities laws would be unaffected by the safe harbor. See Form 8-K Release, §II.D; see also Form 8-K Release at Text of Proposed Amendments, Part 240—General Rules and Regulations, Securities Exchange Act of 1934 (to be codified at 17 CFR § 240.15d-11).

While the safe harbor does offer a shield to companies from liability for late filing, those companies eligible for short form registration would still lose that eligibility in the event of a late filing, regardless of whether the safe harbor was available.¹⁷

C. Other Possible Changes

The Commission indicated in the meeting at which it issued the proposal and in its request for comment that it was considering an approach that either replaced some of the specific disclosure requirements in the proposal with or added a general requirement to disclose, “other material events related to the company’s business and operations.”¹⁸ The Commission also sought comment on additional required disclosure including:

- new disclosure item for waivers of corporate ethics or codes of conduct;¹⁹
- new disclosure item for changes in critical accounting policies²⁰; and
- extending the requirements for specific disclosure items to Form 6-K (foreign private issuers).²¹

III. Potential Implications for Reporting Companies

The proposed changes would substantially change existing reporting requirements and would significantly affect all issuers. The current SEC disclosure regime is built primarily on quarterly and annual disclosure and — except for the limited items currently included in Form 8-K — does not generally require ongoing disclosure of material events. Although the listing standards of the New York Stock Exchange, Nasdaq and other exchanges and quotation systems require prompt disclosure of material events, those requirements allow some flexibility in the timing and nature of disclosure. This flexibility, together

with the absence of an effective enforcement mechanism for the listing standards, means that issuers currently have considerable latitude to determine whether and when to disclose events that may be deemed material.

The changes to Form 8-K proposed by the Commission, on the other hand, would require disclosure in a defined (and short) period of time for each of the specific items included in the proposal. Taken together, these items are designed to require prompt and thorough disclosure of substantially all events that the Commission appears to consider material to investors. Because of the significant sanctions (including loss of eligibility to use short form registration for even inadvertent failures to file on a timely basis), issuers would need to be especially vigilant in determining when to file current disclosures on Form 8-K and making the disclosure on a timely basis if the proposals are adopted in their current form.

In short, the proposed rules would require substantially more frequent filings for all issuers and would require issuers to establish systems and procedures to diligently monitor the need for disclosure and to draft (and complete review and approval of) disclosure in very compressed time frames.

Comments on the Form 8-K Release must be submitted to the SEC on or before August 26, 2002.²² The release is available online at <http://www.sec.gov/rules/proposed/33-8106.htm>. If you need a printed copy of the Form 8-K Release or have any questions, please do not hesitate to contact:

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¹⁷ In addition, sales under Rule 144 would not be permitted pending filing of the required report. *See Form 8-K Release*, §II.D.

¹⁸ *See Form 8-K Release*, §II.A.3.

¹⁹ The Commission noted that this issue is currently under consideration by self-regulatory organizations such as the New York Stock Exchange. *See Form 8-K Release*, §II.A.3.

²⁰ *Id.*

²¹ *See Form 8-K Release*, §II.A.4.

²² At a meeting on June 12, 2002 the Commissioners appeared to signal that they would not be amenable to extending the comment period beyond sixty days. *See infra* note 1.

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