# INSIDE THE SEC

## Highlights from the 35th Annual Securities Regulation Institute

**by James J. Moloney and David C. Lee**

The 35th Annual Securities Regulation Institute sponsored by Northwestern University School of Law was held January 23–25, 2008, in Coronado, CA. The significant topics that were covered included: (1) small business initiatives; (2) international financial reporting reform; (3) electronic proxy and shareholder access matters; (4) amendments reducing resale restrictions on restricted stock; (5) short sale and other derivative disclosure developments; and (6) Securities and Exchange Commission (Commission or SEC) enforcement matters.

### Overview

Division of Corporation Finance Director John White began the Conference by giving attendees an overview of the Division's and the Commission's various accomplishments in 2007 and goals for 2008. White noted that during 2007 several themes dominated the agency's agenda including: (1) compliance with the executive compensation disclosure requirements adopted in 2006; (2) certain proxy matters tied to changes in technology (e-proxy) and interpretation of prior guidance on shareholder proposals seeking shareholder access; (3) international matters such as deregistration and international financial reporting standards (IFRS); (4) small public company and private offering rulemaking; and (5) guidance to management on compliance with Section 404 of Sarbanes-Oxley (internal control over financial reporting). In 2008, White expects to see further progress in certain key areas noting, for example, the Commission's new Advisory Committee on Improvements to Financial Reporting (CIFiR) that will be seeking steps to improve the comparability, accessibility and reliability of financial statements. In addition, White anticipates further advances in the application of interactive data ( *e.g.,* XBRL). Lastly, White expects to see greater clarification on the appropriate disclosure in financial restatements and the requirements of Item 4.02 of Form 8-K, guidance on how companies can improve disclosure on their Web sites, and a review and possible updating of the SEC's oil and gas disclosure requirements.

### SEC Division of Corporation Finance Update

#### Smaller Public Reporting Company Initiatives

Alan Beller, former Corporation Finance Division Director, addressed some of the recent rulemaking coming out of the Commission applicable to smaller public companies. Mr. Beller noted that in December 2007, the SEC adopted several amendments benefiting smaller public companies. The Commission expanded the eligibility for small business scaled disclosure and reporting requirements to all companies with up to $75 million in public float.[1] In addition, the SEC revised the eligibility requirements of Forms S-3 and F-3 to permit companies that do not meet the $75 million threshold in public float to register primary offerings on such forms subject to a limitation on the amount that may be sold in any one-year period.[2]

Mr. Beller also touched on two new exemptions provided under Section 12(g) of the Securities Exchange Act of 1934 (Exchange Act) providing relief from the registration requirements applicable to compensatory employee stock options. Specifically, the Commission amended Rule 12h-1 to provide relief to companies that are not currently required to file reports under the Exchange Act, and to issuers that are required to file such reports.[3] Mr. Beller noted that these exemptions are a move by the SEC Staff to more closely align the Exchange Act with the exemption provided in Securities Act Rule 701. The private company exemption is limited to Rule 701 persons, applies only to stock options, imposes

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certain restrictions on transferability and requires delivery of the same risk and financial information as Rule 701. With respect to public companies, the exemption covers persons eligible to receive options under the issuer's Form S-8 registration statement as well as eligible participants under Rule 701. If the public company exemption is lost because the company fails to meet the specified conditions, it would need to register the class of option securities within 60 calendar days.[4]

While not publicly available at the time of the Conference, the SEC had adopted amendments to Form D, which will require the electronic filing of information required by the form after March 16, 2009, along with some changes to simplify and revise the overall format of the required disclosure. The SEC has since posted the release on its Web site.[5]

**International Reporting Developments**

Wayne Carnall, the Division of Corporation Finance's new Chief Accountant, as well as John White, each spent a significant amount of time discussing the recent attention paid to International Financial Reporting Standards (IFRS). In December 2007, the SEC adopted rule amendments that allow a foreign private issuer to include financial statements prepared in compliance with IFRS in their SEC filings without providing a reconciliation to US GAAP.[6] White noted that this rulemaking was a big step toward achieving a single set of globally accepted accounting standards. The new rules become effective on March 4, 2008, and apply to financial statements of foreign private issuers with financial periods ending after November 15, 2007. According to White, to the extent foreign private issuers wish to apply the new rules earlier, if for example they plan to file a Form 20-F before March 4th, they may seek a waiver from the Division's Office of the Chief Accountant.

The Commission is still considering the possibility of allowing US issuers to use IFRS instead of US GAAP when preparing their financial statements.[7] However, several speakers at the Conference observed that IFRS' strength is really its weakness. According to Carnall, IFRS is predominantly "principles-based" accounting, and is not applied uniformly in all foreign jurisdictions. Therefore, companies in the United States and abroad seeking to comply with IFRS in their SEC filings can expect to encounter some level of difficulty in achieving complete uniformity and comparability. Nevertheless, most of the speakers agreed that there is a clear trend in accounting globally toward IFRS and away from US GAAP. Thus, greater US regulatory acceptance of financial statements prepared in compliance with some form of IFRS in SEC filings is likely to occur over time. White noted that a summary of the SEC Staff's views on public companies using IFRS is posted on the Commission's Web site.[8]

White also described the SEC amendments adopted in early 2007 enabling many foreign private issuers to deregister their securities in the United States.[9] Under the old rules, a foreign private issuer would need to have less than 300 US holders to deregister their securities, and the rules required a "look-through" to the ultimate beneficial holders of the securities.[10] New Exchange Act Rule 12h-6, however, allows a foreign private issuer to deregister its securities in the United States if the average daily trading volume of the securities in the United States is not more than 5 percent of the average daily trading volume of the securities on a "world-wide" basis during a 12-month period. The new rules became effective in June 2007. In adopting these rules, the SEC concurrently adopted new Form 15F for reporting a deregistration event that must be filed with the Commission electronically. White observed that approximately 100 foreign private issuers (or approximately 9 percent of all foreign registrants) filed Form 15Fs last year to deregister their securities. During the same time, White observed, that approximately 75 new foreign private issuers registered their securities with the SEC.

**Rule 144 and 145 Resale Restrictions Amended**

Steve Bochner summarized the recent amendments to Rule 144,[11] which effectively shorten the holding period for the resale of restricted securities held by non-affiliates from one year to six months. While one condition remains—that is the issuer must be current in its reporting obligation for one full year—following a one-year holding period,

the current reporting requirement set forth in Rule 144(c) falls away and a non-affiliate may resell restricted securities without any limitation. Affiliates of an issuer, however, must continue to satisfy all the applicable volume, manner of sale and notice resale restrictions in Rule 144, including the one-year holding period currently imposed by Rule 144(d).

In addition, Bochner noted that the SEC amended Rule 145 to eliminate the "presumptive underwriter" doctrine that frequently restricts the resale of shares received by affiliates of a target company in a merger transaction.12 In effect, affiliates of a target company in a registered merger transaction can now freely resell the acquiror securities they receive in the transaction so long as they are not an affiliate of the acquiror. The Rule 145 amendments do not, however, apply to transactions involving shell companies.

**PIPE Transactions and Section 5 Issues**

Both John White, and former Corporation Finance Deputy Director Marty Dunn, noted with disapproval the recent cases that have dismissed Section 5 claims brought by the Commission against short sellers in PIPE transactions. For many years, the Division of Corporation Finance has taken the position that a person who sells securities short, and later acquires shares from the issuer in a PIPE transaction to cover the short position, has in effect violated Section 5 if the short position is created prior to the filing and effectiveness of a registration statement relating to the PIPE transaction. The topic arose in light of recent cases that have addressed the issue and found otherwise. In one case, *SEC v. John F. Mangen, Jr. and Hugh L. McColl, III*, the SEC charged an investor with violating Section 5 when it purchased securities in a PIPE transaction and then re-sold those securities under a resale registration statement to cover the short position it created before the filing and effectiveness of the registration statement.[13] The district court judge in this case dismissed the Section 5 charge without opinion. Subsequently, the Southern District Court of New York dismissed a similar Section 5 claim.[14] Both Mr. Dunn and Mr. White indicated they expect to see some Commission action in response to these two cases.

**Schedule 13D Disclosure Issues**

Brian Breheny, former chief of the Office of Mergers & Acquisitions and recently promoted to co-Deputy Director in the Division of Corporation Finance, addressed recent developments in Schedule 13D disclosure, including the level of disclosure relating to cash-settled derivatives in certain filings. In particular, recent media attention was directed at two hedge funds' disclosure of beneficial ownership in their Schedule 13D reports with respect to the adequacy of the funds' disclosure of their derivatives positions.[15] Without getting into the specific facts of any particular situation, Mr. Breheny explained that the SEC Staff likely would be concerned if a reporting person's Schedule 13D report failed to include all shares beneficially owned directly or indirectly, by the reporting persons, but reserved judgment on the proper level of disclosure relating to cash-settled derivatives where the reporting person has no right or ability to acquire beneficial ownership (voting or dispositive powers) over the shares of a specific public reporting company. Mr. Breheny pointed out that the Division of Enforcement has brought several actions recently against violators of the Section 13(d) reporting requirements and will continue to be vigilant in this area in the future.[16]

**Executive Compensation Disclosures**

Shelley Parratt, co-Deputy Director in the Division of Corporation Finance, touched on some of the hot topics coming out of the SEC Staff's review of proxy statements containing the newly mandated disclosures on executive compensation.[17] In particular, Ms. Parratt noted that many issuers have attempted to omit disclosure of performance targets for their executives under the confidentiality provision that is built into the rules.[18] Ms. Parratt explained that in order to omit such information several hurdles must be met. First, the issuer must determine whether the performance target in question is material; if so, the issuer must then determine whether disclosure of that information would cause the company competitive harm. She emphasized that many companies had not gone through the proper analysis, citing examples of instances where a company, when challenged by the SEC Staff on the issue, claimed confidentiality of the information on the basis that if

disclosed, competitors might seek to hire the executive away from the company by offering a slightly better compensation package. Ms. Parratt explained that a more appropriate basis for exclusion might be that disclosure of the performance target(s) would reveal "operational strategies," or allow competitors to undercut the company's pricing of products. Similarly, if disclosure could adversely impact the company's future cost of capital, then confidential treatment may be appropriate.

**Electronic Communications and Proxy Matters**

Mr. Breheny also noted that the SEC's recently adopted rules on electronic shareholder forums serves as another step by the Commission to embrace technology and improve shareholders' and companies' abilities to communicate with one another. The new rules, which became effective on February 25, 2008, facilitate participation on electronic shareholder forums by rendering such activities exempt from the SEC's proxy rules so long as certain conditions are satisfied (*e.g.,* communications occur more than 60 days before the meeting date).[19] In addition, the new rules clarify that persons posting information or making statements on electronic forums remain liable for the content of their communications, thereby providing some comfort that a shareholder, company or third-party that establishes, maintains or operates an electronic shareholder forum will not become liable for the statements or information posted by others on the site.[20]

According to Mr. Breheny, persons may state on an electronic shareholder forum that they are contemplating engaging in a proxy solicitation. But once a decision is made and action taken to solicit proxies, the person would need to comply with the full panoply of the proxy rules.

In addition, the so-called e-proxy rules were discussed, which permit public companies and other persons soliciting shareholders to post proxy materials on a Web site and provide notice to shareholders of the availability of the proxy materials.[21] White indicated that the SEC Staff would continue to monitor developments regarding how the e-proxy model was working in order to make any necessary changes to improve the operation of the rules. One point that was acknowledged by some of the speakers was that while some companies using e-proxy have experienced significant cost-savings, voting by retail shareholders has decreased under e-proxy.

Another significant recent rulemaking project in the proxy area related to shareholder director nominations under Exchange Act Rule 14a-8(i)(8).[22] The SEC's historical position under Rule 14a8(i)(8) was to permit the exclusion from companies' proxy materials of shareholder proposals that may result in a contested election (including those relating to procedures that would result in contested elections). In September 2006, the US Court of Appeals for the Second Circuit in *American Federation of State, County and Municipal Employees, Employees Pension Plan v. American International Group, Inc.*[23] declined to accept the SEC's historical position and held that AIG could not rely on Rule 14a-8(i)(8) to exclude a shareholder proposal seeking to amend AIG's bylaws to establish a procedure pursuant to which AIG would be required to include shareholder nominees for director in the company's proxy materials under certain circumstances.

In response to the Second Circuit's decision in July 2007, the SEC issued two alternative rule proposals. The first proposal related to an amendment of Rule 14a8 to allow shareholders to include shareholder nomination bylaw proposals in issuer proxy materials where the shareholder owned more than 5 percent of the company's shares and provided certain disclosure regarding the shareholder's background and relationship with the company. The second proposal related to an amendment of Rule 14a-8(i)(8) codifying the SEC's historical position, resulting in companies being able to exclude under Rule 14a8(i)(8) shareholder proposals that would result in an immediate election contest or establish a process for shareholders to conduct an election contest in the future. The SEC approved the second proposal on November 28, 2007, which thus codified the SEC's longstanding historical position.[24] The SEC has indicated, however, that it will further consider the issues regarding shareholder director nominations.

## SEC Enforcement

Linda Chatman Thomsen, Director of the SEC's Division of Enforcement, and Brian Cartwright, General Counsel of the SEC, provided a recap of recent trends with respect to the activities of the Division of Enforcement. Ms. Thomsen noted that the Division has brought 21 cases last year against hedge funds. Mr. Cartwright noted that in total the Division brought 645 enforcement cases last year, the second highest in the Commission's history. Of those cases, 219, or approximately one-third were financial fraud cases. Ms. Thomsen also observed a marked increase in the number of Foreign Corrupt Practices Act cases, 9 last year compared to a total of 15 in the entire history of the Act.

## NOTES

1. SEC Release No. 33-8876, "Smaller Reporting Company Regulatory Relief and Simplification," December 19, 2007, available at *http://www.sec.gov/rules/final/2007/33-8876.pdf*.

2. SEC Release No. 33-8878, "Revisions to the Eligibility Requirements for Primary Securities Offerings on Forms S-3 and F-3," December 19, 2007, available at *http://www.sec.gov/rules/final/2007/33-8878.pdf*.

3. SEC Release No. 34-56887, "Exemption of Compensatory Employee Stock Options from Registration under Section 12(g) of the Securities Exchange Act of 1934," December 3, 2007, available at *http://www.sec.gov/rules/final/2007/34-56887.pdf*.

4. *Id.*

5. SEC Release No. 33-8891, "Electronic Filing and Revision of Form D," February 6, 2008, available at *http://www.sec.gov/rules/final/2008/33-8891.pdf*.

6. SEC Release No. 33-8879, "Acceptance From Foreign Private Issuers of Financial Statements Prepared in Accordance With International Financial Reporting Standards Without Reconciliation to U.S. GAAP," December 21, 2007, available at *http://www.sec.gov/rules/final/2007/33-8879.pdf*.

7. SEC Release No. 33-8831, "Concept Release On Allowing U.S. Issuers To Prepare Financial Statements In Accordance With International Financial Reporting Standards (Corrected)," August 7, 2007, available at *http://www.sec.gov/rules/concept/2007/33-8831.pdf*.

8. SEC Roundtable Transcript, "Practical Issues Surrounding the Use of IFRS in the U.S. in Recent Years and its Potential Expanded Use in Future Years," December 17, 2007, available at *http://www.sec.gov/spotlight/ifrsroadmap/ifrsround121707-transcript.pdf*.

9. SEC Release No. 34-55540, "Termination of a Foreign Private Issuer's Registration of a Class of Securities under Section 12(g) and Duty to File Reports under Section 13(a) or 15(d) of the Securities Exchange Act of 1934," March 27, 2007, available at *http://www.sec.gov/rules/final/2007/34-55540.pdf*.

10. *See* David F. Morrison, "Eliminating the US Listing Trap for Foreign Private Issuers,"*Insights*, Vol. 17, No. 12 (December 2003) at p. 15.

11. SEC Release No. 33-8869, "Revisions to Rule 144 and Rule 145 to Shorten Holding Period for Affiliates and Non-Affiliates," December 6, 2007, available at *http://www.sec.gov/rules/final/2007/33-8869.pdf*.

12. *Id.*

13. *SEC v. John F. Mangan, Jr., et al.*, 3:06CV531 (W.D.N.C. October 24, 2007).

14. *SEC v. Edwin Buchanan Lyon, IV, et al.*, 06 Civ. 14338 (S.D.N.Y. January 2, 2008).

15. *See* Andrew R. Sorkin, "A Loophole Lets a Foot in the Door,"*New York Times*(January 15, 2008).

16. S*ee* SEC Litigation Rel. Nos. 18943 (October 26, 2004), 19605 (March 9, 2006), 19542 (January 25, 2006), 19428 (October 13, 2005), and 51585 (April 30, 2005).

17. "Staff Observations in the Review of Executive Compensation Disclosure, Division of Corporation Finance," available at *http://www.sec.gov/divisions/corpfin/guidance/execcompdisclosure.htm*.

18. *See* Instruction 4 to Item 402(b) of Regulation S-K.

19. SEC Release No. 34-57172, "Electronic Shareholder Forums," January 18, 2007, available at *http://www.sec.gov/rules/final/2008/34-57172.pdf*.

20. *Id.*

21. SEC Release No. 34-55146, "Internet Availability of Proxy Materials," January 22, 2007, available at *http://www.sec.gov/rules/final/2007/34-55146.pdf*.

22. SEC Release No. 34- 56161, "Shareholder Proposals Relating to the Election of Directors," (Proposed Rules) July 27, 2007, available at *http://www.sec.gov/rules/proposed/2007/34-56161.pdf*.

23. *American Federation of State, County and Municipal Employees, Employees Pension Plan v. American International Group, Inc.,*462 F.3d 121 (2d Cir. 2006).

24. SEC Release No. 34-56914, "Shareholder Proposals Relating to the Election of Directors," (Final Rules) December 6, 2007, available at *http://www.sec.gov/rules/final/2007/34-56914.pdf*.