



HIGHLIGHTS AND PITFALLS

Economic Crisis Impacts

Disclosure in 1934 Act Reports

A reader noted an uptick in the amount of disclosure that issuers are including in their filings about the general state of the economy and the circumstances surrounding the current financial market meltdown, and wondered to what extent issuers are obligated to (or should) discuss the economy and market conditions at a time when investors are obviously being bombarded with an overwhelming amount of news on the subject.

No Way to Avoid It Now

It is virtually impossible today for an issuer to provide adequate disclosure in its MD&A, risk factors, etc. without addressing the general macro-economic trends, market conditions and adverse financing conditions arising from the credit crisis. While details on broader economic and market trends may not have been necessary at the time of the issuer's last Form 10-K, when the financial crisis seemed more contained to particular industries such as financial institutions, the current sorry state of affairs should compel issuers to take another look at what they plan to say about economic and market conditions in their upcoming 10-Q, etc., in particular risk factors and MD&A disclosure, and also whether current updating is advisable.

The SEC's View

The SEC addressed this kind of disclosure head-on in an *amicus* brief submitted in *Kapps v. Torch Offshore, Inc.*, No. 03-30227 (Fifth Circuit, June 2003), available under "Amicus/Friend of Court Briefs" in the Litigation section on sec.gov. The SEC's brief argues that the District Court was incorrect when it held the "[f]ederal securities laws do not impose a duty on issuers to disclose industry-wide trends or publicly available information."

In its argument, the SEC noted: "There is no blanket requirement that the information [in this case, information required under the Securities Act] be firm-specific, or that it not be publicly available." With respect to MD&A, where disclosure about the economy is most likely to be necessary, "The relevant provision of [S-K] Item 303 is not limited to disclosure of trends that are firm-specific or that are not available to the public. Rather, under the plain language of the Item, issuers must disclose 'any known trends...that have had or that the registrant reasonably believes will have a material favorable or unfavorable impact' on company finances (emphasis added). Many such trends will be industry-wide or publicly available, but that does not excuse the issuer from complying with the requirements of the Item."

In support of its argument that Item 303 contemplates disclosure of broader economic trends, the SEC focused on the 1980 MD&A amendments. Specifically, the Commission noted a subsequent concept release (Rel. No. 33-6711 (April 21, 1987)), which indicates that the 1980 changes reflected the SEC's "concerns about the economic climate of the time. High interest rates and inflation were significant problems and the revised MD&A was designed to foster disclosure of trends and uncertainties arising from these and other factors."

Updating Risk Factors

While the SEC has not addressed the point directly, risk factors are the logical place beyond the MD&A where discussion of economic, market and financing conditions is warranted. With risk factors (including updating) now required in periodic reports (see our July-August 2006 issue at pg 2), issuers will likely need to reconsider for their upcoming 10-Q generalized descriptions of broad economic risks, to reflect the stark realities of the world economy. Further, in light of current credit market conditions, many issuers that had not previously considered financing risks may need to consider including additional risk factors

(and most likely accompanying disclosure in the liquidity section of MD&A), to address, e.g., previously unforeseen lack of access to commercial paper, bank financing and other sources of funds. Investors, etc. will now need to know about intricacies of financial instruments and markets (e.g., commercial paper) that previously may not have been material. [It appears that some companies are beginning to turn to their credit facilities now that other means of cash are not as available; Goodyear drew \$600 million of its \$1.5 billion credit lines because of an inability to access some U.S. cash investments, and GM drew down \$3.4 billion of its \$4.5 billion credit agreement (partially to retire debt maturities coming due).]

8-K Updating. Form 10-Q (Part II, Item 1A) only requires disclosure of material risk factor changes, i.e., from the 10-K. Now may be the first time that many issuers will be in a position to update the often static risk factor disclosure included in the 10-K, and even to include new risk factors.

However, the severity of the economic crisis has become apparent more than a month prior to most issuers' next 10-Q filing. With events moving so fast, some issuers and counsel may be faced with the question of whether to update their risk factor disclosure sooner (e.g., on an Item 8.01 Form 8-K, to be reported or further updated in the Q). Moreover, some issuers may have some particular antifraud, 1933 Act liability, Regulation FD or similar reasons for disclosing updated information on a more current basis, or if the issuer is in the market purchasing its own securities (at today's low prices). Transparency and corporate governance concerns also may augur for 8-K updating.

Recent Examples

Footnoted.org's astute reader of SEC filings, Michele Leder, notes that, in July, Apple added a conspicuous new risk factor to its third quarter 10-Q to specifically indicate that worldwide economic conditions "have recently deteriorated significantly in many countries and regions" and "may remain depressed" for the foreseeable future. Apple went on to note that the resulting impact on consumer spending could have a "material adverse effect on demand" for Apple's products and services and on its financial condition and operating results. (Apple, contrary to the SEC's admonitions in Section VII.A.1 of Rel. No. 33-8591, July 19, 2005, includes all its risk factors in each 10-Q, rather than just disclosing any material changes as contemplated in Part II, Item 1A.) The new risk factor represented a significant change in tone for Apple on its prospects for growth, and seemed to adequately foreshadow the relative collapse of consumer spending and confidence that emerged by summer's end.

General Electric went the extra step of filing updated risk factors with its Form 8-K Item 8.01 filed to announce Warren Buffet's investment in the company on October 1. Among the specific risks that GE cited: (1) Congress's potential failure to pass bailout legislation, (2) unprecedented levels of market volatility, (3) the impact of the credit crisis on the operations of GE Capital, (4) weakness in the real estate market, and (5) failing to maintain the company's high credit ratings.

The Perils of Overemphasis on General Conditions

One particular concern is the potential for overemphasis on external economic, market and credit conditions as a source for adverse business trends specific to an issuer. In some cases, this overemphasis may be potentially misleading, particularly if the issuer does not provide adequate disclosure about specific trends or uncertainties with respect to its own operations that may have little to do with economic or market conditions. In some instances, issuers may be tempted by the fact that it is much easier to blame the economy than to criticize one's own business. Issuers need to strike a balance in discussing both company-specific and macro-economic trends and uncertainties and the potential impact of those trends and uncertainties on the issuer.

Watch for further developments (and examples) on TheCorporateCounsel.net.

More Meltdown Fallout—Falling Share Prices Can Affect S-3 Eligibility, WKSJ Status, Listing

The drastic decline in equity prices over the past several months is starting to affect issuers' eligibility when filing a 1933 Act registration statement, and may even place some issuers in jeopardy of delisting. With the confluence of events making access to capital more difficult, this may be an area where the SEC, instead of, e.g., chasing short sellers (see pg 10), might consider providing some temporary relief.

December S-3/S-3ASR Filing Deadline Looming

Even though very few 1933 Act registration statements are being filed these days, a deadline is coming for a spate of S-3 shelf filings: When the SEC adopted changes to shelf offerings as part of the 2005 Securities Act Reforms, it did away with the former limitation on the amount of securities that could be registered

for shelf offerings, under paragraphs (ix) and (x) of 1933 Act Rule 415(a)(1) (*i.e.*, to the amount that the issuer had a bona fide intention to sell within two years), in favor of current 415(a)(5)'s requirement that a new shelf registration statement must be filed every three years. The third anniversary of the effective date of these amendments is rapidly approaching, and with that will come the need to "refresh" many shelf S-3 registration statements by or soon after December 1.

In order to ease the transition to a new shelf registration statement, the Reforms included Rule 415(a)(6), which provides that an old shelf registration statement may continue to be used for up to six months after the third anniversary of the old shelf's effective date, so long as the new registration statement is (i) filed before that date, and (ii) has not yet been declared effective.

Moreover, in Question 12 of its Securities Offering Reform Transition FAQs, the Staff indicated that, for any shelf registration statement that was effective before December 1, 2005, the three-year period in Rule 415(a)(5) is deemed to begin running on December 1, 2005, regardless of how long prior to December 1, 2005 that registration statement became effective. Thus, for all of those issuers who had "grandfathered" shelf registration statements (as well as those issuers who rushed out to file an automatic or other shelf registration statement right after the Reforms were effective), the time is fast approaching to file a new registration statement before the old registration statement expires.

S-3 Primary Eligibility. With the extraordinary drop in equity prices, some issuers approaching the December 1 Form S-3 filing deadline will find themselves with a public float of less than \$75 million (measuring their float based on a price within 60 days prior to the date of filing).

The New Limited Primary Eligibility. Luckily for these issuers, S-3 primary eligibility is no longer lost entirely when float falls below \$75 million, because issuers can now rely on new General Instruction I.B.6., which provides primary offering eligibility to issuers with a float of less than \$75 million for registration in any 12-month period of up to one-third of their float amount, provided the issuer has at least one class of equity securities listed and registered on a national securities exchange. (See our January-February 2008 issue at pg 10.)

Plus the Six-Month Reprieve. Moreover, while an issuer's access to capital would be subject to the new amount limit under a shelf relying on General Instruction I.B.6., the issuer could file the new shelf registration before the old shelf expires (*e.g.*, by December 1 for old grandfathered shelves), continue to use the old shelf (with unlimited shelf offering potential) for as long as possible during Rule 415(a)(6)'s 180-day grace period, and hope that the issuer's float bounces back above the \$75 million threshold so that full shelf access would be available going forward. (Instruction 3 to General Instruction I.B.6. provides that, if the issuer's float equals or exceeds \$75 million at any time subsequent to the effective date of the new registration statement, then the cap on sales no longer applies and the registration statement is considered filed pursuant to General Instruction I.B.1.)

Loss of WKSI Status

The rout in stock prices could likewise push larger issuers out of WKSI status just at the time they must assess their WKSI status for the purpose of filing a fresh shelf registration statement under 415(a)(5). As our readers may recall, in determining WKSI status under the Rule 405 definition, the issuer looks at whether worldwide public float was \$700 million within 60 days of the later of (1) the time of filing the most recent shelf registration statement or (2) the time of its most recent 1933 Act Section 10(a)(3) amendment. (See our March-April 2007 issue at pg 5.) The confluence of (artificially) depressed stock prices and the upcoming third anniversary shelf deadline may force a number of issuers off of automatic shelf and expose them to the potential delays in capital raising attendant to a regular old shelf, *i.e.*, S-3 with potential of Staff review and the lack of (i) flexibility to add securities by post-effective amendment, (ii) liberalized use of prospectus supplements and (iii) pay-as-you-go registration.

Filing a non-automatic shelf should still provide an issuer the benefit of the up to 180-day grace period of 415(a)(6) for the old shelf. An issuer facing a depressed public float could hold off on filing the new shelf as long as possible prior to the three-year anniversary (presumably, the old automatic shelf registration statement was filed some time after the December 1, 2005 effective date of the rules) to see if its stock price recovers. If not, filing a non-automatic shelf would become necessary to stay in the market with the old shelf (at least until the 10(a)(3) update), and if the stock price recovers during the grace period, the issuer could potentially file a new S-3ASR and rely on Rule 457(p) to carry forward unused filing fees for unsold securities from the prior shelf.

No Current Relief from AF, etc. Status

The current market sell-off won't provide a significant number of calendar year issuers the benefit of longer 10-K/Q deadlines (by falling out of LAF or AF status), because float for those purposes is measured at the end of the second fiscal quarter, and for calendar year issuers is not measured again until next June. [An issuer that determines it has become a Smaller Reporting Company (per 12b-2) as of the last business day of its second fiscal quarter is permitted to transition to the scaled disclosure requirements in the 10-Q for that second quarter.]

Exchange Minimum Share Price and Public Float Requirements

Following September 11, 2001, Nasdaq imposed an across-the-board, three-month moratorium on the application of its minimum bid and public float requirements for continued listing on Nasdaq. It may be time for Nasdaq to consider this action again, as the prices of its listed issuers' securities are being driven down to unprecedented levels by extraordinary market forces. At this point, however, no such move has been proposed, and any change would have to go through the SEC for approval.

Nasdaq staff is always monitoring the operation of other Nasdaq rules, including the minimum bid requirement. (Even if Nasdaq doesn't act, there are already some generous grace periods built into the system for delistings in these circumstances, including an automatic six-month grace period, followed by another six months where a company meets the Capital Market standards, and then the appeal process.) Similar action by the NYSE may also help stem the tide on delistings at a time when investors can't necessarily afford to have their securities delisted and moved into the OTCBB or the Pink Sheets.

How the SEC Can Help—Emergency Action Versus “Position Taking”

This seems like a situation where the SEC might recognize that these extraordinary circumstances warrant some relief for shelf filers and WKSIs that are “on the ropes” due, for the most part, to market conditions beyond their control.

Interim Final Rules. The SEC's hands are tied to some extent, because (as pointed out in our November-December 1996 issue at pg 7) its 1933 Act exemptive authority under Section 28 is limited to action by rule or regulation. Conceivably, the SEC could act quickly by adopting “interim final rules,” based on a finding “for good cause...that notice and public procedure are impracticable, unnecessary, or contrary to the public interest.” (See § 553(b) of the Administrative Procedures Act.) Interim final rules can become effective immediately, with a notice and comment period that *follows* effectiveness, and any comments to be taken into account when the SEC supposedly “finalizes” the interim final rules. [The SEC recently adopted an interim final temporary rule with respect to naked short selling and will adopt interim final rules implementing Form SH; the Commission last adopted interim final rules (hastily) in December 2006, with questionable (some say disastrous) results, when it changed the presentation of equity awards in the Summary Compensation Table (see our January-February 2007 issue at pg 5).]

Staff Positions. However, there is precedent for the SEC to merely direct the Staff to take “positions” with respect to, e.g., S-3 eligibility and WKSI status, without resorting to rulemaking. In the wake of Hurricane Katrina in 2005, the SEC issued a press release indicating that the Staff was directed to take positions that allowed companies to be deemed current for Form S-8 eligibility purposes and current and timely for Form S-3 and WKSI eligibility purposes, if those companies filed their reports within an extended time frame. (See Press Rel. No. 2005-132 and Rel. No. 34-52444.) Perhaps a similar (but, well-considered) approach today could assure issuers some continuity in access to capital despite the coming arbitrary three-year anniversary.

Pending Commission Proposal Restricting S-3 Eligibility for Debt Securities

The SEC is currently considering a rule proposal to restrict S-3 eligibility in some cases for offerings of investment grade rated non-convertible securities, by removing the investment grade credit rating eligibility criterion from General Instruction I.B.2. and replacing it with the WKSI standard of having issued \$1 billion in non-convertible securities offered for cash in the past three years (on the theory that having references to credit ratings in the SEC's rules places undue reliance on the shaky ratings process). (See Rel. No. 33-8940, July 11, 2008.) As several types of issuers have noted so far in comment letters to the SEC (public utilities, REITs, etc.), the proposals essentially would eliminate shelf eligibility for the types of offerings that these firms often rely on for capital. Meanwhile, the SEC itself acknowledged in the proposing release that the shift from investment grade rating to the \$1 billion WKSI test would open up the shelf to junk bond issuers, while cutting off shelf eligibility of some investment grade debt issuers. [The

SEC has estimated that approximately six issuers would lose shelf eligibility as a result of the proposed rules, basing their calculations on the debt issuances that had occurred in the first part of 2008. Given the current extraordinary financial conditions, we would expect the number of issuers affected to be significantly higher in more normal economic conditions. In fact, we know of only two major debt deals that have closed in the past several weeks: Caterpillar Financial Services (\$1.25B on September 23) and IBM (\$3.9B on October 9).]

SEC Regulation of Investment Banking—R.I.P.

Regulation of investment banks (or the lack thereof) has been a subject of intense hindsight lately. On September 21, the two remaining major independent investment banks opted to form bank holding companies in order to become regulated under the jurisdiction of the Federal Reserve. See also Press Rel. No. 2008-230 (September 26, 2008). Of course, Goldman Sachs and Morgan Stanley remain subject to SEC securities regulation.

A Little History

In 2004, while William Donaldson was SEC Chairman, the five largest independent investment banks voluntarily submitted themselves to SEC jurisdiction as investment bank holding companies (as “consolidated supervised entities”). (Their broker-dealer arms obviously already were under the SEC.) This circumstance had come to pass essentially because European authorities were concerned that U.S. investment banks weren’t adequately regulated.

The result was Appendix E to Rule 15c3-1 (the traditional broker-dealer net capital rule). Appendix E, sometimes referred to as the CSE Program, essentially applies net capital requirements at the holding company level, enabling the Commission/Staff to require the investment banks to raise additional capital as well as to dispose of risky assets. But, Appendix E did not apply at the holding company level the 15 times debt-to-capital limit traditionally applied to broker-dealers.

The Commission’s oversight (or lack thereof) under Appendix E is the reason for today’s criticism of the SEC for Bear Stearns, Lehman, etc.

The Role of Mark-to-Market Accounting

Losses incurred from CMOs, etc. backed by mortgages became a major culprit in the crisis, reducing capital (and confidence). In hindsight, most investment banks needed to raise more capital. (Those with capital were able to use some of that capital to hedge their exposure, e.g., Goldman Sachs.)

FAS 157 generally requires assets to be written down to the value that would be realized if the assets were sold. Because the market for mortgage-backed securities essentially dried up, investors have been forced to write these securities down to near zero (with the accompanying income and capital hit). (If value *increases*, FAS 159 provides for adding that amount to income and, hence, capital.)

Interestingly, bank holding companies are allowed to elect “hold-to-maturity” accounting, *i.e.*, valuation based on estimated future cash flow (here, the present value of future mortgage payments and/or amounts realized on foreclosure), usually resulting in much less write-down. While the two remaining investment banks are now treated as bank holding companies, and so can utilize this approach, the SEC issued a press release on September 30 clarifying that (even under 157) there are circumstances where less draconian treatment than mark-to-market might be available, *i.e.*, use of different assumptions where market values aren’t available. (Press Rel. No. 2008-234.) Query to any issuer, whether this approach would allow hold-to-maturity accounting.

It will be interesting to see whether CMO, etc. holders will now go back and restate prior financials, or simply seek to adjust going forward. MD&As (including Critical Accounting Estimates) will only get even more complex!

Impact on Liquidity/Capital. We aren’t economists, but valuation of CMOs above disposable value wouldn’t appear to us to increase liquidity above disposable value.

The Inspector General’s Report

On September 25, the SEC’s Inspector General issued a report criticizing the Commission and, in particular, the Division of Trading and Markets. Interestingly, Senator Grassley, who had initiated the IG’s inspection/report, released the unedited version of the report (on grassley.senate.gov) that included 136 references that T&M deleted from the version on the Inspector General’s page on sec.gov.

The Inspector General also criticizes Corp Fin for *disclosure* deficiencies at Bear Stearns, etc.

NEW DEVELOPMENTS

Legal Opinions in Rule 14a-8 No-Action Letter Requests

Another shareholder proposal season is upon us. In our recent discussion of Corp Fin's no-action letter process, we covered some of the circumstances in which a requester might be well-advised to provide a legal opinion supporting a position advocated in its no-action letter request (see our March-April 2008 issue at pg 4).

Legal Opinion Requirement for (i)(1) and (2) Matters

As our readers may recall, 14a-8(i)(1) allows an issuer to exclude a proposal that is not a proper subject for shareholder action under the laws of the issuer's state of incorporation; 14a-8(i)(2) allows exclusion of a proposal that, if implemented, would cause the issuer to violate any state, federal or foreign law. Where, e.g., a proposed bylaw seeks to confer upon shareholders a right to (a) take an action not approved by the board of directors (e.g., requiring inclusion of shareholder nominees in the issuer's proxy statement) or (b) prevent action that the board wishes to take (e.g., requiring shareholder approval of a poison pill), the issuer may argue that the proposal is excludable on both of these grounds because it would permit shareholders to usurp a function reserved to the board of directors under a state statute that empowers the board to "manage the affairs" of the corporation (e.g., DGCL Section 141(a)). The proponent's usual counterargument is that state law permits shareholders to amend the bylaws to regulate the powers of the board (e.g., DGCL Section 109).

In most cases, the Staff is not qualified or equipped (nor does it desire) to determine state law questions. For that reason, when an issuer seeks to exclude a proposal under (i)(1) or (i)(2), Rule 14a-8(j)(2)(iii) *requires* that the issuer's no-action request be accompanied by a supporting opinion of counsel.

Form of Opinion

The opinion can be included in the text of the no-action request (if the person signing the letter is an attorney) but, in our experience, the opinion is more commonly submitted as a separate letter (addressed to the issuer, with a paragraph consenting to its transmission to the Staff), because the no-action request generally these days comes from in-house counsel or outside securities counsel, and the opinion is rendered by a lawyer or firm that is located in (and expert in the law of) the subject jurisdiction. In either case, the opinion will carry more weight if opining counsel is admitted to practice in the jurisdiction on whose law the opinion is based. The separate opinion is part of the request letter, so is included when the request and response become public (see our March-April 2008 issue at pg 2).

Staff Legal Bulletin 14B (September 15, 2004) says the opinion should take into account the extent to which the legal issue is unresolved or unsettled. The opinion also should be clearly stated as an "opinion" (e.g., "it is our opinion that the proposal, if adopted, would cause the issuer to violate Section 141(a) of the DGCL"). Mere "belief" or advocacy in favor of a particular interpretation of state law will not work.

Unqualified Opinion. Ordinarily, it is not that difficult (or risky) for a law firm to provide an unqualified opinion in this context. Unlike the usual third-party opinion delivered to a client or to a third party at a closing, where an erroneous opinion can result in malpractice liability (or worse), a Rule 14a-8 opinion (although publicly available) is to be relied upon only by the Staff, and only for the purpose of allowing the Staff to determine its no-action position.

There is little adverse consequence to being "wrong" in the opinion. Sometimes, however, we think the reasoning set forth in an opinion doesn't necessarily support counsel's strong conclusion, and we wonder if counsel would be as confident if it were providing an opinion to the issuer's board of directors that the subject bylaw, if adopted, could be disregarded as invalid under state law. Ultimately, counsel's integrity (and the prospect of being embarrassed by a contrary opinion from proponent's counsel—see below) is what makes the process work.

Along these lines, the Staff has admonished counsel (in SLAB 14B) to avoid making unsupported assumptions about how the proposal might operate in a hypothetical situation, and then basing the opinion on that hypothetical. If the opinion addresses a "straw man" (e.g., counsel hypothesizes an extreme set of facts and argues that the proposal's application to those facts could result in a violation of state law), the Staff will likely disregard it and will respond with a letter saying that the issuer "failed to meet its burden" of establishing the excludability of the proposal (rather than that the Staff is unable to concur that the proposal is excludable). [As we have discussed, the Staff generally does not discuss 14a-8 no-action requests with counsel before issuing a response and, therefore, issuers are not able to avoid a negative response by withdrawing the request, as in other contexts.]

Legal Opinion Response from Proponent

The issuer bears the burden of establishing that a proposal is excludable, and therefore 14a-8(j)(2)(iii) does not impose an obligation on the proponent to submit a legal opinion supporting the validity of the proposal. Nevertheless, after the issuer submits an opinion, the proponent often submits its own legal opinion. (As our readers may recall, the issuer is required by 14a-8(j)(1) to simultaneously provide a copy of its no-action request letter to the proponent, who then may respond to the Staff per 14a-8(k).)

Nature of Staff Response

If the Staff concludes that the issuer has “failed to meet its burden,” the issuer must include the proposal in the proxy statement. If, on the other hand, the Staff declines to express a view, the issuer is free to exclude the proposal; the proponent’s only recourse is to bring an action in federal court to compel the issuer to include it. The proponent’s commencement of litigation has the effect of asking a federal court to resolve a substantive state law issue.

Impact of Delaware’s New Certification Procedure

Obviously, a system that requires resolution of state law questions by either the Staff (based on issuer or proponent advocacy and legal opinions) or the federal courts is not ideal. The increasing frequency of conflicting legal opinions under (i)(1) and (i)(2) led the Delaware legislature to amend Article IV, Section 11(8) of the Delaware Constitution on May 15, 2007 to provide the Delaware Supreme Court authority to determine questions of law certified to it by the SEC. This new procedure may become the primary means for resolving questions that arise under DGCL Sections 109 and 141(a) regarding the validity of shareholder-initiated bylaw amendments.

As we have discussed, the new Delaware certification process was tested for the first time in connection with a proposed bylaw amendment submitted to CA, Inc. by AFSCME in March 2008. (See our July-August 2008 issue at pg 5.) The SEC’s certification there noted that, in the absence of resolution of the subject questions, the Staff would deny CA’s no-action request on the ground that CA failed to satisfy its burden of establishing the excludability of the (expense reimbursement) proposal.

The Delaware court acted in just three weeks (on the date that CA needed to finalize its proxy statement), holding that the bylaw was a proper subject for shareholder action but, if adopted, would violate state law (because it was worded in such a way that it could have required CA’s board to reimburse expenses sometimes possibly in breach of its fiduciary duties). *CA, Inc. v. AFSCME Employees Pension Plan*, No. 329, 2008 (Del. July 17, 2008). Based on the court’s ruling, the Staff issued a no-action letter (also dated July 17) allowing CA to exclude the proposal under (i)(2).

We were pleased to see the new Delaware process play out well. It has the potential to remove the Staff as arbiter of state law, result in resolution of the questions before the issuer has to file its proxy statement, and keep state law matters out of federal court and before judges best equipped to address them.

Precatory Proposals Can Also Raise (i)(1) and (2) Issues

In our July-August 2008 issue (at pg 4), we noted that Lucian Bebchuk had decided not to wait for the Staff to rule on the excludability of his shareholder proposal, submitted to Electronic Arts, for a bylaw amendment that would allow shareholders access to the proxy statement for the purpose of proposing virtually any bylaw amendment, and instead took his case directly to federal court by filing a declaratory judgment action (which remains pending). (See our May-June 2008 at pg 11.) Unlike many issuers that received Bebchuk’s proposal, Electronic Arts did not argue in its no-action request that the proposal was excludable under Rule 14a-8(i)(1) or (2), presumably because the proposal submitted to Electronic Arts was “precatory,” while some issuers received this proposal in a binding form.

Obviously, a proponent prefers that its proposal, if approved by shareholders, be binding on the issuer. Otherwise, the issuer is free to disregard the recommendation or to address the shareholder’s concern in a way that is unsatisfactory to the shareholder (e.g., by implementing a modified plurality voting system in lieu of majority voting). A proposal may, however, need to be precatory (i.e., cast as a non-binding recommendation that the board take certain action) in order to avoid exclusion under (i)(1) or (i)(2). See Note to Rule 14a-8(i)(1) and Rel. No. 34-12999 (1976). The notion here is that a binding proposal would allow shareholders to dictate a process or outcome that, under state law, should be left to the discretion of the board of directors, while a mere recommendation, if approved, would leave the board free to exercise its business judgment as contemplated by state law. See, e.g., *Advocat Inc.* (February 2003) (proposed bylaw requiring that board obtain shareholder approval before adopting a poison pill not excludable if recast as a recommendation).

Even a precatory proposal can be subject to exclusion under (i)(1) and (i)(2), however. Thus, if a proposed bylaw requiring the board to obtain shareholder approval before taking certain action would improperly restrict the board's authority under state law, even a precatory proposal merely recommending that the board adopt such a bylaw could be excludable under (i)(1) and (i)(2), because implementation of the proposal would cause the issuer to violate state law. See *MeadWestvaco Corp.* (February 27, 2005) (precatory proposal to amend bylaws to limit executive compensation); *Pennzoil Co.* (March 22, 1993) (option repricings); *Mattel Inc.* (March 25, 2002) (poison pill).

Legal Opinions in Other 14a-8 No-Action Requests

The exclusions in (i)(1) and (i)(2) are not the only exclusions that may raise questions of state law that may call for an opinion of counsel under 14a-8(j)(2)(iii). An opinion may be helpful, for example, where the issuer argues that a proposal is excludable under (i)(10) as having been substantially implemented because the issuer's action on the matter is more effective or enforceable under state law (see *Exxon Mobil Corp.*, March 24, 2008), or under (i)(6) as beyond the issuer's power to implement (see *priceline.com Inc.*, March 27, 2008).

In addition, opinions sometimes are in no-action, etc. requests outside the Rule 14a-8 context, for example, to support the requester's position that a stock repurchase is not an issuer tender offer (see *Orange Hospitality, Inc.*, September 9, 2004), that an investment product is not a security (see *Diamond Investors and Manufacturers AG*, June 30, 1975), or that an offering of securities is exempt from registration under the 1933 Act (see *Minnesota Mutual Companies Inc.*, November 24, 1999). These opinions usually address matters of federal securities law and, therefore, ordinarily are included within the text of the no-action request (sometimes simply by adding "it is our opinion that..." to the legal position being advocated). Of course, the Staff is better equipped to assess opinions on application of the federal securities laws.

Rule 701 Heads-Ups—Measurement Date(s) for Restricted Stock/RSUs

A reader recently received mixed signals from the Staff on how restricted stock/RSUs play out under Rule 701: Is the "sale" deemed to occur on (a) grant at the grant-date stock price or (b) vesting at the then current price, for purposes of the Rule 701 limit calculation and for determining whether the \$5 million disclosure requirement threshold has been reached? And, assuming the disclosure threshold (for all grants that are relying on the 701 exemption) has been exceeded, what is the disclosure point for restricted stock, *i.e.*, grant or vesting?

Some Background

Per the 1999 amendments, the Rule 701 limit and disclosure threshold calculations are based on "actual sales or amounts to be sold (as with options) in a 12-month period." (Rel. No. 33-7645, February 25, 1999.) Rule 701(d)(3)(ii) expressly provides that, for the limit and disclosure threshold calculations, options are treated as sales at the grant date (*i.e.*, at the exercise price), irrespective of vesting and whether or not the options are ever actually exercised. [In today's FAS 123(R) world, one might readily detour off into wondering whether the Rule 701 amount for options might be the grant-date fair value of the option instead; but, the 1999 adopting release tellingly notes that "the purpose is to measure the securities that will be sold under the [Rule]."]

Rule 701 is silent as to the "sale" date of restricted stock. However, the adopting release purports to address both deferred compensation (it's upfront, *i.e.*, the deferral election date) and restricted stock (rather unhelpfully saying that the restricted stock "calculations will be made as of the *transaction* date." [Emphasis added.]

In our March-April 1999 issue (at pg 5) we said the Staff had confirmed to us that restricted stock would go into the 701 limit calculation as though the shares were sold on the grant date, consistent with the ease of keeping track of, and complying with, the 701 limit, so that post-grant price fluctuations would not be relevant. But, that position never made the CDI or its predecessors, and there are problems getting there on one's own analysis: As mentioned above, the Rule/release confirm upfront treatment for options and deferred compensation, but ambiguously provide the "transaction date" for restricted stock. Moreover, option stock, when ultimately sold by the company to the option holder, will in fact be sold at the exercise price (so the price/value is the same at either point), whereas with restricted stock the price/value may well vary based on when the "sale" is deemed to occur. Finally, RSUs (the choice these days of many companies versus traditional restricted stock), where shares aren't issued until vesting, etc., might further suggest that the transaction doesn't occur until the actual stock issuance down the road.

Recent Staff Dialogue

We had thought these past nine years that the Staff was adhering to the grant-date "sale" position for restricted stock/RSUs, at least for limit calculation purposes. But, our reader tells us that, after first hearing from the Office of Small Business Policy Staff that the grant date governs, a follow-up inquiry (relating to timing of the 701 disclosures – see below) resulted in the Staff instead simply referring (via e-mail) to the "transaction date" discussion in the adopting release.

We hope the Staff can be talked out of this one. It doesn't make sense to us that grant amounts determined in year one would impact the limit calculation (and grant practices) for future years, with numbers that can't be calculated upfront. (While a company presumably can control, and keep track of, vesting dates, as opposed to option exercises, it cannot similarly control stock price fluctuations.) Moreover, even where the limit is not exceeded in future years, there could be an unforeseeable exceeding of the \$5 million disclosure threshold.

Disclosure Timing

Where the disclosure requirement is triggered, the question arises as to when the required disclosures must be made. For stock options, 701(e)(6) specifically mentions a reasonable period of time prior to exercise. For deferred compensation, 701(e)(6) says that the disclosure trigger is the (upfront) election to defer. For restricted stock, here again, there is no clear specification.

Can the restricted stock grant date be the sale date for calculation purposes, but vesting be the sale date for disclosure purposes? (See the related discussion in our July-August 2005 issue (at pg 3) of the timing of registration/prospectus delivery where restricted stock is registered on S-8.)

No-Sale/No-Foul

It is no wonder that, when we did a little digging into practices here, we found that some counsel actually are able to get comfortable disregarding restricted stock entirely from Rule 701 (both for limit calculation and disclosure purposes), *i.e.*, either because Section 4(2) applies or because there is no "sale" and, hence, no offer (it's like bonus stock, but with vesting). While the Staff's articulated "no-sale" position relates to reporting issuers, *i.e.*, unregistered shares may be distributed to employees under certain stock bonus and other employee benefit plans without registration, and such shares may be freely resold provided (1) the issuer is subject to the reporting requirements of the 1934 Act; (2) the stock is actively traded; and (3) the number of shares being distributed is relatively small in relation to the number of shares of the class outstanding (see our January-February 1980 issue at pg 6), it may still be possible to conclude that there was in fact no "sale" as defined in 1933 Act Section 2(a)(3) of the restricted stock granted by a non-reporting issuer.

JCEB Rule 701 Item

Before leaving Rule 701, we note that the ABA's Joint Committee on Employee Benefits discussed with the Staff (at their May 2008 meeting) the situation where a foreign private issuer has de-registered under the 1934 Act and, thus, has become a non-reporting company that can utilize Rule 701. See Question 12 of the JCEB Report posted on TheCorporateCounsel.net.

Stock option grants registered on S-8 back when the company was registered would not be a problem under the Rule 701 limit because, there, you look at the time of grant. However, as discussed above, the 701 *disclosure* requirements apply incident to *exercises*, which can occur after de-registration. The JCEB suggested to the Staff that these exercises not count for purposes of the \$5 million disclosure threshold. The Staff, while recognizing that the Rule doesn't deal with this situation, didn't exactly agree. But the Staff indicated it might be willing to consider no-action relief on a case-by-case basis depending on the circumstances (*e.g.*, were there are large numbers granted under S-8 and small numbers now). The Staff acknowledges that the same principles would apply to a (domestic or otherwise) issuer that goes private.

New 1934 Act CDIs—Staff Confirms 10-K Delinquency Date Where Issuer Doesn't File Proxy Statement Within 120 Days After Yearend

The Staff's latest round of CDIs provide useful updates to interpretations of 1934 Act sections, rules and forms (see the Exchange Act Rules Compliance and Disclosure Interpretations, dated September 30, 2008; Exchange Act Forms Compliance and Disclosure Interpretations, dated October 1, 2008; Exchange Act Sections Compliance and Disclosure Interpretations, dated October 8, 2008). These interpretations largely update the TIM, although the preface to each of the CDIs refers only to updating interpretations from "prior publications."

In our July-August 2007 issue (at pg 11) we addressed the impact on 1934 Act currency and timeliness where an issuer timely files its 10-K, intending to forward-incorporate Part III by reference (as is typical), but then fails to file its definitive proxy statement (or information statement), or add the Part III information by amending its 10-K, by the 120-day deadline in 10-K General Instruction G.(3).

The Staff recently confirmed our thinking in Exchange Act Rules CDI Question 135.10, *i.e.*, that the issuer could become eligible to use S-3 again after timely filing its reports for the 12 months after the original 10-K due date, rather than 12 months after the "due date" for the proxy statement or 10-K/A filing (120 days after the end of the fiscal year). Thus, the delinquency dates back to the original 10-K due date.

We had wondered whether the filing of the proxy statement after the 120-day period (rather than filing a 10-K/A) would suffice to include the Part III information as part of the 10-K. The Staff did not address this question in the new CDIs, noting only in Exchange Act Forms CDI Question 104.09 that an issuer must amend the Form 10-K within the 120-day period to provide the Part III information that would otherwise have been incorporated by reference. We still don't think that incorporation by reference of a late-filed proxy statement is permitted (and nothing in the Staff's new guidance suggests otherwise), so the issuer should file a 10-K/A to include the Part III information once the proxy statement is filed outside of the 120-day window.

The Recent Short Sale Ban—Impact on Counterparty Transactions

The SEC's September 18 emergency order banning (for ten days, and extended until October 8) short sales of publicly traded securities of issuers designated as "financial firms" by the SROs (see Rel. No. 34-58592, as amended by Rel. Nos. 34-58592A and 34-58611) restricted the trading activities of more than just hedge funds, etc. Because equity compensation arrangements and some common insider transactions can involve elements of a short sale, issuers would need to revise or monitor their compliance programs to avoid facilitating short sales of their own stock if a ban is imposed again. (Fortunately in the context of the recent ban, there may have been no demand for these transactions, which tend to occur in an up market.)

The ban was more widespread than first thought. There were approximately 1,000 issuers on the list, approaching 10% of all issuers. The SROs were adding issuers almost daily. Issuers were able to opt off the list, but the more likely scenario was for an issuer with a financial institution subsidiary, no matter how insignificant to the issuer's overall business, to seek refuge on the list.

Hedging and Monetization

Pre-paid forward sale contracts (see our January-February 2000 issue at pg 4), costless collars (see the November-December issue of *The Corporate Executive* at pg 1), equity swaps (see the May-June 1994 issue of *The Corporate Executive* at pg 7) and other hedging arrangements that large shareholders sometimes enter into with a broker counterparty usually entail the counterparty shorting some or all of the underlying stock as a means of pricing the arrangement and/or protecting the counterparty from the risk of a decline in the issuer's stock price. [Those short sales generally are attributable to the insider/seller for purposes of Rule 144, at least with respect to pre-paid forwards and probably in the other contexts as well (see *Goldman, Sachs & Co.*, December 20, 1999, discussed in our January-February 2000 issue at pg 4 and our July-August 2007 issue at pg 2), but not for purposes of Section 16(c) (see Romeo and Dye *Section 16 Treatise and Reporting Guide* (3rd Edition 2005) at pg 1400).]

The broker's short sales would violate the ban. Thus, even if an issuer on the short sale list had an insider trading policy that permits insiders to engage in hedging transactions, the counterparty would not be able to accommodate the transaction.

Writing Calls

As our readers know, we don't favor allowing insiders or other employees to write calls on their issuer stock, because it has the appearance of (and is) a bet against the issuer. Nevertheless, some issuers allow employees to write covered calls as a means of generating extra income from shares they own.

When the SEC issued its now-expired July 15, 2008 emergency order, prohibiting short sales of some 19 investment banks and mortgage-related issuers (Rel. No. 34-58166, amended in Rel. No. 34-58190), the Division of Trading and Markets published guidance saying that writing a covered call would not violate the order, nor would the assignment of a call option to the option writer (a mechanism by which an options clearinghouse or broker designates the outstanding option that will be deemed exercised when a long option holder exercises), even if the call writer had not borrowed or arranged to borrow the security prior to the assignment. (*Division of Trading and Markets: Guidance Regarding the Commission's Emergency Order Concerning Short Selling* (July 18, 2008) (Q.4).) However, the writer would need to deliver the stock by the exercise settlement date. We expect the Staff's position applied equally to the September 18 emergency order.

A Section 16 insider who writes a call option must be long the underlying stock at the time the option is written, and remain long the stock, to avoid violating Section 16(c). See Model Form 145 in Romeo and Dye's *Section 16 Forms and Filings Handbook* (6th ed. 2005).

Google's Transferable Employee Stock Option Program

As our readers may recall, Google (but not, apparently, anyone else yet) has implemented a program under which employees may sell their employee stock options to a designated broker, which in turn hedges its position (and assures that the broker will receive freely tradable stock upon later exercise of the option—see our May-June 2007 issue at pg 1) by shorting the underlying stock pursuant to a resale shelf registration statement

(on Form S-3) filed by the issuer. The broker must sell short all of the underlying stock to address the Staff's 1933 Act concerns, and typically buys back some of the shares to maintain its desired hedge level. The broker's short sales would violate a short sale ban, which means the transferable option program would come to a halt. Fortunately for Google and its employees, Google was not on the short sale list. (An issuer's plan, grant agreements and disclosures should contemplate the possible inability to effect the sale of options; Google has reserved the right to suspend the sale program at any time.)

PIPEs

The SEC has not succeeded in persuading the courts that a PIPE investor violates Section 5 when it short-sells the securities to be purchased in the private placement, and later covers the short sale by delivering the privately placed securities pursuant to the resale registration statement filed after the closing of the private placement. (See *SEC v. Mangan* and *SEC v. Gryphon*, discussed in our November-December 2007 issue at pg 6; the Commission recently also struck out on its *Mangan* antifraud claim (*SEC v. Mangan*, W.D.N.C. August 20, 2008).)

At one time, Corp Fin Director John White was saying that the Staff might propose a rule to the Commission to codify its position and effectively reverse the holdings in *Mangan*, etc. Unfortunately, the Staff may now have decided to leave the issue to the courts. Regardless, a PIPE investor's short sale of securities of an issuer included on the short sale list obviously would violate a general ban on short sales of a PIPE issuer.

Broker-Assisted, Same-Day-Sale Cashless Exercises Not Affected

As our readers know, in a typical cashless exercise of an employee stock option, the broker sells the stock underlying the option when the optionee delivers notice of exercise, even though the stock is not issued to the optionee's account until the settlement date (T+3), when the sale proceeds are received and the exercise price and related tax withholding are transmitted to the issuer. Some counsel expressed concern that an issuer subject to the ban should not have allowed its employees to engage in cashless exercises, because the broker's sale of the option stock before it is issued in the optionee's name is a short sale.

We have a hard time swallowing that one. The optionee becomes entitled to the option stock upon delivery of the exercise notice, and the broker becomes entitled to the stock (on T+3) pursuant to a pre-existing agreement with the issuer. These factors, assuring that the optionee in fact is "long" the stock at the time of sale, led the Staff to issue an interpretive letter to this writer over 17 years ago agreeing that a cashless exercise does not involve a short sale in violation of Section 16(c). See *Dean Witter Reynolds Inc.* (April 29, 1991, discussed in the May-June 1991 issue of *The Corporate Executive* at pg 4). The definition of "short sale" for purposes of the recent emergency order (set forth in Rule 200 of Regulation SHO) is virtually the same as under Section 16(c) (see Romeo and Dye, *Section 16 Treatise and Reporting Guide* (3d Edition 2005), at pg 1396). We were comfortable, therefore, that financial firms could continue their cashless exercise programs while the emergency order was in effect.

A Few More Meltdown Thoughts

As we go to press, Treasury has announced it will inject up to \$250 billion equity capital into banks. We wonder about some of the details, such as pricing. *E.g.*, If the huge market rally of Monday, October 13 followed announcement of the Treasury program, should the October 10 stock price be the basis for the deal? Backdating anyone?

What will shareholders say about dilution? We doubt the hastily drawn bailout legislation (which barely addresses the equity investment alternative) speaks to those kind of issues, or insulates issuers/boards from litigation. Look for details of these transactions in issuers' upcoming 8-K reports.

The 20% Shareholder Approval Rule—Exception

Shareholders may have no say here. Generally, a listed issuer's issuance of common stock, or securities convertible into common stock, representing 20% or more of the class outstanding requires shareholder approval. (See, *e.g.*, NYSE Rule 312.03(c).) There is an exception, however, where delaying the transaction in order to obtain shareholder approval "would seriously jeopardize the financial viability of the enterprise." (See NYSE Rule 312.05.) We understand that AIG relied on this exception (after consulting with the NYSE) to issue to the Federal Reserve \$85 billion of preferred stock convertible into 79.9% of AIG's common stock.

Equity Grants Based on Depressed Prices

Speaking of backdating, in coming days we may be hearing about a raft of hastily called compensation committee meetings to consider (*sans* backdating) equity (re)grants at depressed prices. While we don't condone this kind of bottom fishing, we recognize reality. Readers who may need to bone up on the accounting consequences under FAS 123(R) should access the electronic back issues of *The Corporate Executive* on TheCorporateCounsel.net, searching, *e.g.*, "repricing" and FAS 123(R).

It's Here! Lynn, Romanek & Borges' Executive Compensation Treatise

Dave Lynn and Broc Romanek—joined by their new co-author Mark Borges—have just completed their comprehensive treatise of executive compensation disclosures – Lynn, Romanek and Borges' "The Executive Compensation Disclosure Treatise & Reporting Guide." It is massive: over 1000 pages and full of explanations, annotated sample disclosures, analysis of possible situations that you may find yourself in, etc. It's great to have Mark Borges as part of our Treatise team since he was able to lend his well-known experience and wisdom to the project.

Electronic Version Available Now on CompensationDisclosure.com: Those that order a copy can immediately access the Treatise electronically on CompensationDisclosure.com. We will send you an ID and password that will unlock the wealth of practical knowledge in the Treatise; in time for your upcoming proxy preparation.

The New Disclosure Updates Newsletter

We are pleased to announce that Mark Borges has agreed to keep us all updated on the newest best practices and guidance through our new *Disclosure Updates* newsletter. As a bonus, subscribers to the Treatise will receive this quarterly *Updates* newsletter, in which Mark Borges and David Lynn will bring you all the latest that you need to know. You will receive the first two of these issues before the proxy season starts, providing you critical up-to-the-moment guidance to help you navigate this year's pitfalls and expectations.

We thank the many of you that have already ordered the Treatise. And thank you to all those who have sent us encouraging words on this project. We intend to have this be *the* ongoing resource for proxy disclosure (akin to what the Romeo & Dye publications are for Section 16). Those that have not yet signed up, please use the enclosed order form.

A Roadmap to Comply with the SEC's New Regulation FD Guidance

Now that the SEC has made dramatic changes to its positions on what companies can—and should—do online, opportunities (and pitfalls) abound. We have just reviewed the recent Fall issue of the *InvestorRelationships.com* newsletter which provides important practical implementation guidance that our readers who counsel public companies will need. The newsletter is an integral part of the popular new website—InvestorRelationships.com—to help all those responsible for investor relations and corporate governance keep abreast of the fast-paced changes impacting this area. Be sure that you and your clients are taking advantage of this invaluable new resource.

"The SEC's New Corporate Website Guidance: Everything You Need to Know—And Do NOW". Readers will not want to miss our upcoming major webconference with the foremost experts—including Tom Kim, Chief Counsel of the SEC's Division of Corporation Finance—who will address head-on many of the most important questions that practitioners are now asking—"The SEC's New Corporate Website Guidance: Everything You Need to Know—And Do NOW." There will be no charge for this critical webconference for those that subscribe to *InvestorRelationships.com*. To receive both the Fall issue of *InvestorRelationships.com* and to access this critical webconference, we encourage all our readers to take advantage of the no-risk membership offer for InvestorRelationships.com.

Wealth Accumulation and "Walk Away" Amounts

Those of our readers involved in executive compensation and/or proxy disclosures will want to make sure to see the recent issue of *Compensation Standards*, the newsletter that has become an important part of CompensationStandards.com memberships. This issue—which is getting a lot of attention—focuses on the importance for your CD&A disclosures (and in fulfilling directors' fiduciary responsibilities) of providing wealth accumulation/full "walk away" numbers. Readers will want to have that issue in hand to be prepared for discussions with CEOs and directors.

The Advisors' Blog. We recently discovered the new "The Advisors' Blog," maintained by over 30 of the leading compensation consultants and practitioners. We are finding it to be a great way to keep abreast of the latest guidance and practices. Coupled with Mark Borges' "Proxy Disclosure Blog" and Mike Melbinger's Blog, these three blogs should be "must" reading for all your key people. These invaluable resources are part of your CompensationStandards.com membership.

It's Renewal Time

As all subscriptions to *The Corporate Counsel* are on a calendar year basis, renewal time is upon us. Please return the enclosed Renewal Form or go to the "Renewal Center" on TheCorporateCounsel.net to renew your subscription. (Note the reduced price when you renew your subscription to *The Corporate Executive* at the same time.)

—JMB/MC

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