Directors and Officers Securities Litigation Loss Prevention

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DIRECTORS AND OFFICERS SECURITIES LITIGATION LOSS PREVENTION

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INTRODUCTION

Claims under the federal securities laws present the greatest exposure for directors and officers of publicly traded companies. If a material upward or downward movement in a company's stock price is perceived to be caused by surprising disclosures, litigation will likely be filed alleging that the company and its responsible directors and officers improperly delayed disclosure of that surprising information or otherwise misled the investing public. Investors who traded in the company's stock during the period the information was allegedly withheld or misrepresented may claim they were damaged to the extent the stock price when they traded was different from what the stock price would have been if proper disclosure of the information had been made.

Directors and officers cannot avoid securities litigation altogether. A sophisticated plaintiffs' bar has become quite skilled at creating persuasive allegations of wrongdoing, and courts have broadly interpreted many aspects of the federal securities laws. However, a well-conceived, fully implemented securities litigation loss prevention program can reduce the likelihood and severity of such litigation. Furthermore, such a program can significantly reduce the penalties imposed should the corporation be found guilty of criminal violations in federal court.

Assuring compliance with the securities laws does not only reduce liability exposure. Effective disclosure is good business. Credibility with shareholders, analysts, and the financial community benefits a company in the long run. In addition, full compliance with the securities laws helps preserve a company's hard-earned reputation for maintaining the highest legal and ethical standards.

A fundamental goal of an effective securities litigation loss prevention program is to make a company's directors and officers who are involved in disclosure matters realize that improper disclosure can expose the company—and themselves—to potentially catastrophic liability. With that

realization, the directors and officers likely will be more cautious, will seek expert advice more readily, and will apply basic common sense in formulating cautious disclosure philosophies.

This booklet presents a number of specific practices that can be followed to reduce this important liability exposure. Many of these practices are simply common sense, although some reflect the counterintuitive nature of certain aspects of the securities laws. It is important to note that the statements and advice that follow are derived in large part from our observations of what many companies do to manage their securities litigation risk. With the increasing predominance of the Internet, as well as changes in the capital markets and Securities and Exchange Commission (SEC) rules, "best practices" in this area are evolving rapidly. No booklet can describe procedures or policies that will fit every company's situation, nor should any company be expected to adopt all of the procedures discussed herein.

GENERAL SECURITIES LAW COMPLIANCE

The fundamental goal of the federal securities laws, and thus the primary goal of a securities law loss prevention program, is the full, accurate, and timely disclosure of material information. The following 15 guidelines encompass the basics of an effective loss prevention program, as well as the foundations of good corporate disclosure practices.

Establish the proper disclosure culture

Since the adoption of the Sarbanes-Oxley Act of 2002, the business environment surrounding corporate disclosure has profoundly changed. Today, disclosure control adequacy—once primarily the domain of internal and external counsel and certain specified individuals inside the organization—is now a subject to which senior management must devote considerable attention. Senior managers must realize that they are responsible for setting the tone from the top for ethical behavior in deciding what information to disclose or withhold from the investing public. They must realize that they are personally responsible for assessing and managing the company's exposure to risk and ensuring an adequate system of disclosure controls. They must provide appropriate resources and authority to effectively maintain the company's system of disclosure controls and must support compliance programs that remedy past offenses and prevent their reoccurrence. This process requires the active involvement of the CEO and CFO. In the end, demonstrating and demanding ethical behavior with respect to all of the company's disclosure policies is one of senior management's most important goals.

Tell the truth

Although telling the truth seems axiomatic, it may not be as self-evident as one would expect. Senior management must establish a corporate culture that clearly and unequivocally mandates only truthful, forthright communications, both internally and externally. As part of this culture, management should not tolerate clever "spin." At times, it is tempting to

prefer an alternative to complete disclosure because the truth may negatively affect the company's stock price. That temptation must be denied. Communications should be plain, easy to understand, and convey the whole truth, not just a half-truth. Even unsophisticated investors should be able to readily understand the disclosed information.

Use "no comment" responses

A policy of truthful disclosure does not mean that a company is required to answer every question posed to it. Naturally, information that is either confidential or not ripe for public release should be closely protected. The SEC, courts, and securities exchanges recognize that a company may properly avoid premature public disclosure of certain types of information if there is a valid business reason for withholding it. In these cases, "no comment" is an appropriate response to an inquiry. To be useful, however, the "no comment" response must be used in a consistent way. A company that normally denies false rumors, but issues a "no comment" response to an inquiry about a particular rumor may, in essence, be confirming the rumor. (See page 41 for further discussion about rumors.)

Employ a coordinated team approach

No one person or department can fully satisfy securities law disclosure requirements. Rather, an integrated team of outside professionals and company representatives must work together, each with clearly defined and understood responsibilities. Since the adoption of the Sarbanes-Oxley Act, and fueled by the explicit encouragement of the SEC, many companies have implemented formal disclosure committees. However the team is titled, it should be responsible for 1) ensuring that the company's disclosure controls are sufficiently well-designed and implemented to collect the information necessary to satisfy its public disclosure requirements, 2) assessing the materiality of all information made known to it, 3) considering the proper time and manner of disclosing such information and, 4) where necessary, improving the process by which information is internally collected and

analyzed. Inadequate internal communications frequently lead to inadequate disclosures to the investing public.

To ensure that the realities of the company's business and marketplace are accurately reflected in disclosed information, the disclosure team should include at least one businessperson familiar with the company's industry and operational environment who can review each disclosure to ensure that it properly reflects that environment. It may also be appropriate for the disclosure team to consist of the principal accounting or financial officer, the general counsel (or principal outside counsel, as appropriate), the head of investor relations, and/or the principal risk manager. However, the disclosure team should not become so large that the group becomes unmanageable. Frequently, well-functioning disclosure teams meet regularly for drafting sessions, both with and without outside advisors. During these meetings, the disclosure team should function principally in a review-and-oversight function.

Follow a regimen for each disclosure

Each disclosure can create potential liability concerns for the company. Therefore, the company should establish and follow a regimen for each type of disclosure. Although that regimen may differ depending on the type of disclosure, no deviations from that defined regimen should occur. The company must craft each of its disclosures with great care.

As part of a good regimen, some companies have developed internal checklists. Some (although certainly not all) of the important items on such a checklist include:

- Is there a reasonable basis in fact for each of the statements made? Has the company documented that basis in its disclosure library?
- Is each statement made in good faith?

- Are the statements consistent with prior statements and internal forecasts?

- Is the level of disclosure made consistent with other disclosures made in the marketplace?

- Are certain statements attributed to persons outside the organization? If so, are consents necessary or advisable?

- Have all internal and external approvals been obtained?

- Does the disclosure implicitly or explicitly impose a duty to update? If so, can that duty be mitigated?

- Does the disclosure properly take full advantage of the protections available under the Private Securities Litigation Reform Act of 1995 (PSLRA)? (See page 17.)

- To the extent the disclosure is made outside of a filing with the SEC, should it be filed with the SEC in a Form 8-K?

- Has the stock exchange (or automated quotation system) on which the stock trades been properly advised of the material event disclosed?

No single checklist can be all-encompassing. However, to the extent one is created, it will generally ensure that a company's internal disclosure regimen is more consistently followed.

Delegate duties, not responsibility

Although companies typically delegate many aspects of the disclosure process to lower management or outside professionals, senior management is responsible for establishing and maintaining disclosure controls and procedures that are designed to ensure that information required to be disclosed is in fact recorded, processed, summarized, and reported on a

timely basis. This includes controls and procedures designed to ensure that information required to be disclosed by the company in the reports that it files with the SEC is accumulated and communicated to the CEO and CFO, or persons performing similar functions, as appropriate to timely allow decisions regarding required disclosure. Ultimately, the effectiveness of these disclosure controls and procedures must be evaluated and certified by these managers. Accordingly, senior management (and, where appropriate, directors) should personally review all securities law filings and disclosure statements to assure themselves that the company has taken reasonable steps to accurately and completely disclose all relevant material information.

Make disclosures detailed

The more specific and detailed a disclosure is, the more likely it will satisfy investors and the courts. Vague or veiled references to negative information invite false expectations by investors and therefore serve little benefit.

Avoid exaggerated disclosures

Disclosure of good news should not be overly touted, and disclosure of negative news should not be downplayed. A company should resist the temptation to maintain or unduly increase investor confidence at the risk of issuing misleading disclosures. Appropriate restraint in disclosing good news and openness in disclosing negative news builds long-term credibility and helps prevent unreasonable expectations.

Use experienced company spokespersons

Communicate disclosures through a relatively small number of clearly identified company spokespersons who are experienced and schooled in disclosure and investor-relations issues. Articulate this policy to all of the company's employees so that they understand how to respond to all inquiries. The more people who are talking on behalf of a company, the greater the chance for inconsistent, inaccurate, or inappropriate company disclosures. Similarly, the chain of command for approval of written or oral

disclosures should be well-defined and relatively short so that decisions can be made quickly if necessary. (See pages 17-22 and 30-42 for further discussion of disclosure issues.)

Listen to internal skeptics

A company's disclosure decision makers should not casually ignore skeptics within the company who warn management of actual or potential problems. Such warnings may be correct. If a culture exists in which people are writing memos designed to cover themselves because management refuses to listen, potential "smoking guns" are created that may become problematic in subsequent litigation.

To the extent possible, all persons involved in the disclosure process should sign off on the final version of the disclosure before it is released. Nevertheless, because it is unrealistic to expect that all issues involving public statements will be resolved without disagreement or debate, the company should formulate, in advance, a process for resolving all such disagreements that relate to significant or fundamental disclosure items. In this manner, the company will proactively foster an environment of open communication and discourage an environment of senior management override (thus vitiating the effectiveness of the disclosure team) by ensuring that all points of view are appropriately evaluated. This procedure could involve submission of certain issues to the audit committee or the entire board of directors, as appropriate.

Educate key people

Company officers, directors, and key employees should be informed about the disclosure obligations of a publicly traded company and their individual roles in those disclosures. As discussed below, this education should also include their personal obligations and limitations with respect to trading in the company's securities.

Monitor disclosure trends

Closely examine the disclosure documents of similarly situated companies to determine how they address common concerns. If other companies are disclosing a certain level of information, an implication may be created that such information is material and should be disclosed by companies like yours.

Focus on providing a steady "progression of disclosure"

A company usually has ample warning that material nonpublic information is developing. Oftentimes, changes to the company's industry, business, financial condition, competitive strength, and other characteristics appropriate for disclosure are foreshadowed to management or develop gradually over time. In these cases, management should provide a steady progression of disclosure that seeks to accurately describe not only the current situation but also the factors that are reasonably expected to have a material impact on the company's operations in the future. Disclosure of this nature will evolve over time and will demonstrate the truly fluid nature of the relevant issues. As part of this process, management may wish to monitor the investment expectations of investors. If company management detects that those expectations are diverging from reality, appropriate corrective disclosure may be appropriate even if such disclosure is not otherwise required. Timely advance disclosure of potentially troubling information or trends, thus resulting in a gradual decline in stock price, makes a company unattractive as a target of shareholder litigation.

Implement document retention policies

A company should maintain, in one readily accessible file, final copies of its press releases, analyst reports, public filings, and relevant news stories so one can always determine what the current mix of public information is with respect to the company. This mix of information should be reviewed periodically to ascertain whether prior company disclosures have become stale, inaccurate, or misleading with the passage of time and whether it is

appropriate for affirmative new disclosures to correct or update those prior disclosures. In addition, backup documents should be retained that evidence the basis for company disclosures and the resolution of disclosure issues that were identified and addressed.

A document control program should define the procedures for retaining documents relating to the corporation and actions of the board, including financial and legal documents, personnel records, and other files of the corporation. Procedures for periodic review of documents to determine retention/destruction should be established to conform with state laws and evidentiary rules.

Retain experienced legal counsel

Securities law compliance presents complex, judgmental, and evolving issues that can result in catastrophic liability exposure if not properly addressed. It is critical that a company retain and follow the advice of independent legal counsel who is highly experienced in this specialized area of the law and who demonstrates the highest standards of integrity. In addition, many companies have concluded that experienced in-house counsel is also necessary to ensure that one person, intimately familiar with the company, is, at all times, monitoring the affairs of the company and the constantly evolving legal requirements, standards, and practices applicable to it. In each case, counsel should be capable of both guiding the company through the securities law minefield and convincing, where necessary, company executives and employees of the advisability of changing their practices and attitudes in order to create a safer securities environment.

THE SARBANES-OXLEY ACT OF 2002

The Sarbanes-Oxley Act was signed into law on July 30, 2002, and is frequently regarded as the most sweeping government reform of corporate America in the post-Great Depression era. While it is true that the details of the Sarbanes-Oxley Act are represented by a complex set of interwoven rules and amendments to a variety of statutes and regulations, the Act does exhibit a unifying focus—making publicly traded companies more transparent and improving the quality of corporate governance generally. The Act seeks to accomplish those aspirational goals both through an additional level of regulatory oversight and through a more global change in basic corporate behavior. Following are some of the more important topics addressed by the mandates of the Act, all of which should be implemented into any sound securities litigation loss prevention program:

- ***Code of ethics.*** A company should disclose in its annual report whether it has adopted a corporate code of ethics for its principal executive, financial, and accounting officers, its controller, or any individual who is performing an equivalent function. In addition, the company should file with the SEC a copy of its code of conduct as an exhibit to its annual report. Subsequent amendments to or waivers of such code should also be disclosed.

- ***Off-balance sheet transactions.*** A company should provide explanations of those off-balance sheet arrangements that are "reasonably likely to have a material current or future effect" on the company and include such disclosure in the Management's Discussion and Analysis of Financial Conditions and Results of Operations (MD&A) section of its annual and quarterly reports (as required by the SEC).

- ***Contractual obligations.*** A company should provide disclosure in its annual and quarterly reports regarding the company's short-term and long-term contractual obligations.

- ***Reconciliation of non-GAAP financial reporting.*** If a company presents financial information on a basis other than in accordance with GAAP, the company should provide the best comparable GAAP treatment of the financial information together with a reconciliation of the two methods of presentation.

- ***Furnishing earnings reports on Form 8-K.*** The Sarbanes-Oxley Act does not require a publicly traded company to issue press releases with earnings information. However, if a company does release this information to the public, then the company should include the text of the release as an exhibit to a Form 8-K.

- ***Prohibition on director and officer loans.*** The Sarbanes-Oxley Act prohibits companies, with certain narrow exceptions, from directly or indirectly extending, maintaining, or arranging for the extension of credit in the form of personal loans to their executive officers and directors. Accordingly, all public companies should establish not only a policy prohibiting such loans, but also a procedure designed to actively search for any transaction that could arguably be construed as falling within its purview.

- ***Requirement for internal control structures and procedures.*** The CEO and CFO are now explicitly required to participate in establishing, maintaining, and assessing the internal control structures and procedures for the company's financial reporting and to certify these matters in the company's quarterly and annual reports. In addition to certification, management must include an "internal control report" in its annual report, and the company's public accounting firm must attest to management's assessment of its internal control structures.

- ***Required participation of management in the reporting process.*** The Sarbanes-Oxley Act requires a company's CEO and CFO to participate in the preparation of the annual and quarterly reports and

to certify that fact and the accuracy of the financial information contained therein.

- ***Trading restrictions during pension fund blackout period.*** Because the Sarbanes-Oxley Act prohibits officers and directors of a company from trading in the company's stock during a pension fund blackout period, a process should be initiated that prevents such inappropriate trades.

- ***Improper coercion of independent accountants.*** Companies should be aware that the Sarbanes-Oxley Act makes it unlawful for a company's officers or directors, or any person acting under their direction, to "fraudulently influence, coerce, manipulate or mislead any public or certified accountant" auditing a company in order to render such financial statements materially misleading. This prohibited activity includes, by way of illustration, pressuring the accountant to issue an inaccurate report, to omit to perform specified audit and review procedures, to fail to withdraw a previously issued report, or to fail to communicate relevant information to the company's audit committee.

- ***Audit committee disclosures.*** A company should disclose in its annual report 1) whether its audit committee has at least one "audit committee financial expert," the name of this expert, and whether he or she is an independent director, or 2) in the event the issuer has no such expert, a statement explaining why not.

- ***Audit committee requirements.*** The Sarbanes-Oxley Act requires that a company's audit committee 1) be composed entirely of "independent" directors, 2) be directly responsible for the appointment, compensation, and oversight of the audit work done by the company's certified public accountant, 3) establish procedures for receiving, processing, and retaining complaints received by the company concerning accounting controls or auditing issues,

4) provide for the confidential, anonymous submission of complaints by the company's employees, 5) be granted the authority to engage independent advisers, such as legal counsel and accounting advisers, to assist the audit committee in meeting its obligations, and 6) be provided the resources to pay its legal and accounting advisors. Accordingly, a company should review the charter for its audit committee to ensure compliance with these requirements.

- ***Internal control over financial reporting.*** Under Section 404 of the Sarbanes-Oxley Act, a company must include in its annual report a management report regarding internal control over financial reporting. The report must contain 1) a statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting, 2) identification of the framework used to evaluate the effectiveness of internal controls, 3) management's assessment of the effectiveness of internal controls, and 4) a statement that the company's auditor has issued an attestation report on management's assessment. The company must maintain documentation to provide reasonable support for management's assessment of the effectiveness of internal controls, and management is not permitted to conclude that the internal controls are effective if there are one or more material weaknesses in the internal controls.

The Sarbanes-Oxley Act also enhances penalties for publicly traded company officers and directors, including:

- Possible new private rights of action.
- Longer statutes of limitations.
- Bars against serving as director or officer of public company.
- Forfeiture of bonus and equity compensation.

- Monetary fines.

- Criminal sanctions and imprisonment.

In addition, the national securities exchanges have heightened the minimum standards of corporate governance required of listed companies. For example, the boards of directors of companies that are listed on the New York Stock Exchange or the Nasdaq Stock Market must 1) be comprised of a majority of "independent" directors, 2) have an audit committee that has a written charter and consists of at least three members, all of whom must be independent, 3) have a nominating/corporate governance committee and a compensation committee, each of which is comprised entirely of independent directors, and 4) permit non-management directors to convene executive sessions without management participation. Failure to comply with these corporate governance requirements can result in additional requirements for listing or even delisting.

A new age of corporate governance is upon us, and its focus is clearly on the individuals who guide America's public companies. This places tremendous pressure on directors and officers to modify their behavior in a positive way and puts them on notice that they will be held accountable for their failings.

FORWARD-LOOKING STATEMENTS

Particularly difficult liability issues arise with respect to disclosure of "forward-looking" or "soft" information such as revenue, earnings, or loss projections; discussions of plans and objectives; and statements of future economic performance. If forward-looking statements prove incorrect, securities holders may claim that the company and its directors and officers illegally misled them. Except in the case of certain types of prospective information required as part of a company's MD&A discussion (discussed further below), the federal securities laws generally impose no obligation upon a company and its directors and officers to disclose forward-looking information. However, in many instances, failure to discuss management's expectations may result in a negative response from the investment community and greater volatility in stock prices because market analysts are poorly informed. Thus, both disclosing and failing to disclose forward-looking information can lead to securities claims against directors and officers. For that reason, a well-conceived policy regarding when and how forward-looking information is disclosed by a company can be an important part of a company's securities litigation loss prevention program.

Both federal case law and the PSLRA provide varying degrees of protection from liability under the antifraud provisions of the federal securities laws for forward-looking statements if the statements are accompanied by sufficient cautionary language. These judicial and statutory defenses seek to lessen the chilling effect that securities litigation has had on the willingness of companies to advise investors of the companies' informed expectations.

Because courts are still defining the scope and effect of the PSLRA provision, and because the judicially created protection (known as the "bespeaks caution" defense) varies significantly among courts, no universal formula yet exists to assure compliance with the elements of this defense. The following procedures, however, should help your company reduce its exposure in connection with forward-looking statements.

Written Statements

Clearly identify the disclosure as a forward-looking statement

The public should be informed that the disclosure is a forward-looking statement and not a statement of actual fact. Simply using verbs like "project," "plan," or "expect" may not be sufficient. Likewise, although it is not uncommon for companies to use a single, "global" statement indicating that everything in the disclosure that is not historical is forward-looking, that also may be insufficient. A specific, express recognition that a particular statement is forward-looking should be included, thereby invoking the appropriate mental discount factor. Various methods exist for accomplishing this. To be effective, the method selected should not leave any doubt that the specific statement is intended to be forward-looking.

Distinguish forward-looking statements from historical fact

Carefully distinguish forward-looking statements from historical facts. For example, a press release stating that the company expects results of the current quarter to equal or exceed those of the preceding quarter should state clearly whether the statement is based on interim operating results for the quarter or is only based on somewhat more vague expectations. If a press release or other disclosure clearly does not contain any forward-looking statements (either explicitly or by implication), a company may wish to eliminate the use of a forward-looking cautionary statement, since the inclusion of such a statement could be used to demonstrate either 1) that the company did not closely tailor the use of such statements to its disclosures or 2) that the company, in fact, intended a forward-looking statement.

Prominently disclose general disclaimer and cautionary statements

Any forward-looking statement should be accompanied by a general disclaimer that actual results may materially differ and that the forward-looking statement may not accurately predict the future depending on various risks and uncertainties. In addition, the general disclaimer and cautionary statement warnings should be prominent and easy for investors

to locate and understand. These warnings, or at least references to the warnings, should appear near each forward-looking statement. Including warnings in one document does not excuse leaving them out in a later document that contains the same forward-looking statement. Further, the general disclaimer should state that the company does not intend to update forward-looking statements.

Include meaningful cautionary statements

The forward-looking statement should be accompanied by specific, substantive cautionary language that identifies important factors that could cause actual results to differ materially from those predicted. Boilerplate warnings are generally not effective and should be avoided. Instead, tailor the cautionary language to the specific forward-looking statement. This should identify specific events, developments, or other factors that may cause the prediction to not be realized. As a guiding principle, the SEC has stated that a risk factor is not sufficiently specific if it could be added to another company's disclosure document with little or no modification. The more specific the cautionary language, the better the chances of avoiding liability.

Disclose the existence, likelihood, and magnitude of risk

The cautionary language should disclose information sufficient to permit an investor to determine not only the existence of various risks, but also the likelihood that the risk factor will occur and the magnitude of potential loss or consequence to the company should it occur. For example, if one identified risk factor is the possible inability to obtain regulatory approval for a new product, the disclosure should include information regarding potential impediments to approval and the likely effect on the company should it be forced to move forward with its current product mix.

Disclose any underlying assumptions

If a forward-looking statement is based on certain assumptions, those assumptions should also be disclosed and analyzed.

Include a cautionary statement even in brief press releases

It may not be practical to include detailed cautionary statements in press releases, especially brief ones. However, every press release should include at least an abbreviated cautionary statement and general disclaimer. Simply referring to another public document that contains a cautionary statement is probably insufficient. Similarly, use of a standard cautionary statement that is not tailored to the specific information in the press release is probably insufficient.

Oral Statements

Identify the disclosure as a forward-looking statement and make a general disclaimer

Like written forward-looking statements, oral forward-looking statements should be identified as such and accompanied by a general disclaimer. For example, a webcast with analysts and others could start with the following introduction:

> "Certain of the matters we will be discussing today [including matters related to potential revenue and earnings growth in future periods, possible product enhancements, and anticipated strategy changes] consist of forward-looking statements. As such, they are subject to the risks and uncertainties that we discuss in detail in our reports filed with the SEC, including our Form ____ for the [quarter/year] ended ______. Actual results may vary materially. In particular, we note that [revenues and earnings are affected by a number of factors, including the effectiveness of our marketing strategy, the product offerings of our competitors...]. Further, [product enhancements are affected by the availability of additional funds for research and development...and whether and to what extent we modify our current strategy is dependent upon such items as the acceptance of current products...]."

In addition to this introductory statement, where possible the speaker should identify each specific forward-looking statement as such and make additional cautionary statements.

Reference the location of detailed cautionary statements

Unlike written forward-looking statements, oral statements can refer the audience to other public documents to describe the meaningful risk factors. The speaker should state that additional information concerning factors that could cause actual results to differ materially from those in the forward-looking statement is contained in a specifically identified written document that is readily available and that sets forth a meaningful cautionary statement as described above.

Avoid unplanned statements

Discussions with the press and analysts should be carefully planned and closely follow information prepared in advance. Executives should resist the temptation to "shoot from the hip" when asked about future events. Many companies find a script (including responses for anticipated questions) to be useful for this purpose. With the SEC's adoption of Regulation FD on selective disclosure (see page 30), it is more important than ever to avoid unplanned oral exchanges that may reveal nonpublic material information.

Do not guess

Oral statements are particularly susceptible to innocent misstatements because of their fluid nature. When in doubt, do not give details and do not guess.

Forward-Looking Statements in MD&A

In 2003, the SEC published interpretive guidance regarding the disclosure commonly known as Management's Discussion and Analysis of Financial Condition and Results of Operations, or "MD&A." Among other items requiring improvement, the SEC observed that public companies must more

clearly identify, discuss, and analyze known trends, events, demands, commitments, and uncertainties that are reasonably likely to have a material effect on future financial condition or operating performance. The SEC warned that "the disclosures required to address known material trends and uncertainties in the [MD&A] should not be confused with optional forward-looking information. Not all forward-looking information falls within the realm of optional disclosure." Specifically, a company is *required* to disclose forward-looking information related to *material known trends and uncertainties* (to be distinguished from *potential trends*). This disclosure must provide enough information so that investors are able to ascertain the likelihood that past performance is indicative of future performance. As an example, if the period-to-period comparison set forth in the MD&A reveals a material decline in sales, it may be necessary to reveal, not only the underlying causes of the decline, but also whether such causes may negatively affect sales in future periods. As with other forward-looking information, care should be taken to ensure that the protections afforded by appropriate cautionary statements are added to all MD&A disclosures.

DEALING WITH ANALYSTS

How to properly deal with securities analysts is one of the most difficult issues under the federal securities laws. No one set of rules is clearly correct or preferred over another. Therefore, a company, working closely with qualified securities counsel, should devote considerable time and thought to a desirable program for the company under the circumstances and then aggressively implement, monitor, and enforce that program.

Here are a number of suggestions to consider in formulating such a program.

Ensure compliance with Regulation FD

Any communication with analysts necessarily implicates Regulation FD, which the SEC adopted in 2000 and which prohibits selective disclosure and mandates "fair disclosure." As a result, every communication with analysts now must be coordinated with, and considered in light of, that regulation. In addition, procedures should be established to determine whether there has been an unintentional disclosure and how to comply with Regulation FD for such a disclosure. (See pages 30-34 for a more detailed discussion of Regulation FD.)

Establish guidelines for reviewing analyst reports

When possible, senior company managers should refuse to review draft reports from analysts in order to avoid any implication that the company has endorsed or adopted the statements therein. If the company feels compelled to review draft reports, it should establish a standardized review process to minimize the risk that the company will be deemed to have adopted the report. Company guidelines regarding the review of draft reports should include the following:

- Limit corrections to historical factual matters that have previously been announced or are clearly immaterial.

- Refuse to review any conclusions, opinions, predictions, or recommendations for their accuracy or consistency with internal information.

- Maintain a record of all corrections or comments made.

- Require that every analyst whose report is reviewed be given, not later than when the company's comments are given to the analyst, a written statement that the company 1) limits its review to factual materials, 2) does not comment on the appropriateness of any conclusions, opinions, predictions, or recommendations, and 3) refuses to allow attribution of any information in the report to the company.

- Do not provide copies of an analyst's report to third parties, and do not link to analysts reports through the company's Internet site (see pages 37-38).

Limit reactions to analyst forecasts

In light of tremendous uncertainty over the extent of liability exposure in this area, the plaintiffs' advantage of hindsight, and the serious risk of selective disclosure, it is safest if, when asked to comment on projections by analysts, the company spokesperson makes a statement substantially as follows: "As a matter of policy, the company does not comment on the projections of others." Similarly, it is generally inappropriate to express "comfort," indicate whether a particular projection is "within the anticipated range," or otherwise react, albeit subtly, to the forecasts of others.

If the company decides it is appropriate to comment on the forecasts of analysts, it should do so only in press releases or other widely disseminated written disclosures and should do so in a manner consistent with the discussion in the preceding chapter regarding forward-looking statements.

Carefully time the company's analyst contacts

Sometimes the mere timing of conversations with analysts can increase the risk of litigation. For example, holding such a conversation shortly before the company discloses material new information creates the possible appearance that the new information was prematurely leaked to the analyst. Therefore, it is best to avoid contact with analysts in periods shortly before major announcements. If any conversations with outsiders do occur during such periods (for example, after approximate quarterly results are known internally, but have not yet been announced), limit those conversations to clear factual information not related to the results or events to be announced, and maintain a detailed record of the matters discussed.

Monitor the content of discussions with analysts

A company should focus any discussions with analysts on information that is already publicly available in SEC filings or press releases. Most companies ensure through SEC filings and press releases that information important to analysts is in the public domain. The company's written disclosures should provide ample material for its oral communications with the investment community. In light of Regulation FD (discussed below), one person should be responsible for analyzing the statements made to determine whether additional disclosure should be broadly disseminated immediately following the discussion.

Use extra care when contemplating an offering

Extreme caution is required whenever a company is contemplating, or in registration for, a public offering. This is particularly true for communications with analysts while an offering is being contemplated, since the timing of such communications may raise strong concerns about improperly conditioning the market for the offering—an activity commonly known as "gun-jumping." The SEC has stated that an issuer may be considered to be "in registration" at least from the time an issuer reaches an understanding with the broker-dealer that is to act as managing underwriter.

In theory, public presentations, interviews, and meetings with analysts that have been planned well in advance of the company's decision to make an offering will generally not raise concerns. Unfortunately, such meetings with analysts are very likely to give rise to questions about the company's capitalization, liquidity, or similar issues that cannot easily be answered adequately without either referring to a planned offering or risking material omission by failing to refer to a planned offering. While the company is "in registration," it should conduct only regularly scheduled discussions with analysts (e.g., regular open telephone conferences concerning quarterly results) and respond to unsolicited inquiries from analysts on factual matters only. All press releases and contacts with analysts while the company is "in registration" should:

- Be consistent with past practices as to the number, scope, and geographic reach of such releases and contacts.

- Avoid any "hype" that might be construed as conditioning the market, especially forecasts of results or opinions concerning values.

Deal effectively with market rumors

The law generally does not require a company to comment on market rumors, regardless of whether they are correct or incorrect, unless they are attributable to the company. Unless the company is the source of a rumor, a consistent "no comment" policy may be best. If the company does comment on market rumors, it must do so truthfully and not on a selective basis. By responding, a company may create a new duty to update or correct information contained in the company's response and may create an implication that subsequent rumors to which the company does not respond are truthful. (Note: "The company knows of no reason for the movement in our common stock price" is NOT the same as "The company does not comment on common stock trading activity." The former statement can imply a duty to update if knowledge does become available.) The principal exchanges will require issuers to respond promptly to rumors in some

instances where the rumor results in heavy market activity. The Nasdaq Stock Market states, "It may also be appropriate, in certain circumstances, to publicly deny false or inaccurate rumors that are likely to have, or have had an effect on the trading in its securities or would likely have an influence on investment decisions."

Establish and observe company spokesperson procedures

Because of the difficulties regarding contacts with analysts, it is wise to establish specific procedures in this area. First, have all inquiries from analysts directed to one person or department; make sure all other personnel know that they are not allowed to discuss material, nonpublic information with anyone. The designated spokesperson(s) obviously should be thoroughly trained in legal issues relating to communications with analysts and should be able to "think on their feet" since many unexpected situations will arise in this area. As a further precaution, limit access to information that is likely to have an effect on trading in company securities (e.g., information concerning earnings, mergers and acquisitions, and changes in dividends) to those with a need to know.

Procedures should be in place to assure that company executives advise the spokesperson of all major developments so that he or she does not unknowingly make false or misleading statements. It is also advisable that the spokesperson adopt a uniform practice, when confronted with a major inquiry, of responding: "Company policy is that we do not respond to such inquiries without internal review. I will attempt to respond to you by [time]." Thus, the spokesperson reserves sufficient time to confirm information internally, formulate a careful response, and determine if a public announcement should be made in advance of further discussion with the analyst. The response time may be hours or days depending on the nature of the inquiry. Such a procedure will only be effective if 1) the policy statement is made consistently and routinely and 2) the response is delayed even if the spokesperson is confident of the response. Otherwise, the very fact of delaying the response will send a signal to the inquirer.

Have the spokesperson join in executive interviews and presentations

Occasionally, an analyst may wish to interview company executives other than the designated company spokesperson. In such instances, it is advisable that the company spokesperson (who is familiar with appropriate procedures in dealing with analysts) participate in those interviews in order to steer the discussion away from any information that should be avoided. This procedure will also assure that the spokesperson is aware of all disclosures made. The executive should be instructed by the spokesperson to pause briefly before answering questions so that the spokesperson can interrupt if necessary to avoid inappropriate disclosures.

For similar reasons, the designated spokesperson should also review drafts of all material prepared by the company for distribution to analysts or for presentations at meetings of analysts.

Keep a record of conversations

Because there may later be disputes about the substance of conversations with analysts, it is advisable to maintain a log of such conversations with notations or internal memoranda about the subjects covered and information conveyed. It is also advisable to keep copies of all disclosures, press articles, and reports by analysts (including transcripts of broadcasts) concerning the company in a set of binders or similar files, so that the information is well-organized and readily available. This will allow management and company spokespersons to be up-to-date and thoroughly familiar with the information that is available to the public.

A company should not distribute or make available to others a transcript of analyst conference calls without adding appropriate cautionary language to it. The oral disclaimer by the company at the beginning of an analyst conference regarding forward-looking statements and the reference to risk factors in SEC filings are sufficient to invoke the PSLRA protections for oral forward-looking statements, but it may be insufficient when applied to written forward-looking statements. Distribution of a transcript (without

more) may convert the oral disclosures to a written disclosure, and thus may eliminate the safe-harbor protection.

Identify the source of any purchased reports

If a company pays an analyst to write a report about it, the report should disclose that fact and the amount of consideration paid by the company, even if the report is distributed directly by the analyst and not the company.

SELECTIVE DISCLOSURE

Selective disclosure is the practice of disclosing information to one or more third parties prior to full dissemination of that information to the marketplace through press releases or other public disclosures. Typically, selective disclosure situations arise when directors and officers discuss corporate information with analysts and institutional investors before the information is released generally to the investing public. In the past, it was common for companies to conduct periodic closed-conference calls with securities analysts to discuss company performance, prospects, and other important information. However, as discussed below, this practice has been largely abolished by Regulation FD.

Regulation FD eliminates selective disclosure by requiring that whenever a company (or certain persons acting on its behalf, including its senior management) discloses material nonpublic information to securities market professionals or holders of the company's securities who could be reasonably expected to trade on that information, the company must:

- simultaneously provide such information to the general public if the disclosure was intentional; and

- promptly provide such information to the general public if the disclosure was unintentional.

Under Regulation FD, generally, information is "material" if there is a substantial likelihood that a reasonable shareholder would consider it important in making an investment decision. The following types of information are frequently considered material (depending on the circumstances) and are therefore subject to Regulation FD:

- Earnings information.

- Mergers, acquisitions, tender offers, or significant changes in assets.

- New products or discoveries, or developments regarding customers or suppliers (e.g., the acquisition or loss of a contract).

- Change in ownership control or in management.

- Changes in auditors or auditor notification that the company may no longer rely on an auditor's report.

- Significant events regarding the company's securities (e.g., defaults on senior securities, calls of securities for redemption, repurchase plans, stock splits or changes in dividends, changes to the rights of investors, or public or private sales of additional securities).

- Bankruptcies or receiverships.

Regulation FD applies to disclosures by a company's senior management, its investor relations professionals, and others who regularly communicate with market professionals and security holders on behalf of the company. In addition, the regulation only applies to disclosures to securities professionals (such as those affiliated with broker-dealers, investment advisors, certain institutional investment managers, investment companies, and hedge funds) and shareholders of the company to the extent it is reasonably foreseeable that such persons will trade on the information. The regulation generally does not apply to communications with the media, with other insiders, or with customers or suppliers in the ordinary course of business. In addition, the regulation expressly excludes communications with the following groups of persons:

- Temporary insiders who owe the company a duty of trust or confidence, such as attorneys, accountants, or investment bankers.

- Any person who expressly agrees to maintain the information in confidence.

- Any entity whose primary business is the issuance of credit ratings, provided the information is disclosed solely for the purpose of developing a credit rating and the company's ratings are publicly available.

For unintentional selective disclosures, Regulation FD states that the "prompt" subsequent disclosure to the general public must occur within 24 hours after the unintentional disclosure or before commencement of the next day's trading on the New York Stock Exchange (NYSE) (whether or not the stock is actually traded on the NYSE), whichever is later. For example, if a senior official discovers an unintentional selective disclosure of material nonpublic information after the close of markets on Friday, the company will have until the beginning of trading on the NYSE on Monday to widely disseminate that information to the general public.

If public dissemination of information is required, the regulation permits public disclosure by issuing a news release, by filing the information with the SEC, or by other methods that are reasonably designed to provide broad public access without excluding members of the public. A Web site posting, without more communication, is unlikely to be sufficient, at least for now.

Importantly, Regulation FD does not provide a private right of action to shareholders or others if it is violated. However, the SEC can bring an administrative, civil, or enforcement action alleging violation of the regulation. In addition, violations of the regulation presumably can be used by plaintiffs in class actions as evidence of the defendants' allegedly manipulative conduct in connection with the disclosure of material information about the company.

As a result of this regulation, companies significantly changed their practices regarding communications with analysts, including analyst conference calls. Now, material information disclosed in those analyst communications must be simultaneously disclosed to the public. The SEC offers the following as a model for companies to follow:

1. Issue a press release, distributed through regular channels, containing the information. If a company is not widely followed, management should also file an SEC Form 8-K to ensure public dissemination.

2. Provide adequate public notice, by a press release and/or Web site posting, of a scheduled conference call to discuss the announced results. Give investors both the time and date of the conference call and instructions on how to access the call.

3. Hold the conference call in an open manner, permitting investors to listen either by telephonic means or through Internet webcasting. The SEC suggests that issuers should consider providing a means of making the information available for "a reasonable period of time" after the meeting. Many companies include a transcript or audio replay of the conference on their Web sites for this purpose.

Finally, senior managers who participate in the conference call should be well-informed regarding the nature and extent of information already disclosed to the public and should not disclose additional material information in the analysts' conference call. Instead, those calls should now limit themselves to explaining the publicly disclosed information and putting it into context, rather than disclosing new material information.

Outside of a violation of Regulation FD, selective disclosure of material nonpublic information can still create liability for the participating directors and officers under several theories, including illegal insider trading and illegal manipulative conduct in connection with the purchase or sale of securities. Little authority currently exists directly addressing liability exposures for selective disclosures. Critical facts that will affect the directors' and officers' potential liability include: to whom the information is selectively disclosed (i.e., whether it is reasonable to assume that the recipient of such information will use it for personal or client gain); what is disclosed (i.e., the materiality of the information and the degree to which it is considered "hard," factual information versus "soft," qualitative

comments); and when the information is disclosed (i.e., the proximity and time between the selective disclosure and the full public disclosure by the company).

INTERNET DISCLOSURES

Like virtually all other aspects of business, the Internet is creating difficult issues in the context of securities law compliance. As information about companies becomes more readily available over the Internet, and as companies use the Internet for investor communications, traditional notions regarding securities law compliance must evolve to better fit this new paradigm. That evolution will likely take years as regulators and courts struggle with appropriate application of the securities laws to cyberspace. In the meantime, companies and their directors and officers must operate in a world of uncertainty, in which they are subjected to potentially catastrophic liability exposure if their behavior is later found in violation of these ill-defined and evolving rules.

The SEC has been active in policing securities violations through use of the Internet. The SEC's Office of Internet Enforcement reportedly has more than 800 enforcement personnel nationwide and more than 120 persons in a "cyberforce" that actively scans the Internet to identify securities violations. As a result of this policing effort and complaints from the public, the SEC has brought numerous Internet-related enforcement actions alleging a variety of securities law violations. These include insider trading based on sharing material nonpublic information among chat room friends, disseminating on the Internet false reports or information (either positive or negative) about a company, and purchasing or selling securities through the Internet without proper registration and disclosure.

Although the SEC's enforcement efforts are significant, as a practical matter the SEC can monitor only a small portion of the myriad communications occurring daily on the Internet. Thus, public users of the Internet (including professional plaintiff lawyers and disgruntled investors) are the most likely source of allegations against a company and its directors and officers for Internet-related securities violations. Stated differently, despite the tremendous size of the Internet, it is reasonably likely that someone will detect a securities violation and cause the filing of either an administrative proceeding or a private lawsuit.

To some extent, Internet securities loss prevention concepts are not new. Companies and their directors and officers should treat any communication through the Internet—whether via a Web page, an on-line forum, emails or otherwise—the same as they would treat "paper" communications. The same caution and traditional loss prevention concepts that companies recognize and frequently follow continue to apply in the Internet context. However, two areas present new and troubling securities exposures and thus demand specialized loss prevention practices: use of the company's Web site and on-line forums, such as chat rooms and message boards.

Web Sites

Web sites present both opportunities and challenges for companies seeking to communicate timely information to, and create positive relationships with, shareholders. The following procedures should minimize a company's risk of securities law violations through use of a Web site.

Distinguish between current and dated information

Unlike press releases, which are generally considered to be current for only a short time period after the release date, a Web site continuously makes information available to investors and others for as long as the information appears on the Web site. Thus, information that has been on the Web site for some time may appear to be fresh information to a shareholder who accesses the information months after its publication. To reduce the risks associated with the continuous publication of stale information on a Web site, a company should follow these practices:

- Include a prominent disclaimer on the Web site stating that various items of information speak as to a specific date of issuance and may become outdated.

- If any press releases are included on the site, all press releases (good and bad) should be included and maintained identically.

- Older information on the Web site should be placed in a separate, clearly identified "archive" section with an appropriate disclaimer that the information is dated and will not be updated. Not all information should be archived, though. For example, a company should permit shareholder access to replays or transcripts of analyst conference calls for only a short period of time after the conference call (e.g., 7-10 days).

- A designated compliance officer should periodically review the entire Web site to ensure that all information remains current and accurate.

- Each section of the Web site should contain an indication of when that section was last updated.

Manage the content

Web site content is often prepared by different company departments, each trying to communicate to a different target audience. All information and statements on the Web site should ultimately be subject to an internal review and approval by a qualified compliance officer to assure that all disclosures included on the site are accurate, complete, and appropriate, much like the pre-approval for any company press release. With respect to information intended primarily for investors, a separate section of the Web site should be developed, so labeled, and carefully monitored for accuracy, completeness, and timeliness. Further, like all communications by the company, management should ensure that the information on the Web site is consistent with the disclosures made in the company's filings with the SEC. No safe harbor exists for puffing, exaggerated claims or inappropriate disclosures simply because the statement is made on the Web site.

Use hyperlinks with caution

By linking to other sources of information, a company's Web site may be deemed to be adopting or endorsing the content of that other information, and thus the company and its directors and officers may become liable for

misrepresentations in those other materials. One safe practice is not to provide links to analyst reports. If the company strongly desires some reference to analyst reports, its Web site could list the names of all analysts known to follow the company, without providing a hyperlink to any analyst's Web site or reports. The analysts should be listed in alphabetical or chronological order in order to avoid the appearance that the company favors any one over others. If links to analysts are deemed necessary, provide the link in an objective fashion without drawing distinctions between favorable and unfavorable reports. Such links should be accompanied by a disclaimer stating that the company does not endorse or adopt third-party statements or forecasts and assumes no responsibility for ensuring that they remain up-to-date and accurate. The disclaimer should be located so that it will be seen before the analyst reports are viewed. Any identification of analysts should also include a prominent link to the company's own risk disclosures, so that the statutory safe harbor applicable to forward-looking statements arguably applies if the company is deemed to have adopted an analyst's report or estimates.

To reduce concerns arising from links to analyst reports, some companies link to "consensus estimates," which are Web sites maintained by outside service providers that compile the estimates of several analysts. Arguably, this practice reduces liability exposure because 1) the estimates revealed are selected by an independent source, 2) no individual estimate is revealed, only a consensus, and 3) shareholders, who demand this type of information, could obtain it easily anyway. However, hyperlinks of this nature still present many of the problems potentially applicable to direct links to analyst reports and therefore should either be avoided or used with the same precautions discussed above.

Avoid "gun-jumping" activities

Companies are prohibited from offering to sell securities before filing a registration statement with the SEC. A company may not prime the market for an impending securities offering by releasing information that alerts the

public to the possibility of a securities offering or otherwise arouse investor interest in a prospective offering ("gun-jumping"). As a result, information contained on a company's Web site and any links to analyst reports and other information must be very carefully controlled while a company is preparing and conducting a securities offering. It is customary for the SEC to review a company's Web site in connection with its review of the registration statement. Although the company may continue its customary disclosure of company news and developments during that time period if the information is unrelated to the offering, it should avoid any statement regarding the company's financial performance or value during this period. Furthermore, to the extent that a company's Web site contains an interactive feature permitting, for instance, customers to pose questions directly to a senior executive of the company, the company should disable this feature until the registration statement becomes effective. Care should be taken to ensure that all company descriptions on the Web site at the time of the first filing of the registration statement closely mirror those contained in the registration statement itself.

Link disclosure to disclaimer

For several reasons, companies should accompany most disclosures with an appropriate disclaimer. For example, disclosures of forward-looking statements should be accompanied by meaningful cautionary statements in order to qualify for the safe harbor under the PSLRA. It is unclear whether a link to a disclaimer page is sufficient for this purpose. Preferably, the disclaimer should appear on the main page of the company's Web site, as well as on any sections of the site that are intended primarily for investors, thus assuring that the investor will see the disclaimer.

Protect oral transcripts

If a company elects to include a transcript of oral statements (such as analyst conference calls) on its Web site, links to appropriate risk disclosures should be included so that the written transcript arguably is accompanied by

appropriate cautionary language for purposes of the statutory safe harbor for forward-looking statements.

Differentiate from other sites

A company should create a design for its Web site that differentiates it from any other Internet site about the company maintained by others. A notice can appear when a user leaves the Web site (by hyperlink or otherwise) thanking the user for visiting the company site and disclaiming responsibility for information in any other site.

Secure the site

A company should implement security protections for its Web site to ensure that information displayed on the site cannot be altered and additional information cannot be included without the company's knowledge and approval. A number of consulting firms now can perform security audits to determine any exposures presented by a company's Web site practices.

Manage investor relations content

The SEC and the stock exchanges now require the posting of certain information on a company's Web site including a copy of the company's code of ethics (and waivers or amendments to it); insider trading and beneficial ownership reports; quarterly, annual, and current reports filed with the SEC; and other matters. Care should be taken to ensure that all required information is organized, accessible, and updated.

On-Line Forums

Chat rooms, bulletin boards, and other on-line forums create potential problems for companies from a securities law standpoint. These sites publish anonymous communications about companies and their securities with no control over the accuracy of the information disclosed. Because the statements made in these forums are anonymous, they are frequently quite critical and frank. Following are several suggestions for minimizing the risk of securities violations associated with these forums.

Do not sponsor or link to forums

A company should not sponsor or host its own on-line interactive forum where discussions of its financial or business performance are permitted, nor should it include on its Web site a link to investor chat rooms or bulletin boards, thereby suggesting that the company endorses or is entangled with those forums and their content.

Refrain from responding to rumors

Because companies are generally not required to respond to rumors in the market, they should usually refrain from responding to cyber gossip in any way. That position should be consistently maintained regardless of the rumor. Otherwise, selective responses may effectively confirm or deny certain rumors.

One exception to this blanket policy would be if a third party widely disseminates false information on the Internet that appears to be issued by or attributable to the company. Because such communications appear to be coming from the company, an immediate disclaimer by the company of the false information is appropriate. In those rare cases where the company feels compelled to respond to Internet rumors (either for business reasons or because it has arguably become entangled with the statement made), it should do so only after widely disseminating a press release and, if necessary, filing a Form 8-K with the SEC.

Discourage employee participation

Any statement made in these forums by a company employee could be viewed as a disclosure by the company. Therefore, companies should implement policies that discourage employees from participating in forums that discuss or reference the company. A message sent from a company's email address or from a person identified as an employee may appear to be a communication on behalf of the company. If an absolute prohibition is culturally unacceptable or impractical to enforce, employees should at a

minimum be given clear guidelines that proscribe discussions of internal corporate matters, company business, client information, or other confidential business information in such forums. Further, employees should always be prohibited from using company computers and identifying themselves as affiliated with the company when participating in these types of forums.

Even if not attributable to the company, participation in these forums by an employee or other insider creates the risk that the employee or insider will either intentionally or unintentionally disclose material nonpublic information in violation of insider-trading laws. Because companies and their directors and officers can be liable for the illegal insider trading of subordinates, companies should redouble their efforts to periodically inform all employees and insiders of insider-trading prohibitions and to implement appropriate compliance procedures.

Monitor the forums

Companies should monitor Internet chat rooms, message boards, and other sites mentioning the company. Certain service companies sell this service to public companies. Only by knowing the nature and severity of the rumors about the company can executives create an appropriate counterstrategy.

DIRECTOR'S OR OFFICER'S PURCHASE OR SALE OF COMPANY SECURITIES

The federal securities laws impose various limitations, restrictions, and reporting obligations on directors, officers, and others regarding their purchase and sale of securities of their own company.

The SEC and courts have substantial powers in sanctioning and imposing penalties for violations of the federal securities laws. Therefore, a critical component of any securities loss prevention program is the establishment of proper policies and procedures to help assure full compliance by directors and officers with these laws. This is particularly important today in light of the increased emphasis being given by institutional investors and others to the perceived value of directors owning a significant amount of stock in their company.

The following discussion summarizes many of the more important laws relating to directors' and officers' purchases and sales of their company's securities, as well as loss prevention practices to minimize the risks relating to those transactions.

Section 16 Issues

Reporting requirements

Section 16 of the Securities Exchange Act of 1934 (1934 Act) generally requires executive officers, directors, and greater-than-10% stockholders of a publicly traded corporation to file certain reports with the SEC, securities exchanges, and their respective corporations disclosing ownership of, and transactions in, the corporation's equity securities. Further, companies are required to disclose, in proxy materials and Form 10-K, the names of officers, directors, and greater-than-10% stockholders who have failed to file required reports on a timely basis. To avoid the need to make such potentially embarrassing disclosures and to avoid liability concerns, it is particularly important that officers and directors understand and comply with SEC reporting requirements. The Sarbanes-Oxley Act modified the

deadline for filing certain of these reports. Specifically, reporting persons are now required to report acquisitions or dispositions in their company's securities generally within two business days following the transaction. Previously, reporting persons had until 10 days following the end of the month in which the acquisition or disposition in the stock occurred.

Disgorgement of profits

In addition to detailed reporting requirements, Section 16 also contains the so-called "short-swing trading" provision, which requires that any profit realized by an executive officer, director, or greater-than-10% stockholder from any purchase-and-sale or sale-and-purchase of any equity security of the company within any period of less than six months must be disgorged to the company. Unlike other provisions in the federal securities laws, intent to take unfair advantage of nonpublic information is not required for recovery under Section 16(b). In other words, transactions in the company's securities within six months of one another can lead to disgorgement of profits on the transaction irrespective of the reasons for or purposes of the transaction.

It is irrelevant for Section 16(b) purposes whether the purchase or the sale comes first. Furthermore, the courts will match the lowest purchase price with the highest sale price. Thus, although the officer or director may have realized an economic loss, he or she may be treated under Section 16(b) as having realized a "profit" for purposes of the disgorgement rules.

Potential profit disgorgement also may apply to transactions in derivative securities. For example, the purchase of a call option on the company's stock and a sale of either the option or shares of the company's stock within six months would be subject to potential profit disgorgement under Section 16(b). Employee stock options that are not properly structured are the most common form of derivative security that can potentially lead to inadvertent violation of Section 16(b).

Most violations of Section 16 are not discovered by the company or the SEC. Instead, Section 16 violations are actively policed by a small group of

plaintiffs' attorneys who actively monitor filings made with the SEC, looking for trades that are not consistent with the rules. In fact, it has been observed by the courts that in many cases the possibility of recovering attorney's fees will provide the sole stimulus for the enforcement of Section 16(b).

Prohibition of short selling

Section 16(c) of the 1934 Act prohibits any short sale or short sale "against the box" of company stock by any officer, director, or greater-than-10% stockholder. A short sale is the sale of stock not owned by the seller or, if owned, not delivered (the so-called short sale "against the box"), which involves the borrowing of shares by the seller's broker for the account of the seller and delivery of the borrowed shares to the buyer. At some point in the future, the short seller must purchase shares to cover the short position. Because the short seller hopes to be able to purchase company stock at a price lower than the price at which the short sale was made, a short seller expects the stock to decline in market value from present levels.

The prohibition against directors and officers engaging in short sales arose out of the inherent and undeniable conflict between a director's or officer's fiduciary duties to company stockholders and his or her personal benefit from a stock price decline. Particularly difficult questions can arise in the application of Section 16(c) to certain derivative security transactions. As a result, directors and officers should avoid trading in call or put options if possible.

Section 16 compliance program

Because of these various requirements, a company should adopt a program to assist executive officers and directors in their compliance with Section 16. This compliance program could include the following components:

- The company should designate one person (typically someone in the Investor Relations or Legal Departments) to act as its compliance

officer for these purposes. The compliance officer should be trained in Section 16 matters by a knowledgeable securities lawyer and should be required to obtain, read, and refer to some of the materials widely available on the topic.

- All executive officers and directors should receive a memorandum summarizing their responsibilities and the applicable prohibitions and requirements under Section 16.

- Each executive officer and director could be required to sign an agreement with the company to report all transactions in the company's shares to the company prior to, or contemporaneously with, any transaction in the company's securities.

- Each executive officer and director could be required to "pre-clear" each transaction involving the company's securities with the compliance officer to ensure adherence to the company's compliance program.

- Each executive officer and director could be required to sign a power of attorney authorizing the company's compliance officer to sign and file, on behalf of the officer or director, the necessary SEC forms.

- A "Short Swing Profit Rule 16(b) Checklist" could be distributed to each executive officer and director, summarizing the relevant facts that should be considered prior to a purchase or sale of company securities by the director or officer and procedures that should be followed after any such transaction.

- Directors and officers could be encouraged to utilize the services of a single knowledgeable broker to assist in helping to prevent inadvertent short-swing profit and filing violations. By utilizing a single broker, the company's compliance officer could more clearly coordinate with that broker to ensure compliance with the company's policies.

- The company could periodically (but regularly) hold a brief executive review session with its directors and officers to go over the various SEC requirements, review any problems that may have arisen, answer common questions, and highlight common pitfalls.

1933 Act Issues

Under the Securities Act of 1933 (1933 Act), directors and most officers (among others) may not sell securities of the company unless the sale is covered by a 1933 Act registration statement or such sale is made pursuant to an exemption from the registration requirement. The usual exemption relied on by directors and officers is Rule 144 under the 1933 Act, which, among other conditions, generally requires that restricted securities acquired other than in the open market must be held for at least one year and any sales of those securities must be made through transactions with broker-dealers. It is important that the broker-dealer through whom or to whom the director or officer is selling securities be informed that the securities are being sold pursuant to Rule 144.

Under Rule 144, a director or officer may not sell during any three-month period more than the greater of a) 1% of the outstanding securities in that class or b) the weekly trading volume of that class of securities during the four calendar weeks preceding the sale (however, the weekly trading volume portion of the calculation is inapplicable to any security listed only on Nasdaq's OTC bulletin board). In addition, if the amount of securities to be sold in reliance upon the Rule during any three-month period involves more than 500 shares or a sales price exceeding $10,000, a Form 144 must be filed with the SEC and the securities exchanges where that class of the company's securities trades.

Directors and officers should be informed in writing of these restrictions and advised that noncompliance may result in personal liability.

Insider-Trading Restrictions

In the course of their employment with the company or its subsidiaries, officers, directors, and employees frequently come into possession of confidential and highly sensitive information concerning the company, its customers and suppliers, or other companies with which the company has contractual relationships or may be negotiating transactions. Much of this information has a potential for affecting the market price of securities issued by the companies involved. Under some circumstances, the federal securities laws impose onerous civil and criminal penalties on persons who improperly obtain or use material nonpublic information in connection with a purchase or sale of securities.

Persons potentially liable for illegal insider trading include not only the insider who actually trades, but also certain persons who, at the time of an insider-trading violation, "directly or indirectly controlled the person who committed such violation," i.e., an employer or superior officer or director. Any "controlling person" may be liable for civil penalties if the controlling person both 1) knew or recklessly disregarded the fact that the employee was likely to engage in a violation and 2) failed to take appropriate steps to prevent that violation before it occurred.

In recent years, the SEC and governmental prosecutors have vigorously enforced the insider-trading laws against both individuals and institutions. Therefore, it is critical that a company and its directors, officers, and employees understand, comply with, and adopt procedures to protect against violations of the insider-trading laws.

Many corporations have responded to the volatile risks associated with insider trading by adopting policies against and instituting compliance programs regarding insider trading. These policies and programs typically educate insiders about applicable legal prohibitions and frequently require the written permission of the company's general counsel before the insider can trade in company securities. For corporations that are larger or feel

particularly vulnerable to the prospects of insider trading, a more aggressive risk management practice could be implemented whereby corporate insiders are permitted to trade in company securities only during certain predetermined "windows" of time throughout the year. Generally, these window periods are timed to occur just following the announcements of quarterly or annual results, at a point when the marketplace has presumably absorbed the recent announcement, but no new nonpublic material developments have occurred. These trading windows can typically be closed by the company's general counsel if it is perceived that other material nonpublic information may exist.

Another potentially significant risk management practice in this area is the establishment of "blind trusts" for corporate insiders, under which an independent trustee implements purchase and sale transactions for the benefit of the insider without any direction or input from the insider. The transaction could be either in accordance with a predetermined schedule or at the discretion of the trustee.

In addition, a director or officer could establish in advance a so-called 10b5-1 plan, which is a written plan pursuant to which automatic purchases or sales of the company's securities will occur at predetermined amounts, prices, or dates. The plan should not permit the director or officer to exercise subsequent influence over how, when, or whether to effect the transactions or to alter or deviate from the plan in any way.

Simply having a written policy against insider trading in many cases will not shield the company or its directors and officers from liability. The SEC will look behind the policy to see how it has been implemented and whether there were any red flags to indicate that the policy was not being enforced or was ineffective on its face to deal with the kinds of situations the company knew or should have known were taking place. In other words, for any adopted policy or program to be effective, it must be broadly disseminated, actively monitored, and aggressively enforced.

Lock-Up Agreement

It is common for the underwriters in a public offering to request that all officers and directors (as well as certain others, including material stockholders) execute a lock-up agreement that restricts such parties from selling or otherwise pledging or transferring any shares of common stock into the market for a specified period—typically 180 days—following the offering date. The lock-up agreement typically applies to all company stock beneficially owned by the directors and officers, including shares acquired in the open market. Directors and officers who execute a lock-up agreement should refrain from any transaction involving the company's securities during the restricted period unless compliance with the terms of the agreement are assured.

CONCLUSION

Despite some encouraging developments in recent years, such as passage of the PSLRA, liability for securities law violations remains the severest exposure a public company executive is likely to encounter. While this booklet discusses some of the steps a company can implement to control its risk of securities litigation, no set of practices and procedures can substitute for an active and aware management team that seeks and follows the advice of experienced legal, financial, technical, and insurance professionals.

ABOUT THE AUTHOR

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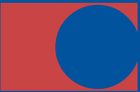

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