January 9, 2006

Exchange Act Reporting Update

As 2006 begins, many reporting companies are beginning the process of preparing and filing their annual reports with the SEC. This client advisory provides updates for reporting companies regarding recent developments for reporting and disclosure obligations under the Securities Exchange Act of 1934.

New Reporting and Disclosure Requirements

Filing Deadlines for Accelerated Filers

In 2002, the SEC adopted an accelerated periodic reporting regime for a new category of issuer, the "accelerated filer," which is defined by Rule 12b-2 under the Exchange Act to refer to an issuer that, as of the end of the fiscal year, meets the following criteria:

- aggregate market value (as of the end of the second quarter) of voting and non-voting common equity held by non-affiliates of the issuer (referred to as "public float") of at least $75 million;
- subject to the reporting requirements of Section 13(a) or 15(d) of the Exchange Act for a period of at least 12 calendar months;
- filed at least one annual report; and
- not eligible to report as a small business issuer.

Under this regime, accelerated filers have been transitioning to shorter filing deadlines and are currently under a 75-day filing deadline for annual reports on Form 10-K and a 40-day filing deadline for quarterly reports on Form 10-Q.

On December 14, 2005, the SEC approved amendments to the accelerated filing deadlines. The amendments create a new category of issuer - the "large accelerated filer" - which will be subject to a 60-day filing deadline for annual reports on Form 10-K and a 40-day filing deadline for quarterly reports on Form 10-Q. A "large accelerated filer" is defined as an accelerated filer with a public float of $700 million or more, as of the last business day of the issuer's most recently completed second fiscal quarter.[1] These new deadlines for large accelerated filers will not apply until fiscal years ending on or after December 15, 2006. Until then, large accelerated filers may file reports within the deadlines currently applicable to accelerated filers. By virtue of the amendments, accelerated filers will continue filing annual and quarterly reports according to the deadlines that are currently applicable (75 days for Forms 10-K and 40 days for Forms 10-Q). Non-accelerated filers will not be affected by the new rules and will still be subject to the longstanding filing deadlines of 90 days for annual reports and 45 days for quarterly reports.

[1] See Rule 12b-2 under the Exchange Act.

The new reporting deadlines are set forth in the following table.

Category of Filer	Deadlines For Reports Beginning with the Annual Report for Fiscal Year Ending On or After December 15, 2005		Deadlines For Reports Beginning with the Annual Report for Fiscal Year Ending On or After December 15, 2006	
	10-K Deadline (Days After Period End)	10-Q Deadline (Days After Period End)	10-K Deadline (Days After Period End)	10-Q Deadline (Days After Period End)
Large Accelerated Filer ($700M public float)	75 days	40 days	60 days	40 days
Accelerated Filer ($75M public float)	75 days	40 days	75 days	40 days
Non-accelerated Filer (less than $75M public float)	90 days	45 days	90 days	45 days

The amendments also add flexibility to the determination of accelerated filer and large accelerated filer status. Now, a filer may exit the accelerated filing system if, as of the last business day of its most recently completed second fiscal quarter, it had less than a $50 million public float. Further, a large accelerated filer may terminate its status as a large accelerated filer and become an accelerated filer if its public float was less than $500 million as of the last business day of its most recently completed second fiscal quarter. This is a significant change from the prior rules, under which an accelerated filer had to be eligible to file reports as a small business issuer in order to terminate its accelerated filer status.[2]

Section 404 Compliance Deadlines

The SEC's rules under Section 404 of the Sarbanes-Oxley Act of 2002 require a management report on internal control over financial reporting in a company's annual report on Form 10-K.[3] In

---

[2] To be eligible to file reports as a small business issuer, a reporting issuer has to meet the following conditions for two consecutive years: (1) have revenues of less than $25 million; (2) be a United States or Canadian issuer; (3) not be an investment company or an asset-backed issuer; (4) if a majority owned subsidiary, be owned by a small business issuer; and (5) have a public float of less than $25 million.

[3] See Item 308 of Regulation S-K. Management's report must contain the following:

- a statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting;
- a statement identifying the framework used by management to evaluate the effectiveness of this internal control; and

(continued…)

order to give issuers time to prepare for this requirement, the SEC implemented a phase-in period in which accelerated filers were required to implement the rules first, to be followed, a year later, by non-accelerated filers. On three separate occasions since its adoption of rules under Section 404, the SEC has extended the compliance dates for the rules, mainly in recognition of the substantial amount of work necessary to achieve initial compliance.

In the most recent change, the SEC continued to extend the compliance deadline for non-accelerated filers and required accelerated filers to comply with the new rules under Section 404 beginning with their first annual report for the fiscal year ending on or after November 15, 2004. Non-accelerated filers (including foreign private issuers that file on Form 20-F) now must first comply with the rules beginning with their first annual report for the fiscal year ending on or after July 15, 2007. This means that a non-accelerated filer with a December 31 year-end will have to comply with the Section 404 requirements for the first time in its Form 10-K for the year ended December 31, 2007.[4]

Implementation and Compliance With SFAS 123

In December 2004, the Financial Accounting Standards Board revised the Statement of Financial Accounting Standards No. 123, Share-Based Payment ("SFAS 123R"), the accounting standard that governs how reporting issuers must account for stock-based compensation.[5] Under SFAS 123R, an issuer must account for share-based payments using the "fair value" method, thus requiring the abandonment of the widely-used "intrinsic value" method of accounting set forth in APB No. 25.

An issuer that is not a small business issuer must comply with SFAS 123R beginning with the first interim or annual reporting period in its first fiscal year beginning after June 15, 2005. Small business issuers will be required to comply with the standard beginning with the first interim or annual reporting period of the issuer's first fiscal year that begins after December 15, 2005. As a result of these compliance dates, any issuer with a December 31 fiscal year-end will have to comply with SFAS 123R in its Form 10-Q for the fiscal quarter ended March 31, 2006. These implementation deadlines were adopted to allow issuers to change accounting systems in the beginning rather than the middle of the fiscal year.

- management's year-end assessment of the effectiveness of this internal control and disclosure regarding any "material weaknesses" in such control; and a statement that the company's auditor has issued an attestation report on management's assessment.

[4] Until non-accelerated filers become subject to the internal control reporting requirements, they may continue to file modified Section 302 certifications with their periodic reports. For such issuers, certifications may omit:

- introductory language in the fourth full paragraph of the certification that refers to the certifying officers' responsibility for establishing and maintaining internal control over financial reporting for the company; and
- paragraph (b) of the fourth full paragraph which covers that the design of internal control over financial reporting by certifying officers.

[5] SFAS 123R superseded Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees." SFAS 123R applies only to share-based compensation; it does not change FASB accounting guidance for share-based payment transactions with parties other than employees. See generally SFAS 123 and Emerging Issues Task Force Issue No. 96-18, "Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services."

The American Jobs Creation Act

Section 6707A of the American Jobs Creation Act of 2004, or "AJCA," amended the Internal Revenue Code to impose a monetary penalty for the failure to include on any tax return or tax statement information regarding certain "reportable transactions." Section 6707A also requires a reporting issuer to disclose penalties owed to the IRS under Section 6707A in its annual report filed with the SEC.[6] This requirement is included only in the Internal Revenue Code and not in any SEC form or rule.

Section 6707A requires that an issuer make this disclosure in the "Legal Proceedings" section of its annual report on Form 10-K or Form 10-KSB. The disclosure must include

- a statement as to whether the issuer has paid the penalty in full;
- the Internal Revenue Code section and subparagraph under which the penalty was determined; and
- a description of the penalty.

An issuer must provide this disclosure in its annual report for the fiscal year in which the IRS sent the issuer notice of and demand for the penalty. If the issuer has paid the penalty prior to receiving the notice and demand for payment, it should provide this disclosure in its Form 10-K or Form 10-KSB for the fiscal year in which payment was made. If the issuer fails to disclose the penalty, it must provide the disclosure in its annual report the following year. The obligation to make the disclosure under Section 6707A(e) carries forward for each successive year until disclosure is made. Significantly, each failure to disclose will lead to the accrual of additional penalties under Section 6707A(e), each of which also must be disclosed.

Changes to Certain Equity Compensation Plans

In October of 2005, the IRS published proposed regulations interpreting the deferred compensation rules in Internal Revenue Code Section 409A.[7] The regulations provide important guidance regarding the application of Section 409A to stock options, stock appreciation rights, restricted stock, and other forms of equity compensation. As companies begin to make changes to their equity compensation plans to comply with these regulations, they may trigger disclosure obligations under the Exchange Act. For the most part, an issuer is not required to disclose changes to its equity compensation plans unless the plan relates to the compensation of a director or a named executive officer, in which case, it likely will be deemed to be an amendment to a material definitive agreement. Any material amendment of a material definitive agreement must be disclosed by filing a current report on Form 8-K with the SEC.

Disclosure of Unresolved Staff Comments

In recently adopted amendments to the rules governing the registration of offers and sales of securities under the Securities Act 1933, the SEC amended Form 10-K to require that certain issuers

---

[6] For a discussion of the penalties imposed by Section 6707A, see Revenue Procedure 2005-51, available at http://www.irs.gov/irb/2005-33_IRB/ar14.html.

[7] Covington & Burling has published a client advisory concerning the proposed Treasury regulations, entitled New Rules for Equity Compensation. Copies of this advisory are available upon request.

disclose material unresolved written SEC staff comments.[8] As a result of these and other amendments, an accelerated filer or a large accelerated filer must describe in its annual report on Form 10-K the substance of any unresolved written staff comments that the issuer believes to be material, if those comments were outstanding for at least 180 days as of the end of the fiscal year and remain outstanding at the time of filing.

New Risk Factor Disclosure Requirements for Periodic Reports

In the Offering Reform Release, the SEC also amended Form 10-K and Form 10 under the Exchange Act to require that an issuer include, "where appropriate," risk factor disclosures. The standard for risk factor disclosure for these filings is the same as it is for a Securities Act registration statement: an issuer must provide a discussion of the most significant factors that would make an investment in the issuer's securities speculative or risky. The SEC also amended Form 10-Q to require that an issuer include in its quarterly reports on Form 10-Q updates to the risks disclosed in its annual report on Form 10-K. As with disclosures in a Securities Act registration statement, these risk factors will have to be provided in plain English. This new disclosure requirement became effective December 1, 2005. Small business issuers are not subject to the risk factor disclosure requirement.

New "Check the Box" Disclosure Requirements

The SEC has adopted several amendments that add new "check the box" disclosures to Exchange Act periodic reports. Since 2002, a reporting issuer has had to evaluate and disclose on the cover of its periodic reports whether it qualifies as an accelerated filer for the purposes of the Exchange Act. Now, in addition to this requirement, an issuer must disclose whether it is a large accelerated filer, a well-known seasoned issuer under Securities Act Rule 405, a shell company as defined by Exchange Act Rule 12b-2 or a voluntary filer. A voluntary filer is an issuer filing periodic reports in spite of the fact that it is not required to do so under the Exchange Act. A typical example of a voluntary filer is an issuer that has completed a registered offering under the Securities Act and continued to file Exchange Act reports even after its reporting obligations have been suspended, for instance, to fulfill contractual arrangements, such as under an indenture.

NASD Interim Reporting Requirements for Foreign Private Issuers

Under current SEC rules, a foreign private issuer is required to file annual reports on Form 20-F no later than six months after the end of its fiscal year. The National Association of Securities Dealers has adopted a new rule requiring semi-annual reporting by Nasdaq-listed foreign private issuers.[9] Effective for interim periods beginning after January 1, 2006, the rule change requires a Nasdaq-listed foreign private issuer to provide, in a press release that would be submitted on Form 6-K, an interim balance sheet and semi-annual income statement no later than six months following the end of the issuer's second fiscal quarter.[10] The information provided in the press release would need to be translated into English but would not have to be reconciled to U.S. GAAP.

---

[8] See *Securities Offering Reform*, Rel. No. 33-8591 (Jul. 19, 2005) ("Offering Reform Release").

[9] See *Order Approving Proposed Rule Change and Amendments Nos. 1 and 2 thereto to Require Semi-Annual Financial Reporting by Foreign Private Issuers*, Rel. No. 34-52192 (Aug. 2, 2005) available at http://www.sec.gov/rules/sro/nasd/34-52192.pdf.

[10] Starting January 1, 2006, the new submission requirement can be found at Nasdaq Marketplace Rules 4350(b)(4) and 4360(b)(2)(C).

Expected Changes in Reporting and Disclosure Requirements

Proposal for Electronic Proxy Materials

Under current SEC interpretations, an issuer must deliver its proxy statement (or information statement), glossy annual report and form of proxy (hereafter collectively referred to as "proxy materials") to shareholders in paper form, unless the issuer obtains affirmative shareholder consent to electronic delivery. Recently, the SEC proposed rule amendments that would eliminate the requirement that an issuer obtain consent before delivering these materials through an Internet website. These amendments would create a "notice and access" model that is predicated on Internet availability of the proxy materials. Under this model, an issuer could post its proxy materials on an Internet website specified in a "Notice of Electronic Proxy Materials" that the issuer would send to its shareholders at least 30 days before the date of the annual or special meeting. This notice could be sent by paper or electronically in accordance with Interpretive Guidance given by the SEC in 2000.[11] The notice would have to contain a legend that advises shareholders of specified information about the meeting and include a clear and impartial description of the matters to be considered at the meeting along with the company's recommendation regarding those matters. The proxy card would have to be accompanied by, and delivered through the same medium as, either the notice or the proxy statement. In order to rely on this notice and access model of delivery, an issuer would have to undertake to provide its shareholders with paper copies of any materials so delivered upon request. Shareholders holding shares through a intermediary would receive the notice and voting instruction form through the intermediary and may request copies of the proxy materials through the intermediary or directly from the company.

Persons soliciting proxies other than the issuer would be able to rely on the proposed "notice and access" model in substantially the same manner as an issuer with the following exceptions. A notice from a person other than the issuer may be sent by the later of 30 days before the meeting or 10 days after the issuer filed its proxy materials. Further, a soliciting person other than the issuer may limit its solicitation to shareholders who are willing to access the soliciting person's proxy materials electronically. In such limited solicitations, the soliciting person would have no obligation to offer to deliver copies of the proxy materials to any shareholder. In addition, unlike an issuer, a soliciting person would not be required to deliver a Notice of Electronic Proxy Materials. Instead, a soliciting person could choose to simply post its proxy materials on an Internet website and direct shareholders to the website through the use of other soliciting materials under Rule 14a-12. The comment period for the proposed rules will end on February 13, 2006.

NYSE Proposes Additional Disclosures Regarding Director Independence

In November 2005, the NYSE submitted to the SEC a proposal to amend the corporate governance listing standards in Section 303A of the NYSE's Listed Company Manual. Among other changes, the proposals would amend the commentary that accompanies Section 303A.02 of the NYSE's Listed Company Manual (although not the independence standards themselves) to provide additional guidance as to required disclosure with respect to a board's determination that a director is independent.

Under the current commentary, a company is required to disclose the "identity of the independent directors and the basis for a board determination that a relationship is not material."

---

[11] See *Use of Electronic Media,* Rel. No. 33-7856 (Apr. 28, 2000).

Further, the current commentary allows a board to create categorical standards of independence and make a general statement that directors meet those standards without detailing particular aspects of the immaterial relationships between individual directors and the company. According to its submission to the SEC, the NYSE believes that disclosure provided by some listed companies in 2005 was not sufficient to allow investors to assess adequately the quality of the board's independence determination where such determination was based on the use of "categorical standards" of independence.

Under the proposed changes to the commentary, with respect to each independent director, a listed company must disclose either that the director has no relationships with the listed company (other than being a director and/or a shareholder of the listed company) or only immaterial relationships with the listed company. If an immaterial relationship exists, the company has two choices for disclosure. It may provide a specific description of such relationship, as well as the basis for the board's determination that such relationship does not preclude an independence determination. Alternatively, a board may determine that certain relationships are categorically immaterial, describe those types of relationships and indicate which directors fall within those categories, without needing to disclose the specifics of any individual immaterial relationship. The revised commentary also will clarify, however, that a listed company may not treat as categorically immaterial any relationship required to be disclosed as a related party transaction or relationship under Item 404 of SEC Regulation S-K.

The NYSE has proposed a number of changes to its listing standards that are in addition to the disclosures regarding director independence. As a result of the changes, the NYSE governance standards would:

- require written notification to the NYSE of any non-compliance (as opposed to just material non-compliance) with NYSE governance standards;
- require that all listed companies maintain publicly-accessible websites;
- require that a listed foreign private issuer disclose on its website the significant differences between its corporate governance practices in its home country and the requirements of the NYSE governance requirements that apply to a U.S. company;
- permit companies to satisfy the requirement that "non-management" directors meet regularly by holding meetings that are limited to "independent" directors;
- provide companies conducting initial public offerings, foreign private issuers becoming U.S. companies, and companies emerging from bankruptcy, a five-day transition period from the date of the status change until commencement of the initial independence requirements applicable to all other listed companies (instead of requiring compliance immediately); and
- require that a listed company disclose any waiver of the code of business conduct and ethics in favor of executive officers or directors within four business days (as opposed to the previous requirement that such disclosures be made within two to three business days).

Proposals to Allow Foreign Private Issuers to Exit the Exchange Act Reporting System

Under current rules, a foreign private issuer that has a class of its securities that is registered under the Exchange Act may terminate its reporting obligations stemming from such registration if that class has fewer than 300 record holders who are U.S. residents. If that issuer previously conducted a registered offering of its securities under the Securities Act, however, it is not be able to terminate its reporting obligations completely, but instead only can suspend its reporting obligations for as long as its number of record holders remains below 300. If the number of its holders rises above 300 in the future, however, the issuer again becomes subject to the reporting obligations of the Exchange Act. As a result of these rules, a foreign private issuer may have to file reports with the SEC in spite of relatively low levels of interest in its securities by U.S. holders and often cannot terminate its reporting obligations permanently.

To make it easier for foreign private issuers to terminate Exchange Act reporting obligations, the SEC recently proposed amendments to the rules under the Exchange Act that govern this process. Under proposed Rule 12h-6, a foreign private issuer would be eligible to terminate its reporting obligations stemming from a class of its equity securities if it has

- not sold, privately or publicly, its securities in the U.S. during the preceding 12 months; and
- for at least the two preceding years:
  - maintained a listing of the class of securities on an exchange in its home country; and
  - filed all required reports, including at least two annual reports, with the SEC.

If eligible, a foreign private issuer would be able to terminate its reporting obligations and Exchange Act registration by filing a Form 15F if it met one of the following criteria:

- U.S. residents hold no more than 5% of the issuer's worldwide public float;
- the class of securities held by fewer than 300 persons on a worldwide basis; or
- the class of securities held by fewer than 300 persons resident in the United States.

In addition to the foregoing benchmarks that apply to all foreign private issuers, a foreign private issuer that qualifies as a well-known seasoned issuer also is eligible to terminate its reporting obligations under the Exchange Act based on its trading volume and share ownership. Such an issuer may terminate its reporting obligations if the U.S. average daily trading volume of its securities has been no greater than 5% of the average daily trading volume of that class of securities in its primary trading market and U.S. residents hold no more than 10% of its worldwide public float.

A foreign private issuer that has reporting obligations stemming from its sale of debt securities under the Securities Act must satisfy fewer conditions to terminate its reporting obligations under Rule 12h-6. Such an issuer may terminate its reporting obligations if it

- has filed all required reports, including at least one annual report, with the SEC; and
- the class of debt securities is either held of record by less than 300 persons on a worldwide basis or less than 300 persons resident in the United States.

The SEC also has proposed to amend Exchange Act Rule 12g3-2(b). Rule 12g3-2(b) exempts a foreign private issuer from registering a class of its securities under the Exchange Act if, among other conditions, it provides to the SEC materials that it files in its principal jurisdiction or trading market (collectively "home country materials"). Under the current rule, an issuer is not eligible to rely on Rule 12g3-2(b) until at least 18 months after its reporting obligations under the Exchange Act have been suspended or terminated. The proposed amendments would permit a foreign private issuer to rely on Rule 12g3-2(b) immediately upon suspending or terminating its Exchange Act reporting obligations. As a condition to such reliance, a foreign private issuer would have to publish in English any home country materials required by Rule 12g3-2(b) on its Internet web site or through an electronic information delivery system that is generally available to the public in its primary trading market.

David B.H. Martin
Keir D. Gumbs
Michael Riella

* * *

If you have any questions concerning the material discussed in this client alert, please contact the following members of our securities practice group:

David Martin	Washington, DC	dmartin@cov.com
Bruce Bennett	New York	bbennett@cov.com
Bruce Deming	San Francisco	bdeming@cov.com
Edward Britton	London	ebritton@cov.com