Members Only

IR Update

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What the SEC has in store for your periodic reports

By Lois Yurow

As you may have read in last month's Update, the SEC's recent "Aircraft Carrier" release contains a comprehensive set of proposals to reform the current system of registering, marketing, and selling securities. But don't think that you can ignore Aircraft Carrier just because your company does not have any near-term plans to go into the market. The Securities and Exchange Commission also hopes to change some filing and content requirements for 8-Ks, 10-Qs, and 10-Ks.

If Aircraft Carrier is adopted, most companies will find it more convenient to issue securities. In contrast, the suggested reforms for periodic reports were written with investors in mind. As Brian Lane, director of the SEC's Division of Corporation Finance, explained at a recent conference sponsored by Glasser LegalWorks, investors rely heavily on 10-Qs and 10-Ks. That makes sense. Unless a company has offered securities recently, its 10-Qs, and maybe even its 10-K, will be more current than the company's most recent prospectus. Under the Aircraft Carrier rules, investors will come to rely on periodic reports even more, because many companies will streamline their prospectuses by incorporating (referring investors to) those documents.

There are four ways that Aircraft Carrier may change the periodic reporting system. The messages to reporting companies are: file sooner, disclose more, write more clearly, and take more responsibility for what you say.

File sooner

Under current law public companies have 90 days from year-end to file a 10-K and 45 days from quarter-end to file a 10-Q. The SEC wants to shorten these deadlines for three reasons.

First, companies apparently do not need so much time to compile their reports. Internal accounting and recordkeeping systems are more efficient than they were when the current deadlines were established,

and so is the filing process. As the Aircraft Carrier release points out, companies commonly announce their earnings well before they file reports containing the same information.

Second, since reporting companies typically generate "core financial data" and other material information weeks before they file, that information can, and probably will, be disclosed to analysts and large investors before it is available to the market generally. Even a company that scrupulously issues a press release before talking to market professionals can be guilty of selective disclosure. The popular media does not pick up every press release, and the services that can disseminate every release verbatim are not freely available to everyone.

Third, if periodic reports are to have any value at all, they must contain current information. These days 10-Qs and 10-Ks are anticlimactic; most of the information they contain is stale at the time of filing.

The SEC is considering two different ways to get information on file in a time frame that is reasonable for issuers but still useful to investors. Formally, the SEC proposes that public companies file selected financial data on a form 8-K on whichever comes earlier: 30 days after the end of each of the company's first three fiscal quarters and 60 days after the end of its fiscal year, or the date the company publicly releases the financial data.

A company that files its entire 10-Q or 10-K within the stated 30- or 60-day time frame would not need to make the supplemental 8-K filing. In fact, as an alternative to a new 8-K requirement, the SEC solicited comments on whether it should simply accelerate the filing deadlines for 10-Qs and 10-Ks.

Aircraft Carrier also includes a proposal to accelerate deadlines for 8-Ks. These "current reports" presently are filed anywhere from five business days to 15 calendar days after the triggering event. Under the proposed rules, companies would have to file anything except financial data in time frames ranging from one business day to five calendar days after the triggering event. Again, the SEC wants to reduce opportunities for selective disclosure and ensure that material information is available to all investors as quickly as practicable.

Disclose more

The SEC hopes to add a significant disclosure item to 10-Ks and 10-Qs, and to expand the list of triggering events for 8-Ks.

The prospectus for a public offering must describe the risks of buying the offered security, but this disclosure may be stale and unhelpful to investors who are trading in the secondary market. According to the

SEC's Brian Lane, these investors need current risk information just as much as those who purchased the securities when first issued. To that end, the SEC wants public companies to describe company risk factors — things that "may have a negative impact on the [company's] future financial performance" — in their 10-Ks, and to update that information in their 10-Qs. Reporting companies that offer new securities can incorporate risk-factor sections from their periodic reports in their prospectuses to avoid repetition.

The proposed rules would expand the list of events that trigger an 8-K filing requirement by five items:

1. Material modifications to the rights of security holders. This category, which currently is not subject to disclosure until a 10-Q is filed, could include events like bylaw amendments or the issuance of a new class of securities.
2. Departure of a chief executive. There currently is no obligation (other than general principles of materiality) to disclose the resignation or termination of a CFO, CEO, COO or president. The proposed rules require a company to state the reason for any such departure and to name the replacement, if one has been chosen.
3. Material defaults. This category, which currently is not subject to disclosure until a 10-Q is filed, is designed so that companies report an event like a default on a sinking fund payment or preferred dividend. However, the text of the proposed rule is broad enough to pick up any material default (in payment or performance) on any material indebtedness.
4. Certain problems with auditors. This new category of information includes cases where auditors tell a reporting company either that it may no longer rely on an audit report or that the auditors will not consent to the use of a prior audit report in a new filing.
5. Company name changes. There currently is no obligation (other than general principles of materiality) to report such changes.

Write more clearly

The SEC recently adopted rules requiring risk-factor sections in offering prospectuses to be drafted in plain English. To be consistent, Aircraft Carrier requires plain English for company risk discussions in 10-Ks and 10-Qs. Moreover, the SEC is soliciting comments on whether it should require plain English generally for periodic reports or at least for those sections that issuers can incorporate in their prospectuses.

Take more responsibility

Aircraft Carrier includes two measures that were designed to make companies devote more attention to their periodic reports. One would increase the amount of a 10-Q that is subject to liability. Under current law, financial information in a 10-Q is not deemed "filed" for

certain purposes. Specifically, disappointed investors cannot use section 18 of the Securities Exchange Act — the section that permits investors to sue over "false or misleading statements" in periodic reports — to sue a reporting company for something that appears in the quarterly financial statements or MD&A. The SEC wants to make that remedy available to investors, in part to highlight the importance of 10-Qs.

A change in the status of financial information from "not filed" to "filed" presents a great topic for securities lawyers to argue about but likely will not be a real concern to many CFOs, who may not even be aware of the filed/not filed distinction. In contrast, the SEC's proposed signature and certification measures will hit home.

Right now the only individual who must personally sign a 10-Q is the principal financial or chief accounting officer. The SEC proposes to require individual signatures from the principal executive officer(s), the principal financial officer and the chief accounting officer, and a majority of the board of directors. This is the same as the list of people who currently sign a 10-K or a registration statement.

Apart from the administrative hassle of collecting all those signatures each quarter, should you worry about this change? The answer is yes. Currently, when officers and directors sign a periodic report, all they represent is that they are authorized to sign. If Aircraft Carrier is adopted, all signatures on a 10-Q or 10-K (and a host of other filed reports) will follow this statement:

"The undersigned certifies that he/she has read this report and to his/her knowledge the report does not contain any material misstatements or material omissions." The SEC hopes that this certification will cause "management [to] take a more active role in . . . disclosure." As you might expect, many boards of directors are less than pleased. Attorneys on the Glasser LegalWorks panel summarized their concerns.

First, the certification is inconsistent with the traditional "oversight" role of a board of directors. State law, specifically the business judgment rule, typically permits a board to rely on experts (such as lawyers and accountants), so long as that reliance is reasonable. Board members are not required to become experts, and many don't have time to do so. Nevertheless, if a majority of the board is required to sign and vouch for the contents of each quarterly report, members may feel obligated to micromanage rather than just supervise.

Second, according to a partner at Gibson, Dunn & Crutcher, unless the SEC expects board members to "investigate" quarterly reports (and gives additional time to perform that investigation), the certification will just add liability without improving information. Even

worse, Peggy Foran of Pfizer Inc. predicts that boards will start requiring legal opinions for periodic reports, which would be expensive and time-consuming.

Brian Lane insists that the SEC does not expect directors to independently confirm the details of each 10-Q or 10-K, but they must read reports in light of their own personal knowledge. As the Aircraft Carrier release makes clear, the SEC wants to put a stop to the practice of directors signing signature pages for documents they have never even seen.

Third, making board members sign and certify 10-Qs is impractical, because they will want to meet to discuss drafts. In particular, members will want to consider whether the report includes all the relevant risk factors if that feature of Aircraft Carrier is adopted. For larger companies with far-flung boards, there isn't enough time to draft a report, get copies to board members and convene a meeting before filing deadlines, especially if those deadlines are accelerated.

Foran suggested that the SEC could achieve its goals in a less burdensome way by beefing up requirements for, and disclosure obligations of, audit committees. In fact, the SEC is venturing into this territory, but in a slightly different way. Aircraft Carrier solicits comments on whether each reporting company should be required to file a report from management to the audit committee disclosing "the procedures . . . established to assure the accuracy and adequacy of [periodic] reports."

Conclusion

Aircraft Carrier is filled with trade-offs. If the entire package of proposed rules is adopted, it will be far easier (and faster and cheaper) for most issuers to offer new securities. However, in exchange for that ease, so long as their securities remain in the market, public companies will bear new burdens.

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