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SEC Year in Review

Significant 1999 Developments

Executive Summary

During 1999, the SEC formalized much of the guidance it had provided in speeches, letters and other forums in previous years. Many of the new rules and proposals were aimed at discouraging "earnings management" and increasing financial statement transparency. Others were geared toward enhancing the corporate governance, facilitating cross-border offerings, and clarifying insider-trading rules.

The staff issued three Staff Accounting Bulletins (SABs). SAB No. 99, "Materiality," provides guidance on assessing materiality and disclosing immaterial, intentional misstatements. SAB No.100, "Restructuring and Impairment Charges," provides guidance on the accounting for, and disclosure of, certain expenses and liabilities commonly associated with restructuring activities and business combinations. It also provides guidance for the recognition and disclosure of asset impairment charges. SAB No. 101, "Revenue Recognition in Financial Statements," summarizes staff views regarding the application of generally accepted accounting principles (GAAP) to revenue recognition.

In late December, in response to recommendations made by the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, the SEC adopted new rules to enhance corporate governance and improve the reliability of financial statements. Several regulations were amended to require companies, including small business issuers, to have their independent auditors review their interim financial statements before filing their Form 10-Q or Form 10-QSB. The amendments also require companies to include information about their audit committees, as well as a report from the audit committee.

The SEC recently pursued several initiatives to facilitate the flow of capital across borders and to support increasing harmonization of disclosure and accounting standards. In September 1999, the SEC adopted new rules to update and simplify its disclosure requirements for foreign private issuers. In February 2000, the SEC issued a concept release seeking feedback on the use of international accounting standards.

In yet another action to address "abusive" earnings management and to make financial statements more transparent, the SEC recently proposed that companies be required to: (1) increase disclosures about changes in valuation and loss accrual accounts, along with the underlying assumptions; and (2) provide more information

about long-lived assets and related accumulated depreciation, depletion, and amortization.

In December, the SEC also proposed three new rules to promote full and fair disclosure of insider information and to strengthen existing prohibitions against insider trading. Regulation FD addresses selective disclosure of material nonpublic information. Rule 10b5-1 would clarify whether insider-trading liability depends on a trader's "use" or "knowing possession" of material nonpublic information. Rule 10b5-2 would specify what types of family or other non-business relationships give rise to insider-trading violations.

Three Staff Accounting Bulletins Issued

SABs often provide the staff's views on specific questions relating to a specified situation. SAB Nos. 99, 100 and 101, however, have broad applicability to most registrants.

SAB No. 99 – Materiality

In his 1998 speech, "The Numbers Game," SEC Chairman Arthur Levitt expressed concern that some companies misuse the concept of materiality to help meet or exceed analysts' consensus earnings estimates. In 1999, the SEC staff issued SAB No. 99, formalizing its views in this area. While the SAB indicates that it is not intended to change current law or professional standards, but bring together in one place all relevant material, certain aspects of it seem to go beyond current practice.

Assessing Materiality – The concept of materiality comprises both qualitative and quantitative factors. The SAB is clear that using purely *quantitative* materiality criteria (e.g., 5% of net income) is not enough. While quantitative criteria may be a good first step, the SAB stresses that registrants must consider all relevant factors when determining if a misstatement is material. Examples of *qualitative* considerations are:

- Whether the misstatement arises from a "hard" (i.e., known) or "soft" (i.e., estimated or projected) error;
- Whether the misstatement masks changes in earnings trends;
- Whether the misstatement hides a failure to meet analysts' consensus estimates and, in that regard, whether even a quantitatively small error might cause a significant stock market reaction based on past patterns of market performance;
- Whether the misstatement changes a loss into income or vice versa;
- Whether the misstatement concerns a reportable segment which is identified as significant to the current and future business;
- Whether the misstatement affects compliance with regulatory requirements, loan covenants or other contractual provisions;
- Whether the misstatement increases management's compensation; and
- Whether the misstatement conceals an unlawful transaction.

The staff assumes that investors would be particularly concerned if management intentionally misstated items, even if immaterial in size, in order to manage earnings to conform to analysts' expectations.

Aggregating and Netting Misstatements – Registrants should consider misstatements individually (i.e., in relation to individual line items, sub-totals and totals) and in the aggregate. Moreover, in evaluating individual line items, misstatements of one line item (e.g., revenues) should not be offset by misstatements of other line items (e.g., G&A expenses). The staff further cautions registrants to exercise particular care when considering the offset of "hard" errors with "soft" errors and to consider the effect of prior period misstatements on the current year, as well as the effect of current misstatements on future financial statements.

Immaterial Intentional Misstatements – These misstatements are not permitted and, in certain circumstances, may be unlawful. Even if misstatements are immaterial, registrants must comply with the 1934 Act requirement to keep books and records that are accurate in "reasonable" detail. Companies should consider the following factors to assess whether that requirement has been met:

- <u>The significance of the misstatement</u> – Clearly inconsequential misstatements can be treated differently from more significant ones.
- <u>How the misstatement arose</u> – Insignificant misstatements from normal processing will not fail the requirement. However, it is unlikely that it is ever reasonable to record misstatements or not to correct known misstatements in order to manage earnings. (This criterion raises the specter of the SEC evaluating management's intent based on hindsight.)
- <u>The cost of correcting the misstatement</u> – The registrant need not spend a lot to correct small misstatements, but it is unlikely that failure to correct when there is little cost will be considered reasonable.
- <u>The clarity of related accounting guidance</u> – Whenever the accounting treatment is clear, the case for leaving a misstatement uncorrected is weaker.

The Auditor's Response to Intentional Misstatements – Because an intentional misstatement may be a violation of the 1934 Act, it may be an illegal act. The auditor must take steps to ensure that the client's audit committee is adequately informed of such illegal acts regardless of whether they have a material effect on the financial statements or are offset by other misstatements. Moreover, intentional misstatements may reflect a reportable condition or material weakness that also should be reported to the audit committee.

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Industry Practice – The SEC staff believes that authoritative accounting literature always takes precedence over industry practices that are contrary to GAAP.

SAB No. 100 -- Restructuring and Impairment Charges

In his "Numbers Game" speech, Chairman Levitt also expressed concern over the growing number of companies using restructuring and asset impairment charges to improperly manage earnings. He promised that the SEC staff would communicate its interpretations as to accounting for and disclosure of such charges. SAB No. 100 does just that. It reiterates the current criteria for restructuring and impairment charges found in Emerging Issues Task Force (EITF) Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs incurred in a Restructuring);" EITF Issue No. 95-3, "Recognition of Liabilities in Connection with a Purchase Business Combination;" and Statement of Financial Accounting Standards No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of" (SFAS No. 121) and provides guidance on how the staff interprets and applies those criteria. Registrants are reminded that costs or charges falling within the scope of these rules *must* be accounted for in accordance with the appropriate standard. Further, the SAB notes that EITF 94-3, EITF 95-3 and SFAS No. 121 *must not* be applied to events or circumstances falling outside their respective scopes.

Restructuring Charges – The term "restructuring charges" is not defined in the existing authoritative literature. These charges often result from the consolidation or relocation of operations, or the disposal or abandonment of productive assets. They also may be incurred in connection with a business combination or a change in a company's strategic plan. Some types of restructuring charges, such as "exit costs" as defined in EITF No. 94-3, must be recognized as liabilities and charged to expense when management commits to a restructuring plan. Other restructuring-type charges must not be recognized until they are actually incurred. The SAB provides examples of: (1) the characteristics needed for an exit plan to qualify as a basis for recognizing a liability for exit costs and involuntary employee termination benefits; and (2) characteristics of exit costs. The plan must be similar in detail to the detail in operating/capital budgets. It also must specify significant actions, include timetables and should generally be attainable within one year. In addition, management must be able to reliably estimate the nature, timing and amount of exit costs.

The SAB also reminds registrants of the income statement presentation of restructuring charges and the disclosure requirements of EITF Nos. 94-3 and 94-5 for the financial statements and Management's Discussion and Analysis. Generally, restructuring charges do not qualify for treatment as a discontinued operation.

Impairment Charges – Standards for recognizing and measuring impairment of long-lived assets, certain identifiable intangibles, and goodwill related to those assets held and used are found in SFAS No. 121, along with rules for the accounting for assets to be disposed of. The SAB provides examples of assets meeting the definition of "to be disposed of." The SAB also provides guidance on "enterprise level goodwill" (goodwill that is not specifically identified with impaired assets), which is not covered by that SFAS, but rather by Accounting Principles Board Opinion No. 17, "Intangible Assets" (APB No. 17). Currently, three general methodologies have evolved under APB No. 17 for measuring impairment of enterprise goodwill: (1) market value; (2) undiscounted cash flows; and (3) discounted cash flows. The SAB provides the staff's views about applying these methodologies and the required disclosures. It states that, when there is a change in the method used to assess the carrying value of goodwill, the SEC will require a preferability letter from the company's auditors.

The SAB also reminds registrants that depreciable lives, amortization periods, and salvage values of long-lived assets need to be reviewed, and, where appropriate, changed on a timely basis. In the staff's view, recognition of an impairment charge is not an acceptable substitute for choosing the appropriate amortization or depreciation period, or subsequently adjusting the period as company or industry conditions change.

Certain Liabilities and Other Loss Accruals – Finally, the SAB provides guidance regarding the measurement of liabilities and other loss accruals assumed in a purchase business combination. APB No. 16, "Business Combinations," requires that liabilities assumed in a business purchase be recorded in the purchase price allocation at fair value. Although there could be differences between the fair value to the acquirer and historical cost to the acquiree, the staff believes that the differences generally should not be material to the financial statements if the seller's liabilities were properly estimated in accordance with GAAP. The staff cautions that a seller's erroneous application of GAAP should not be corrected through purchase price allocations.

SAB No. 101 – Revenue Recognition in Financial Statements

This SAB recaps the staff's views regarding the application of GAAP to revenue recognition. It was issued, in part, due to the large number of revenue recognition issues faced by registrants. In 1999, for example, a report sponsored by the Committee of Sponsoring Organizations of the Treadway Commission, "Fraudulent Financial Reporting: 1987-1997, An Analysis of U.S. Public Companies," indicated

that over half of financial reporting frauds in the study involved overstating revenues.

Current accounting literature on revenue recognition includes broad conceptual discussions as well as specific guidance for certain industries such as real estate, cable television and franchising. If a transaction is within the scope of specific authoritative literature that provides revenue recognition guidance, the staff reminds registrants that the literature should be applied. In the absence of authoritative literature addressing specific arrangements or a specific industry, the staff will consider existing authoritative literature, as well as the recognition criteria set forth in the FASB conceptual framework. Under the framework, revenue should not be recognized until it is realized or realizable and the earnings process is substantially complete. The staff believes that revenue generally is realized or realizable and earned when all of the following criteria are met:

- Persuasive evidence of an arrangement exists.
- Delivery has occurred or services have been rendered.
- Collectibility is reasonably assured.
- Seller's price to the buyer is fixed or determinable.

The SAB also provides examples of evidence that suggest that revenue recognition has not occurred, including:

- The buyer has the right to return and:
  - Does not pay or is not obligated to pay until a later date
  - Does not pay and is not obligated to pay until product is resold or consumed
  - Has no risk of theft or physical damage
  - Has no economic substance apart from seller
  - Seller is committed to additional performance
- Seller is obligated to repurchase, and:
  - Interest-free or below-market financing is provided;
  - Seller pays buyer's interest costs
  - Seller's practice includes refunds for buyer's interest expense
- The seller has guaranteed a minimum resale value.
- The product was delivered for demonstration purposes only.

The SAB discusses criteria for revenue recognition when goods are not yet delivered (bill and hold transactions). The following conditions must have occurred for revenue to be recognized:

- The risks of ownership have passed to the buyer.
- A fixed commitment, preferably in writing, by the buyer exists.
- The buyer has a substantial business purpose for requesting the seller to hold the goods.
- No additional performance is required of the seller.
- The seller physically segregates the goods and holds only for the buyer.
- The goods are complete and ready for shipment.

In addition to the above, registrants also should consider:

- The date by which the seller expects payment and if the normal terms were modified;
- The seller's past experience with bill and hold transactions;
- Whether the buyer bears the risk of loss based on a decline in market value of the goods;
- If the seller's custodial risks are insurable and insured; and
- Whether the business reasons for the bill and hold introduced a contingency in the buyer's commitment.

The SAB reminds registrants to review transactions with non-refundable, up-front fees very carefully to determine the appropriate revenue recognition. Only if the up-front fee is in exchange for products delivered or services performed would it represent the culmination of a separate earnings process. Fees received for services to be performed over a period of time generally should be recognized on a straight-line basis over the life of the arrangement.

The SAB also discusses when an Internet company should record its sales of products and cost of sales on a gross basis rather than as a commission on a net basis, and how retail companies should display sales of leased or licensed departments.

- Generally, revenue cannot be reported "gross" in the income statement unless the seller:
  - Acts as a principal in the transaction;
  - Takes title to the products; and
  - Has risks and rewards of ownership.
- Revenue should be reported "net" when:
  - The above criteria are not met for gross presentation; or
  - The seller only acts as an agent or broker.

Finally, the SAB provides guidance on disclosures that registrants should make about their revenue recognition policies and the impact of events and trends on revenue.

Registrants may need to change their accounting policies to comply with the SAB. The staff will not require retroactive restatement of prior period financial statements so long as the registrant's former policy was not an improper application of GAAP and the registrant adopts a change in accounting principle to comply with the SAB, no later than the first fiscal quarter of the fiscal year beginning after December 15, 1999.

SAB No. 101 and other recent SABs can be obtained on the SEC Web site at http://www.sec.gov.

Responsibilities of Audit Committees Expanded

In September 1998, the SEC, the New York Stock Exchange and the National Association of Securities Dealers sponsored a "blue-ribbon"

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panel to study how to increase the effectiveness of audit committees in overseeing the corporate financial reporting process. In 1999, the panel issued its 10 recommendations to improve the effectiveness of corporate audit committees. In response, the SEC amended several rules and regulations to:

- Require the independent auditors to review the financial information included in the company's Form 10-Q or 10-QSB prior to filing with the SEC;
- Require all companies (except small business issuers), regardless of size or public float, to provide at year-end a footnote containing quarterly information and a reconciliation and description of any adjustments made to quarterly information previously reported in a Form 10-Q;
- Require that proxy statements include a report of the company's audit committee stating that the audit committee has: (1) reviewed and discussed the audited financial statements with management; (2) discussed with the auditors matters required to be discussed under SAS 61 and SAS 90; and (3) received from the auditors disclosures regarding the auditors' independence;
- Require the report of the audit committee to include a statement by the audit committee, whether, based on the review and discussions noted above, the audit committee recommended to the Board of Directors that the audited financial statements be included in the company's Form 10-K or 10KSB;
- Require companies to disclose in their proxy statements whether the audit committee has a written charter, and to file a copy of their charter at least every three years;
- Require companies whose securities are listed on the NYSE or AMEX or are quoted on NASDAQ to disclose in their proxy statements information concerning the independence of audit committee members; and
- Provide "safe harbor" for the new proxy statement disclosures to protect companies and their directors.

In general, the effective dates of the new rules are as follows:

- Quarterly financial statements are required to be reviewed for all fiscal quarters ending after March 15, 2000.
- New proxy disclosures are required for proxies and information statements relating to votes of shareholders occurring after December 15, 2000.
- Quarterly information is required to be included in annual filings made after December 15, 2000.
- For companies listed as of December 14, 1999, changes to stock exchange rules are effective:
  - as of June 14, 2000 for adopting a formal written audit committee charter; and
  - as of June 14, 2001 for meeting the audit committee structure and membership requirements.

For more detailed coverage of the new rules, see our March 2000 Financial Reporting newsletter, "New Audit Committee Rules."

Staff Legal Bulletins

The staff continued to issue Staff Legal Bulletins (SLBs) in 1999 to clarify or interpret rules and regulations.

SLB 7, "Plain English Disclosure," was issued by the staff of the Division of Corporation Finance in September 1998 to answer commonly asked questions about the plain English rules. In 1999, it was updated to eliminate questions and answers that applied to the phase-in period and to provide new guidance on when the plain English rules apply to Form S-3 post-effective amendments. These rules, which became effective October 1, 1998, require registrants to write certain sections of a prospectus (summary, risk factors, front and back cover) in plain English. In addition, registrants must use clear, concise, and understandable language throughout the rest of the document. According to the updated guidance, a registrant must rewrite a post-effective amendment to a Form S-3 in plain English if: (1) it incorporates by reference audited financial statements that are more recent than those incorporated in any earlier post-effective amendment or the original registration statement; or (2) it is required to be post-effectively amended under Section 10(a)(3) of the Securities Act.

"A Plain English Handbook – How to Create Clear SEC Disclosure Documents" is available at the SEC Web site at http://www.sec.gov.

SLB 9 was issued by the staff of the SEC Division of Market Regulation to answer questions raised about various provisions of Regulation M, which became effective in March 1997. It continues the anti-manipulation objectives of the trading practice rules but eases regulatory burdens on offering participants.

EDGAR Modernization

During 1999, the SEC took steps to modernize its Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system in order to make the system easier to use and more attractive to users. The SEC will now accept filings submitted to EDGAR in HyperText Markup Language (HTML), in addition to documents submitted in American Standard Code for Information Interchange (ASCII) format. Filers also have the option of accompanying their required filings with unofficial copies in Portable Document Format (PDF) which can include graphics, varied fonts and other visual displays.

The SEC also adopted an updated EDGAR Filer Manual that describes technical formatting requirements. Filers must comply with the provisions of the manual to assure timely acceptance of and processing of their filings. It is

available at the SEC Web site at http://www.sec.gov/asec/ofis/filerman.htm.

International Accounting and Disclosure Standards

The SEC pursued several initiatives to facilitate the flow of capital across borders and to support increasing harmonization of disclosure and accounting standards. In September 1999, the SEC adopted new rules to update and simplify its disclosure requirements for foreign private issuers. In February 2000, the SEC issued a concept release seeking feedback on the use of international accounting standards.

New Disclosure Standards Adopted

The new rules conform to the international disclosure standards endorsed by the International Organization of Securities Commissions in 1998. They will enable issuers to prepare one basic disclosure document that will be accepted in many jurisdictions and replace most of the non-financial statement disclosure requirements of Form 20-F. The SEC also made changes to the registration statements used by foreign private issuers under the Securities Act of 1933 to incorporate the changes in Form 20-F and revise the definition of "foreign private issuer" to clarify how foreign companies should determine whether their shareholders are U.S. residents. The amendments do not change the financial statement reconciliation requirement for foreign private issuers, nor do they eliminate the disclosure requirements for topics not covered by the international disclosure standards, such as market risk. The changes to Form 20-F, the Securities Act registration forms and the "foreign private issuer" definition, become effective for fiscal years ending on or after September 30, 2000. Foreign registrants are encouraged to use the new forms before that date.

Specific changes to registration and report forms – Form 20-F is used by foreign private issuers as an initial registration statement and as an annual report form under the Exchange Act. The amendments to Form 20-F replace prior items 1-14 (excluding Item 9A, Quantitative and Qualitative Disclosures about Market Risk) with ten new items:

1. Identity of Directors, Senior Management and Advisors
2. Offer Statistics and Expected Timetable
3. Key Information
4. Information on the Company
5. Operating and Financial Review and Prospects
6. Directors, Senior Management and Employees
7. Major Shareholders and Related Party Transactions
8. Financial Information
9. The Offering and Listing
10. Additional Information

Item 9A has been renumbered as Item 11. The items previously designated as Item 15, Defaults Upon Senior Securities, and Item 16, Changes in Securities and Changes in Security for Registered Securities, also have been retained and renumbered as Items 12 and 13.

Elimination of Rule 3-19 of Regulation S-X – The SEC replaced Rule 3-19 which specifies the content, age and other requirements for financial statements of foreign private issuers with new Item 8 of Form 20-F. The only substantive change relates to the age of financial statements. Item 8 of Form 20-F requires that audited financial statements be no older than 15 months at the effective date of the registration statement, instead of the 18 months allowed under Rule 3-19. In the case of the issuer's initial public offering in the United States, the audited financial statements also must be no older than 12 months at the time the offering document is filed, unless the foreign private issuer is already public in its home country. Item 8 further requires interim financial statements, including U.S. GAAP information, covering at least six months of the issuer's fiscal year, if the date of the registration statement is more than nine months after the end of the issuer's last fiscal year. The interim information may be unaudited.

Definition of "Foreign Private Issuer" – The definition of foreign private issuer (Rule 405 under the Securities Act and Rule 3b-4 under the Exchange Act) determines an issuer's eligibility to use certain SEC forms and to benefit from certain concessions under the SEC rules. Changes to the definition clarify how issuers should calculate their U.S. ownership for purposes of the definition. To qualify as a foreign private issuer, no more than 50 percent of the outstanding voting securities can be owned directly or indirectly by residents of the United States. The amendments change the test from a record ownership test to one that more closely reflects the beneficial ownership of the issuer's securities.

Feedback Sought on Use of International Accounting Standards

The SEC is considering whether it should accept financial statements of foreign private issuers prepared using standards promulgated by the International Accounting Standards Committee (IASC) without reconciliation to U.S. GAAP. Under current SEC regulations, financial statement requirements for foreign private issuers are similar to those for domestic issuers, except that a foreign private issuer may prepare its financial statements in accordance with U.S. GAAP or with another comprehensive basis of accounting (including standards promulgated by the IASC). A foreign private issuer using accounting standards other than U.S. GAAP, however, must provide an audited reconciliation to U.S. GAAP, except that certain International Accounting Standards (IAS) may be used without reconciliation to U.S. GAAP (e.g., IAS 7, "Cash Flow Statements," IAS 22, "Business Combinations," and IAS 21, "The Effects of Changes in

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Foreign Exchange Rates.")

Before modifying its current requirement for all financial statements to be reconciled to U.S. GAAP, the SEC is soliciting comments from domestic and foreign parties regarding IASC standards and the infrastructure necessary for supporting IASC reporting. The concept release poses 26 questions that concentrate on three major areas: (1) the quality of IASC standards; (2) whether modification of the current reconciliation requirements would put domestic registrants at a competitive disadvantage to foreign issuers; and (3) the experience of auditors, preparers and regulators with IASC standards. The release is available at the SEC Web site at http://www.sec.gov/rules/concept/34-42430.htm. The comment period ends May 23, 2000.

Proposed New Rules on Supplementary Information

In yet another action to address "abusive" earnings management and to make financial statements more transparent, the SEC recently proposed that companies be required: (1) to increase disclosures about changes in valuation and loss accrual accounts along with the underlying assumptions and (2) to provide more information about long-lived assets and related accumulated depreciation, depletion, and amortization. The comment period for the proposal ends April 17, 2000.

The proposed rules would create a new Item 302 (c) of Regulation S-K to clarify, expand and reposition the disclosures required under Rule 12-09 of Regulation S-X about activities in a registrant's valuation and reserve accounts. Currently, registrants must provide a schedule (Schedule II) showing beginning and ending account balances as well as activity, including any adjustments, during the year for individually significant valuation and qualifying accounts and reserves. The SEC noted that compliance with the schedule requirements is mixed, possibly due to a lack of understanding as to what constitutes a valuation or reserve account. The proposed rule replaces the term "reserve account" with the term "loss accrual" and provides a list of commonly reported loss accrual or valuation accounts. It requires registrants to provide, for each period for which an audited income statement is presented, a detailed narrative discussion about assumptions underlying the recognition of a valuation or loss accrual account along with the nature of any changes in those assumptions that require adjustments to the financial statements. The SEC believes that the free-writing style permitted by Regulation S-K encourages registrants to better communicate the financial reporting effects of changes in facts and circumstances.

The proposal also would add a new item 302(d) to Regulation S-K to reinstate disclosures about property, plant and equipment previously disclosed under Rules 12-06 and 12-07 of Regulation S-X and to add a requirement to disclose information about salvage value. Rules 12-06 and 12-07 required schedules of the activity in specific fixed asset accounts. They were rescinded in 1994 and, since that time, financial statement users have complained about the inability to recreate the detailed information formerly presented in the schedules. Under Item 302(d), registrants would be required to provide information concerning property, plant, and equipment, and related accumulated depreciation, depletion, and amortization, as well as information about intangible assets. Additional disclosures about goodwill also would be required. When goodwill from different business acquisitions has varying useful lives, registrants would be required to disclose the amount of total goodwill as well as the balance of each component assigned a different useful life.

Revision to Rule 504 of Regulation D

Recent fraudulent transactions in the over-the-counter markets of "microcap" companies have involved freely tradable securities issued in Rule 504 transactions. To curb these abuses, the SEC amended Rule 504 in April 1999. Rule 504 originally was designed to aid small businesses in obtaining seed capital. It allows non-reporting companies to offer and sell up to $1 million in stock in a 12-month period to an unlimited number of persons without regard to their sophistication. The stock is not required to be registered with the SEC, but may need to be registered with the state(s) in which it is offered for sale. Prior to the amendment, general solicitation and advertising were permitted, and the stock was immediately available for resale by unaffiliated parties not acting as underwriters. Under the amended rule, stock issued under the registration exemption will be "restricted" and issuers are prohibited from general solicitation and advertising unless: (1) the transactions are registered under a state law requiring public filing and delivery of a disclosure document before sale or (2) the securities are issued under a state law exemption that permits general solicitation and general advertising so long as sales are made only to "accredited investors."

"Aircraft Carrier" Proposal

In 1998, the Commission issued its long awaited proposal to overhaul the current registration system. Dubbed the "Aircraft Carrier" proposal based on its size, it would substantially change the registration and periodic reporting processes. The public comment period ended in June 1999, and no final rules or proposals have yet been issued. Although the SEC no longer expects to completely

overhaul the system with one broad initiative, some of the proposals will be developed into new rules and regulations on a project-by-project basis.

New Rules Proposed on Selective Disclosures and Insider Trading

In December 1999, the SEC proposed three new rules to promote full and fair disclosure of insider-trading information and to strengthen existing prohibitions against insider trading. Comments are due by March 29, 2000. The initiative was triggered by reports of company officials making selective disclosures to analysts and institutional investors without making similar disclosures to other investors. Currently, registrants must report specified information on a regular basis in periodic reports such as Forms 10-K and 10-Q. They also must report some types of events on Form 8-K soon after they occur. Absent a specific duty to disclose, however, the securities laws do not require companies to publicly disclose all material events as soon as they occur. Thus, registrants retain control over the audience for some important disclosures such as quarterly earnings or sales figures. Although selective disclosure is not a new practice, the impact appears to be much greater in today's more volatile, earnings-sensitive markets. Highlights of the proposed rules follow:

- Regulation FD addresses selective disclosure of material nonpublic information. It would not require pubic companies to disclose all material developments when they occur. Rather, it would require issuers intentionally disclosing material nonpublic information to do so through public disclosure rather than selective disclosure. Further, whenever an issuer learns that it has made a non-intentional material selective disclosure, regulation would require the issuer to promptly disclose the information publicly.
- Rule 10b5-1 would clarify whether insider-trading liability depends on a trader's "use" or "knowing possession" of material nonpublic information. Under the proposed rule, insider-trading liability generally would arise when a person trades while "aware" of material nonpublic information unless the trade resulted from a pre-existing plan.
- Rule 10b5-2 would specify what types of family or other non-business relationships can give rise to liability under the misappropriation theory of insider trading.

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