



ZAG/S&W CORPORATE ADVISORY

What Public Companies Need to Know About This Year's Annual Reports and Proxy Statements – *2006-07 Edition!*

Each year, we provide a summary regarding the latest SEC and stock exchange rule changes impacting annual reporting obligations for public companies.¹ While this year's changes are primarily driven by the SEC's new executive compensation disclosure rules, there have been a few other notable new rules and several proposals that will impact upcoming annual reports on Forms 10-K and 20-F or annual proxy statements. This advisory presents some of the key issues² that clients should consider while preparing annual disclosure documents for fiscal years ending on or after December 31, 2006.

NEW RULES AND CHANGES

Executive Compensation and Related Person Transaction Disclosure. In response to an increasing outcry over exorbitant pay and severance packages for public company executives, in August 2006 the SEC finalized an overhaul to the disclosures about executive and director compensation, related person transactions and other corporate governance matters required in 10-Ks and proxy statements. The new "Compensation Discussion and Analysis" and compensation tables and related narratives in particular will require significant effort and advance planning by companies and their advisors. In addition, the expansion of the definitions of "related person" and "transaction" combined with the SEC's focus on "principles based" disclosure will likely lead to challenging disclosure decisions. For more information about these items, please see our September 2006 advisory: "[SEC Adopts Sweeping Reforms to Executive Compensation Disclosure](#)." Although the bulk of the new rules relates directly to disclosures about compensation practices and policies, many less obvious changes to the annual reporting process are also included, such as moving the stock performance graph from the proxy statement to the annual report, requiring additional information about independent directors' relationships with companies and adding disclosure of pledged shares by insiders. In addition, due to some of the new disclosures required, companies will need to consider adopting policies covering approval of related person transactions, option granting practices and other compensation policies, as well as carefully review existing board committee charters and guidelines to address the new rules. To capture many of the new rules and their nuances, companies may

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further need to make adjustments to their disclosure controls and procedures and annual director and officer questionnaires.

Accelerated 10-K Deadlines for Largest Companies. Last year, the filing deadline for "accelerated filers"³ for 10-Ks was reduced to 75 days after the end of the relevant year. This year, "large accelerated filers'" 10-K deadline will be further reduced to 60 days (March 1), though last year's deadlines for other filers remain the same.

Nasdaq Changes. During 2006, Nasdaq converted into a stock exchange. For listed companies, this change in status has resulted in a few practical changes, most notably in the names used to refer to companies' listings. Companies formerly listed on the Nasdaq National Market are now either on the Nasdaq Global Market (NasdaqGM) or the more elite Nasdaq Global Select Market (NasdaqGS) and should use the applicable updated name in all filings and communications.

In addition, in connection with the conversion to exchange status, Nasdaq listed companies' securities that were formerly registered under Section 12(g) under the Securities Exchange Act of 1934 were automatically transferred to registration under Section 12(b), a distinction that shows up in annual reporting on the cover page of 10-Ks. This designation as an exchange also has a practical impact on reporting of historical stock prices. Price data in 10-Ks and other filings for exchanges is based on high and low sales prices, which differs from high and low bid information used for other markets.

At the time of the conversion to an exchange, Nasdaq also made some minor changes to its definitions for independent director. Generally these clarify some of the independence criteria rather than make substantive changes, but listed companies should nonetheless confirm that their independent directors meet the standards as currently worded.

New York Stock Exchange Changes. NYSE has replaced its rules requiring mailing of annual financial statements with a requirement that a listed company's audited financial statements (which can be through the 10-K) be made available on or by a link through its website. The link or posting must have a prominent legend undertaking to deliver a paper copy upon request

free of charge. NYSE-listed companies will also have to issue a press release stating that the annual report has been filed with the SEC and specifying the company's website address. The revised NYSE rules eliminate NYSE requirements regulating deadlines for annual reports, notices of late annual reports, content of annual reports and financial statements and distribution of annual reports - essentially NYSE now leaves this to SEC rules and requires listed companies to meet SEC deadlines. The rules further eliminate a requirement to send copies of the annual report to NYSE, though informally NYSE has indicated that they would still like copies. Lastly, the new rules require listed companies to have and maintain a website.

NYSE has also updated its form, available on NYSE's website, to be used by listed companies to annually certify their compliance with NYSE's corporate governance listing standards.

Internal Control Over Financial Reporting. Under Section 404 of the Sarbanes-Oxley Act of 2002, accelerated filers have to file with their 10-Ks management reports, audit reports and CEO and CFO certifications relating to the effectiveness of their internal control over financial reporting.

For non-accelerated filers, the deadline for compliance with these requirements was recently extended such that non-accelerated filers need not comply with these rules until their first fiscal year ending after December 15, 2007 for management's report and after December 15, 2008 for audit reports on internal controls.⁴ The SEC has also proposed to eliminate, for all companies, the current requirement for an audit report on management's report separate from the direct audit report on the internal controls themselves.

As a response to the many criticisms of the costs and burdens caused by the SEC's rules under Section 404 of the Sarbanes-Oxley Act, in addition to the extensions for non-accelerated filers and new transition rules for IPOs, the SEC has proposed interpretive guidance to make management's assessment of internal control under Sarbanes-Oxley Section 404 more efficient and effective by focusing on risk and materiality. The guidance emphasizes top-down and scalable methods and procedures.

The Public Company Accounting Oversight Board also has proposed a new internal control audit standard which would supercede the current PCAOB standard for Section 404 audits. The PCAOB's goal is to focus the internal control audit on the most "important" matters. Their proposal tries to eliminate procedures that are unnecessary to achieve the intended benefits (including by permitting use of prior years' work by auditors, and requiring auditors to consider whether and how to use the work of others). The proposal provides a simplified standard that is shorter, easier to understand, and more clearly scalable to audits of companies of all sizes and complexity. It achieves these goals by reducing granularity, redefining key terms, clarifying that the auditor's evaluation of materiality for purposes of an internal control audit is based on the same principles applicable to financial statement audits and consolidating the PCAOB's standards on using the work of others in internal control audits and in financial statement audits into one new standard, so as to better facilitate integration of the two audits.

UPCOMING RULES, CHANGES AND TRENDS

Electronic "Delivery" of Proxy Statements and Annual Reports

The SEC recently approved a system of electronic "delivery" of proxy statements and annual reports that will allow (and possibly mandate) companies to post these documents on their websites rather than mail them to shareholders. Under this new "notice and access" model, companies will post their materials on the Internet and simply send shareholders a hard copy notice of the materials' location and availability, all within certain specified timeframes. Persons other than companies that are soliciting proxies would also be able to utilize this model. However, these rules are not effective until July 2007, meaning the related cost savings and conveniences will have to wait another year.

Limitations on Tax Services Provided by Auditors

The PCAOB has adopted rules that treat registered public accounting firms as not being independent of their audit clients if (1) they enter into contingent fee arrangements with those clients; (2) the firm provides services related to marketing, planning or opining in favor of the tax treatment of a transaction that is a confidential transaction under Treasury regulations or that is

based on an aggressive interpretation of applicable tax laws and regulations; or (3) the firm provides tax services to persons in a reporting oversight role of an audit client. The rules also increase a firm's required actions in connection with seeking audit committee pre-approval of tax services. Companies should consider the impact of these rules on their audit committee pre-approval policies. In addition, companies should consider adding items to their director and officer questionnaires to help alert them to any tax services received by relevant individuals from the companies' outside auditors.

New York Stock Exchange Proposals

No discretionary voting on directors. NYSE has proposed rules that would eliminate the ability of NYSE-member brokers to vote in their own discretion on the election of directors in the absence of instructions from the beneficial owners of voting stock held through these brokers. Director elections would become non-routine matters, making it harder for nominees to get requisite votes where the company has a majority vote requirement. As there is an increasing trend by companies to move from plurality voting to majority voting for director elections, companies considering such a change should keep in mind the potential difficulties posed by the NYSE proposal. If approved by the SEC, the NYSE rule would take effect in the beginning of 2008.

Corporate Governance. NYSE proposals still pending from 2005 would require that companies disclose which directors are independent based on one of two alternatives. First, a company could determine that certain types of relationships with the company are categorically immaterial, describe those categories and not have to make any more detailed disclosure about director relationships that fall within those categories. Alternatively, a company that did not have categorical standards would need to include specific descriptions of every relationship with the company for each director and disclose the basis for the board's determination that such relationships do not preclude the director's independence. Note that new SEC rules will require proxy disclosure this year, by category or type, of any transactions, relationships or arrangements considered by the board in making independence determinations.

Other NYSE rule proposals that would impact corporate governance include:

- clarifying that audit committees must meet (in person or telephonically) to review and discuss Management's Discussion and Analysis of Financial Condition and Results of Operations, or MD&A, in quarterly and annual reports, rather than just conducting an individual "polling" of audit committee members in lieu of a meeting;
- clarifying that meetings of independent directors (as opposed to the potentially broader group of non-management directors) can satisfy the requirement to hold executive sessions and related director communications rules;
- clarifying that prompt disclosure of director and executive officer code of conduct waivers requires disclosure within 4 business days on an 8-K, press releases or company website;
- no longer requiring proxy statement disclosure regarding the availability of board committee charters, codes of conduct and corporate governance guidelines;
- eliminating the requirement to disclose in annual reports to shareholders that a company has filed the NYSE-required CEO certification and the SEC's CEO and CFO certifications; and
- requiring listed company CEOs to promptly make disclosure to NYSE in writing after becoming aware of *any* non-compliance with corporate governance listing standards, not just material non-compliance.

Other Proxy Issues and Trends.

- *Majority voting for directors.* Many companies are receiving shareholder proposals for companies to mandate majority voting for directors instead of plurality voting, which is the most widespread system for elections. Companies often fight such proposals, as they can be unworkable when a company does not have a contested election and a nominee does not receive a majority of the votes cast. Some companies are voluntarily adopting (and disclosing) alternative systems or policies even in the absence of shareholder proposals. These alternatives are designed to address the process a company using plurality voting will follow, and the possible remedies the company will pursue, if a nominee receives a majority of "withhold" votes.
- *Other shareholder proposals.* A recent federal court case has called into question the SEC's policy for allowing companies to exclude from their proxy statements certain shareholder proposals relating to procedures for the election of directors. In reaction, the SEC indicated that it would attempt to clarify its position, leading to speculation that the rules and policies for what companies can exclude will become narrower, thus allowing more shareholder proposals and director nominees to find their way into proxy statements. To date, apparently due to lack of consensus among the five SEC commissioners, the SEC has not yet taken any action.
- *SEC comments.* SEC comment letters are now publicly available 45 days after the SEC's review has been completed. A review of recent comment letters reveals that frequent areas of focus relevant to 10-Ks are MD&A trend disclosure, use of non-GAAP financial measures and explanations regarding their importance to investors, conclusions and wording surrounding disclosure controls and procedures and internal control over financial reporting, option grant practices and a variety of accounting issues.
- *SEC technology.* The SEC is conducting a pilot program, likely to be mandatory at some point in the future, regarding the use of interactive data, also known as Extensible Business Reporting Language (XBRL). Interactive data pinpoints all of the facts and figures trapped in dense documents, allowing investors to immediately pull out the information they want, and compare it to the results of other companies, performance in past years, industry averages and other data. Interactive data "tags" all of the key facts in large documents, so that software can instantaneously recognize them and serve them up to the investor. The SEC also announced that it will be updating and likely replacing its EDGAR system in the next couple of years.
- *Disclosure of caps on liability of accountants.* Some accounting firms continue to demand in their engagement letters that clients agree to resolve disputes outside of the court system, in the event of a claim by the client. Some investors have expressed concern about the impact of such arrangements on the accountants' independence and impartiality, as well as audit quality and reliability. As a result, companies are increasingly disclosing such arrangements to their investors to

promote transparency, particularly where shareholders are voting on auditor ratification.

- *Tax rules impacting compensation.* As part of the American Jobs Creation Act of 2004, Internal Revenue Code Section 409A transition rules continue to impact the structure of many compensation arrangements, including deferred compensation, employment agreements, severance agreements and equity compensation. Because many of these arrangements are the subject of proxy disclosure, 10-K exhibit filings or shareholder votes, companies should be reviewing their compensation arrangements prior to the preparation of their 10-Ks and proxy statements to ensure compliance with Section 409A and related IRS regulations and guidance.

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The summary above is meant to describe the major changes affecting upcoming annual reports and proxy statements. To discuss these topics in more detail or other matters relating to annual reporting, please contact your lawyer at Sullivan & Worcester LLP or the lawyer above.

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¹ For last year's summary, see our January 2006 client advisory: "[What Public Companies Need to Know About This Year's Annual Reports and Proxy Statements – 2005-06 Edition!](#)."

² This advisory is not intended to cover changes that might affect the preparation of financial statements or other financial information.

³ An "accelerated filer" is a public company that at the end of its fiscal year: (1) has a public float (i.e., voting and non-voting common equity not held by affiliates of the company) of at least \$75 million as of the last day of its most recently completed second fiscal quarter; (2) has been filing periodic reports (e.g., 10-Ks and 10-Qs) under the Securities Exchange Act of 1934 for at least 12 months; (3) has filed at least one annual report; and (4) is not eligible to file 10-K and 10-Q forms applicable to small business issuers. A "large accelerated filer" has a public float of at least \$700 million and meets the rest of the accelerated filer criteria.

⁴ Foreign private issuers that meet the definition of accelerated filer have to comply with the internal control rules for fiscal years ending after July 15, 2006. Foreign private issuers that are accelerated filers, but not large accelerated filers, need only provide management's report; audit reports on such issuers' internal controls will be required for fiscal years ending after July 15, 2007.