

NOVEMBER 14, 2000

CURRENT ISSUES AND RULEMAKING PROJECTS

DIVISION OF CORPORATION FINANCE

**Securities and Exchange Commission
Washington, D.C. 20549**

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[Asterisks mark substantive changes from the last version of this outline posted on the web site (July 25, 2000).]

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Please also see "Current Accounting and Disclosure Issues in the Division of Corporation Finance," available on our web site at www.sec.gov/rules/othrindx.htm.

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DIVISION OF CORPORATION FINANCE
NOVEMBER 14, 2000**

In addition to this outline, several other sources of information about issues involving the Division of Corporation Finance are available in the "Current SEC Rulemaking" section of the Securities and Exchange Commission's web site, <http://www.sec.gov>.

- Releases, Staff Legal Bulletins, Staff Accounting Bulletins
- Division of Corporation Finance: Frequently Requested Accounting and Financial Reporting Interpretations and Guidance
- Division of Corporation Finance: Current Accounting and Disclosure Issues in the Division of Corporation Finance
- Division of Corporation Finance: Manual of Publicly Available Telephone Interpretations (including updates)
- A number of the forms and regulations administered by the Division are available in the "Small Business Information" section of the web site.

I. DIVISION ORGANIZATION AND EMPLOYMENT OPPORTUNITIES

The Division's organizational structure follows:

Division Director - David B. H. Martin (202) 942-2800

Deputy Director - Michael McAlevey (202) 942-2810

Operations

Principal Associate Director (Disclosure Operations)
- Shelley Parratt (202) 942-2830

Associate Director (Disclosure Operations)
- James Daly (202) 942-2881

Associate Director (Disclosure Operations)
- William L. Tolbert, Jr. (202) 942-2891

Disclosure Support

Associate Director (Legal)
- Martin P. Dunn (202) 942-2890

Associate Director (Regulatory Policy)
- Mauri Osheroff (202) 942-2840

Associate Director (Chief Accountant)
- Robert Bayless (202) 942-2850

Senior Counsel to the Director
- Anita Klein (202) 942-2980

Assistant Directors

Health Care and Insurance
- Jeffrey P. Riedler (202) 942-1840

Consumer Products
- H. Christopher Owings (202) 942-1900

Computers and Office Equipment
- Barbara Jacobs (202) 942-1800

Natural Resources
- Roger Schwall (202) 942-1870

Transportation and Leisure
- Max Webb (202) 942-1850

Manufacturing and Construction
- Steven Duvall (202) 942-1950

Financial Services
- Todd Schiffman (202) 942-1760

Real Estate and Business Services
- Karen Garnett (202) 942-1960

Small Business
- Vacant (202) 942-2950

Electronics and Machinery
- Peggy Fisher (202) 942-1880

Telecommunications
- Barry Summer (202) 942-1990

Structured Finance and New Products
- Mark W. Green (202) 942-1940

Other Offices

Office of Chief Counsel
- Paula Dubberly, Chief (202) 942-2900

Office of Mergers and Acquisitions
- Dennis O. Garris, Chief (202) 942-2920

Office of International Corporate Finance
- Paul Dudek, Chief (202) 942-2990

Office of EDGAR and Information Analysis
- Herbert Scholl, Chief (202) 942-2930

Office of Rulemaking
- Elizabeth Murphy, Chief (202) 942-2900

Office of Small Business Policy
- Richard Wulff, Chief (202) 942-2950

Division Employment Opportunities for Accountants and Attorneys

Accountants

The Division has about 110 staff accountants with specialized expertise in the various industry offices. The Division provides a fast-paced, challenging work environment for accounting professionals. Our staff works on hot IPOs and current and emerging accounting issues. We influence accounting standards and practices and interact with the top professionals in the securities industry.

A staff accountant's responsibilities include examining financial statements in public filings and finding solutions to the most difficult and controversial accounting issues. A minimum of three years' experience in a public accounting firm or public company dealing with SEC reporting is required. If you want to experience a unique learning opportunity and explore the depth and breadth of accounting theory, principles, and practices, call (202) 942-2960 for information on employment opportunities in the Division.

Attorneys

The Division has about 130 attorneys who process filings and draft and interpret regulations. Every year, we recruit top law school graduates, and from time to time have positions for lateral applicants with solid legal skills and experience. Applicants should demonstrate an ability to accept major responsibilities. We prefer applicants who have had experience in securities transactions involving public companies. It is also helpful, but not necessary, if applicants have accounting and/or business training.

Responsibilities include analyzing and commenting on disclosure documents in public offerings, including those relating to mergers and acquisitions. The positions involve working directly with companies, their executives, underwriters and investment banking firms, outside counsel and outside accountants. The work involves innovative financing and business structures. Interested persons should send

resumes to -- Division of Corporation Finance, U.S. Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549.

II. MERGERS AND ACQUISITIONS

In addition to the matters in this section, see Section IX.I. below, "Financial Statements in Hostile Exchange Offers." Also, see the Third Supplement to our Manual of Publicly Available Telephone Interpretations.

A. Regulation of Takeovers and Security Holder Communications

On October 22, 1999, the Commission adopted a new regulatory scheme for business combination transactions and security holder communications (Securities Act Release No. 7760). The new rules and amendments became effective January 24, 2000. The amendments significantly update the existing regulations to meet the realities of today's markets while maintaining important investor protections. Specifically, the amendments reduce restrictions on communications, balance the regulatory treatment of cash and stock tender offers, and update, simplify and harmonize the disclosure requirements.

1. Reduce Restrictions on Communications

The Securities Act, as well as the proxy and tender offer rules, restrict communications. The new rules and amendments relax these restrictions by permitting the dissemination of more information on a timely basis without triggering the need to file a mandated disclosure document. Under the new scheme, a complete disclosure document still must be provided before a security holder may vote or tender securities, but other communications regarding the transaction are permitted. This should permit more informed voting and tendering decisions. The content of communications is not restricted, but anyone relying on the new rules must file written communications relating to the transaction on the date of first use, so that all security holders have access to the information. In particular, the amendments permit more communications:

- before the filing of a registration statement relating to either a stock merger or a stock tender offer transaction;
- before the filing of a proxy statement (regardless of the subject matter or contested nature of the solicitation); and
- regarding a proposed tender offer without "commencing" the offer and requiring the filing and dissemination of specified information.

The amendments also harmonize the various communications principles applicable to business combination transactions under the Securities Act, tender offer rules and proxy rules. Confidential treatment of merger proxy statements is retained, but only under limited circumstances. Under the new scheme, if parties to a transaction publicly disclose information beyond that specified in Rule 135, the proxy statement must be filed publicly. If a proxy statement is filed confidentially, but

later the parties disclose information beyond Rule 135, then the proxy statement must be re-filed publicly.

2. Balance the Regulatory Treatment of Cash and Stock Tender Offers

Registered stock tender offers (exchange offers) are subject to regulatory delays not imposed on cash tender offers. A cash tender offer may commence as soon as a tender offer schedule is filed and the information disseminated to security holders, while an exchange offer may not commence before a registration statement is filed and becomes effective. The delay associated with exchange offers may cause some bidders to favor cash over stock as consideration in a business combination transaction. In addition, the different regulatory treatment can give a bidder offering cash a timing advantage over a competing bidder offering stock. The amendments adopted balance the regulatory treatment of cash and stock tender offers to the extent practicable.

Under the new rules third-party or issuer exchange offers may commence as early as the filing of a registration statement, or on a later date selected by the bidder, before effectiveness of the registration statement. As a result, a bidder offering securities will not need to wait until effectiveness to commence an exchange offer. Early commencement is not mandatory, but rather at the election of the bidder. A bidder may file a registration statement, wait for staff comments, if any, and then decide to commence its offer. Any securities tendered in the offer could not be purchased until after the registration statement becomes effective, the minimum 20 business day tender offer period has expired, and all material changes are disseminated to security holders with adequate time remaining in the offer to review and act upon the information. A bidder need not deliver a final prospectus to security holders. Security holders may withdraw tendered securities at any time before they are purchased by the bidder.

3. Updating, Simplifying and Harmonizing the Disclosure Requirements

The procedural and disclosure requirements for business combination transactions vary depending upon the form of the transaction. The amendments clarify and harmonize many of the requirements. The amendments also make the requirements easier to understand and facilitate compliance with the regulations.

The substantive disclosure requirements for tender offers, going-private transactions and other extraordinary transactions remain substantially the same, but are moved to one central location within the rules, called "Regulation M-A." In some cases, harmonization reduces the disclosure requirements. The amendments also update the rules in several respects. The more significant amendments:

- combine the existing schedules for issuer and third-party tender offers into one new schedule available for all tender offers, called "Schedule TO";

- require a plain English summary term sheet in all tender offers, mergers and going-private transactions, except when the transaction is already subject to the plain English requirements of the Securities Act rules;
- update and generally reduce the financial statements required for business combinations;
- require pro forma and related financial information in negotiated cash tender offers when the bidder intends to engage in a back-end securities transaction;
- permit an optional subsequent offering period after completion of a tender offer during which security holders can tender their shares without withdrawal rights;
- revise Rule 13e-1, which requires issuers to report intended repurchases of their own securities once a third-party tender offer has commenced, so that the required information need not be disseminated to security holders and to provide an exclusion from the rule for certain periodic, routine purchases;
- conform the current security holder list requirement in the tender offer rules with the comparable provision in the proxy rules so that the list will include non-objecting beneficial owners; and
- clarify the rule that prohibits purchases outside a tender offer (Rule 10b-13), codify prior interpretations of and exemptions from the rule; add several new exceptions to the rule, and redesignate it as new Rule 14e-5.

B. Cross-Border Tender Offers, Rights Offers and Business Combinations

The Commission has adopted exemptive provisions to facilitate the inclusion of U.S. investors in tender and exchange offers, business combinations and rights offerings for the securities of foreign companies (Securities Act Release No. 7759 (October 22, 1999)).

1. Reasons for the Exemptions

Although it is very common for U.S. persons to hold securities of foreign companies, they often are unable to participate fully in tender offers, rights offerings and business combinations involving those securities. Offerors often exclude U.S. security holders due to conflicts between U.S. regulation and the regulation of the home jurisdiction or the perceived burdens of complying with multiple regulatory regimes.

In tender offers where the bidder is offering its own securities and rights offers where existing shareholders are offered the opportunity to buy more stock, in the absence of an exemption (such as the new exemptions contained in the release), inclusion of U.S. holders would require registration under the Securities

Act. Registration requires the issuer to provide to shareholders financial statements prepared in accordance with U.S. accounting standards. Also, the issuer would incur an ongoing reporting obligation in the United States.

2. Harmful Effects of Excluding U.S. Investors

U.S. investors often are unable to receive the full benefits offered to other investors in these types of offshore transactions. When bidders exclude the U.S. security holders from tender or exchange offers, the U.S. investors are denied the opportunity to receive the full value of the premium offered for their shares. (In some cases, these holders may eventually have their securities acquired in a compulsory acquisition when the offeror completes the acquisition.) Similarly, when issuers exclude their U.S. security holders from participation in rights offerings, the U.S. investors lose the opportunity to retain their relative ownership position or possibly to purchase at a discount. (In some instances, they may be able to receive the cash value of their rights.)

These offshore transactions may affect the interests of the U.S. investors in the foreign securities, regardless of whether they receive information about the transaction or are able to participate directly in the offer. For example, market activity in the stock after announcement of a tender offer may affect the price of the stock. Even though U.S. investors cannot participate in the tender offer, they must react to the event by deciding whether to sell, hold, or buy additional securities. Offerors will often take affirmative steps to prevent their informational materials from being disseminated in the United States as a means to avoid triggering U.S. regulatory requirements. U.S. investors, therefore, must make this decision without the benefit of information required by either U.S. or foreign securities regulation.

3. The Exemptions

The new exemptions balance the need to promote the inclusion of U.S. investors in these types of cross-border transactions against the need to provide U.S. investors with the protections of the U.S. securities laws. The U.S. anti-fraud and anti-manipulation rules and civil liability provisions will continue to apply to these transactions. The rule changes became effective January 24, 2000.

New provisions in the tender offer rules exempt:

- tender offers for the securities of foreign private issuers from most provisions of the Exchange Act and rules governing tender offers when U.S. security holders hold 10 percent or less of the foreign company's securities that are subject to the offer (the "Tier I exemption").
- tender offers from certain limited provisions of the Securities Exchange Act of 1934 and rules governing tender offers when U.S. security holders hold 40 percent or less of a foreign private issuer's securities that are subject to the offer (the "Tier II exemption"). The Tier II exemption represents a codification of current exemptive and interpretive positions that eliminate frequent areas of conflict between U.S. and foreign regulatory requirements.

- tender offers for the securities of foreign private issuers from Rule 10b-13 of the Exchange Act (redesignated Rule 14e-5 in the Regulation M-A rulemaking), which will permit purchases outside the tender offer during the offer when U.S. security holders hold 10 percent or less of the subject securities.

In addition, two new exemptions from the Securities Act registration and Trust Indenture Act provisions exempt:

- under new Rule 801, rights offerings of equity securities by foreign private issuers from the registration requirements of the Securities Act when U.S. security holders hold 10 percent or less of the securities.
- under new Rule 802, securities issued in an exchange offer, merger or similar transaction for a foreign private issuer from the registration requirements of the Securities Act and the qualification requirements of the Trust Indenture Act when U.S. security holders hold 10 percent or less of the subject class of securities.

Some of the more significant changes from the November 1998 proposals include:

- The U.S. ownership thresholds for the Rule 801 and Rule 802 registration exemptions have been increased from five to 10 percent.
- Under a “cash-only alternative” for Tier I tender offers, bidders will be permitted to offer cash in the United States while offering securities offshore without violating the equal treatment requirements of the tender offer rules. The bidder must have a reasonable basis to believe that the cash being offered to U.S. security holders is substantially equivalent to the value of the consideration being offered to non-U.S. holders.
- Holders in both rights offerings and exchange offers would receive restricted stock under Rule 144 only to the extent their existing holdings were restricted. We had proposed treating all securities issued in rights offerings as restricted.
- In determining U.S. ownership, an offeror would be required to “look through” the record ownership of certain brokers, dealers, banks or nominees holding securities for the accounts of their customers. Ten percent holders, foreign or domestic, are excluded from the calculation, rather than just foreign 10 percent holders as had been proposed. Securities held by the bidder also are excluded from the calculation.

C. Mini-Tender Offers and Tender Offers for Limited Partnership Units

The Commission issued an interpretive release on July 24, 2000 (Exchange Act Release No. 43069) that provides guidance on:

- the disclosure and dissemination of tender offers that result in the bidder holding five percent or less of the outstanding securities of a company ("mini-tender offers"); and
- the disclosure in tender offers for limited partnership units.

1. Mini-Tender Offers

a. Background

"Mini-tender offers" are tender offers that would result in the bidder holding not more than five percent of a company's securities, and are generally structured to avoid the filing, disclosure and procedural requirements of Section 14(d) of the Exchange Act and Regulation 14D. Mini-tender offers, however, remain subject to the antifraud provisions of Section 14(e) and the substantive and procedural requirements of Regulation 14E. These requirements provide that a tender offer be open for at least 20 business days, that the offer remain open for 10 business days following a change in the offering price or the percentage of securities being sought, and that the bidder promptly pay for or return securities when the tender offer expires.

Because mini-tender offers are not subject to Section 14(d) and Regulation 14D, offerors are able to design the offer as a first-come, first-served offer without withdrawal rights and prorationing. This structure pressures security holders into tendering quickly. Permanently locked into their decision, security holders are then unable to take advantage of new information or opportunities that may become available during the course of the offer. Disclosure in mini-tender offers is usually deficient, and ordinarily does not communicate the absence of these procedural protections to security holders.

Because of inadequate disclosure, some bidders have also been able to devise schemes to confuse security holders about the actual offer price. In some cases, the offer is for less than the market price. In other cases, a premium is initially offered but bidders never intend to pay a premium for the securities – they wait and do not pay for the securities tendered until the market price rises above the offer price. They then sell the securities in the market and pay tendering security holders with the proceeds. The Commission believes these practices are "fraudulent practices" within the meaning of Section 14(e).

b. Disclosure Guidelines

The interpretive release sets out specific disclosure guidelines for bidders in mini-tender offers in order to avoid "fraudulent, deceptive or manipulative practices" within the meaning of Section 14(e). Bidders should provide clear disclosures concerning the offer price, price changes, ability to finance the offer, identity of the

bidder, plans or proposals, conditions to the offer, possible extension of the offer, pro rata acceptance, withdrawal rights, and the forthcoming target recommendation.

For example, bidders should disclose clearly if the offer price is below the market price. Bidders who make mini-tender offers at, or slightly above, the market price of the security should communicate whether they only intend to purchase the shares if the market price rises above the offer price. Because security holders generally are not permitted to withdraw their securities from the offer once the securities have been tendered, failing to disclose the bidder's actual intentions may be deemed a "fraudulent, deceptive or manipulative practice" within the meaning of Section 14(e).

Similarly, bidders who do not have the financing necessary to purchase the shares in the offer, and merely expect to sell tendered shares in the market at a higher price and then use the proceeds to pay the security holders who tendered at a lower price, would be under the same obligation to disclose their plan in the tender offer materials. Rule 14e-8(c) also expressly prohibits a person from publicly announcing a tender offer if that person "does not have the reasonable belief that the person will have the means to purchase the securities to complete the offer."

c. Dissemination Guidelines

The bidder in a tender offer must make reasonable efforts to disseminate material information about the tender offer to security holders. The failure to disseminate the disclosure frustrates the purpose of the tender offer rules. The Commission believes dissemination of material information using mechanisms the bidder knows or is reckless in not knowing are inadequate would be a "fraudulent, deceptive or manipulative" practice within the meaning of Section 14(e) and Rule 14e-1. It is the bidder's obligation to assure that security holders get material information about the tender offer, including material changes. Posting the information on a web site would not, by itself, be adequate dissemination. Not all security holders have access to the Internet. Further, merely sending the offering documents to DTC is not an adequate means of communicating the information to security holders.

d. Prompt Payment

Rule 14e-1(c) requires bidders to pay the consideration offered or return the tendered securities promptly after the termination or withdrawal of the tender offer. The rule does not define "promptly." The Commission believes payment is prompt if made according to current settlement practices (within three business days). Bidders who delay payment because they expect to pay security holders with sales proceeds of shares sold in the market at a price higher than the offer price risk violating Section 14(e) and Rule 14e-1(c).

If the target is a limited partnership, and its securities are not listed on an exchange or quoted on an interdealer quotation system, it may not be possible to pay within three days due to delays in transferring the limited partnership interests. When the bidder is a third party and cannot control the transfer and settlement process, we would consider a reasonable extension of the three-day period to be in

compliance with Rule 14e-1(c). If the bidder is an affiliate, however, and is able to control the settlement process, payment should not be delayed for these reasons and should be made as soon as possible.

2. Tender Offers For Limited Partnership Units

a. Background

Tender offers for limited partnership units, whether or not the bidder is affiliated with the target, raise significant disclosure issues due to the nature of limited partnership investments and offers. Limited partnership units may be difficult to sell, and general partners face conflicts of interest in deciding when and whether to liquidate the partnership.

b. Disclosure Guidelines for Limited Partnership Tender Offers

i. Bidder Disclosure Guidelines

In preparing disclosure documents for these transactions, bidders are advised to remember that the 1991 release adopting the roll-up provisions (Securities Act Release No. 6922 (October 30, 1991)) specifically addresses transactions, which, although by definition not roll-ups, raise similar concerns. To avoid misleading security holders, and to help investors make an informed investment decision, the interpretive release states that bidders should disclose known risks, conflicts of interest, market prices, methods of determining the offer price, third party reports, valuations by the general partner, offer purpose and plans, property/business disclosure, financial information, tax consequences, transfer or processing fees, and anticipated price reductions due to distributions.

When determining the adequacy of disclosure, bidders should focus on the materiality of the information to security holders (Securities Act Release No. 6900 (June 17, 1991)). For example, bidders should disclose any valuation analysis that is materially related to the transaction or used in determining offer price, and whether transfer fees may reduce the amount of consideration received on a per unit or per investor basis. If the bidder is affiliated with the target, it should disclose the benefits of the transaction to the bidder and the reasons for conducting the tender offer versus liquidating the partnership.

ii. Target Disclosure Guidelines

Rule 14e-2 requires the general partner to respond within 10 days of commencement of an offer by publicly stating the reasons for a position with respect to the offer. To avoid misleading security holders, and in order to assist investors in making an informed investment decision, we recommend that targets disclose third party reports, valuations by the general partner, and any conflicts of interest that arise when making a recommendation. For example, disclose, if true, why the partnership is not being liquidated in accordance with the terms in the original offering document.

D. Current Issues

1. Investment Banking Firm Disclaimers

Boards of directors of companies soliciting shareholder voting and/or investment decisions in connection with mergers and other extraordinary transactions often retain investment banking firms as financial advisors, in many cases to render an opinion on the financial fairness of the transaction. In connection with its review of proxy statements, Securities Act registration statements and other Commission filings made in this context, the staff increasingly has observed the appearance of disclaimers by or on behalf of the financial advisor regarding shareholders' right to rely on a fairness opinion that the advisor has furnished to the registrant's board, a special committee of the board, and/or the registrant. Examples of such disclaimers include the following:

- "No one other than the Board of Directors [or the Special Committee and/or the Company] has the right to rely on this opinion;"
- "This opinion is provided solely/only to the Board of Directors [or the Special Committee and/or the Company];"
- "This opinion is solely/only for the benefit of the Board of Directors [or the Special Committee and/or the Company];"
- "No one may rely on this opinion without the prior consent of the Financial Advisor;" and
- "This opinion is addressed [solely/only] to the Board of Directors [Special Committee and/or the Company] and is not intended to be relied upon by any shareholder."

During the review and comment process, the staff has objected to such statements as inconsistent with the balance of the registrant's disclosure addressing the fairness to shareholders of the proposed transaction from a financial perspective. Specifically, the staff has requested that any such direct or indirect disclaimer of responsibility to shareholders, whether made by or on behalf of the financial advisor, be deleted from any portion of the disclosure document in which it appears (including exhibits). Alternatively, the registrant may add an explanation that clarifies:

- the basis for the advisor's belief that shareholders cannot rely on its opinion, including (but not limited to) whether the advisor intends to assert the substance of the disclaimer as a defense to shareholder claims that might be brought against it under applicable state law;
- whether the governing state law has addressed the availability of such a defense to the advisor in connection with any such shareholder claim; if not, a statement must be added that the issue necessarily would have to be resolved by a court of competent jurisdiction; and

- that the availability or non-availability of such a defense will have no effect on the rights and responsibilities of the board of directors under governing state law, or the rights and responsibilities of the board or the advisor under the federal securities laws.

2. Identifying the Bidder in a Tender Offer

Rule 14d-1(c)(1) of Regulation 14D defines "bidder" in a tender offer as "any person who makes a tender offer or on whose behalf a tender offer is made." The term bidder, for Regulation 14D purposes, does not include an issuer that makes a tender offer for its own securities. Each bidder in a tender offer subject to Regulation 14D must file a Schedule TO and disseminate the information required by that schedule.

The determination of who is the bidder does not necessarily stop at the entity used to make the offer and purchase the securities. Rule 14d-1(c)(1) also requires persons "on whose behalf" the tender offer is being made to be included as bidders. For instance, where a parent company forms an acquisition entity for the purpose of making the tender offer, both the acquisition entity and the parent company are bidders even though the acquisition entity will purchase all securities tendered. The staff views the acquisition entity as the nominal bidder and the parent company as the real bidder. They both should be named bidders in the Schedule TO. Each offer must have at least one real bidder, and there can be co-bidders as well.

The fact that the parent company or other persons control the purchaser through share ownership does not mean that the entity is automatically viewed as a bidder. Instead, we look at the parent's or control person's role in the tender offer. Bidder status is a question that is determined by the particular facts and circumstances of each transaction. A similar analysis of bidder status is made in a tender offer subject only to Regulation 14E. When we analyze who is the bidder, some relevant factors include:

- Did the person play a significant role in initiating, structuring, and negotiating the tender offer?
- Is the person acting together with the named bidder?
- To what extent did or does the person control the terms of the offer?
- Is the person providing financing for the tender offer, or playing a primary role in obtaining financing?
- Does the person control the named bidder, directly or indirectly?
- Did the person form the nominal bidder, or cause it to be formed?, and
- Would the person beneficially own the securities purchased by the named bidder in the tender offer or the assets of the target company?

One or two of these factors may control the determination, depending on the circumstances. These factors are not exclusive.

We also consider whether adding the person as a named bidder means shareholders will receive material information that is not otherwise required under the control person instruction, Instruction C to Schedule TO. However, this issue is not dispositive of bidder status. A person who qualifies as a bidder under Rule 14d-1(c)(1) must be included as a bidder on the Schedule TO even if the disclosure in the Schedule TO will not change as a result. Instruction C elicits information about the control persons of the bidder. Merely disclosing the Instruction C information does not eliminate the requirement that the real bidder sign the Schedule TO and take direct responsibility for the disclosure. Where the real bidder does not sign the Schedule TO and does not provide the required disclosure, the parties run the risk of having to extend the offer to provide a full 20 business day period for shareholders to consider the new information.

If a named bidder is an established entity with substantive operations and assets apart from those related to the offer, the staff ordinarily will not go further up the chain of ownership to analyze whether that entity's control persons are bidders. However, it still would be possible for other parties involved with the offer to be co-bidders. The factors listed above would be used in the analysis. In addition, we would consider the degree to which the other party acted with the named bidder, and the extent to which the other party benefits from the transaction.

3. Schedule 13E-3 Filing Obligations of Issuers or Affiliates Engaged in a Going-Private Transaction

Generally, Exchange Act Rule 13e-3 requires that each issuer and affiliate engaged, directly or indirectly, in a going-private transaction file a Schedule 13E-3 with the Commission and furnish the required disclosures (e.g., the statement of "reasonable belief" as to the fairness or unfairness of the proposed transaction) directly to the holders of the class of equity securities that is the subject of the transaction. A joint filing may be permissible in this situation, provided each filing person individually makes the required disclosures and signs the Schedule 13E-3.

Two separate but related issues may be raised with respect to the determination of "filing-person" status in situations where a third party proposes a transaction with an issuer that has at least one of the requisite "going-private" effects: first, what entities or persons are "affiliates" of the issuer within the scope of Rule 13e-3(a)(1) and, second, when should those affiliates be deemed to be engaged, either directly or indirectly, in the going-private transaction. While resolution of both issues necessarily turns on all relevant facts and circumstances of a particular transaction, you should note the following.

First, the staff consistently has taken the position that members of senior management of the issuer that is going private are affiliates of that issuer. Depending on the particular facts and circumstances of the transaction, such management also might be deemed to be engaged in the transaction. As

a result, such management-affiliates may incur a Schedule 13E-3 filing obligation separate from that of the issuer. For example, the staff has taken the position that members of senior management of an issuer that will be going private are required to file a Schedule 13E-3 where the transaction will be effected through merger of the issuer into the purchaser or that purchaser's acquisition subsidiary, even though:

- such management's involvement in the issuer's negotiations with the purchaser is limited to the terms of each manager's future employment with and/or equity participation in the surviving company; and
- the issuer's board of directors appointed a special committee of outside directors to negotiate all other terms of the transaction except management's role in the surviving entity.

An important aspect of the staff's analysis was the fact that the issuer's management ultimately would hold a material amount of the surviving company's outstanding equity securities, occupy seats on the board of this company in addition to senior management positions, and otherwise be in a position to "control" the surviving company within the meaning of Exchange Act Rule 12b-2 (*i.e.*, "possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.").

Second, questions have arisen regarding the nature and scope of the Schedule 13E-3 filing obligation of an acquiring person, or "purchaser," in a merger or other going-private transaction. In the situation described in above, where management of the issuer-seller that will be going private is essentially "on both sides" of the transaction, the purchaser also may be deemed to be an affiliate of the issuer engaged in the transaction and, as a consequence, required to file on Schedule 13E-3. See Exchange Act Release No. 16075 (August 2, 1979) (noting that "affiliates of the seller often become affiliates of the purchaser through means other than equity ownership, and thereby are in control of the seller's business both before and after the transaction. In such cases the sale, in substance and effect, is being made to an affiliate of the issuer..."). Accordingly, the issuer-seller, its senior management and the purchaser may be deemed Schedule 13E-3 filing persons in connection with the going-private transaction. Where the purchaser has created a merger subsidiary or other acquisition vehicle to effect the transaction, moreover, the staff will "look through" the acquisition vehicle and treat as a separate, affiliated purchaser the intermediate or ultimate parent of that acquisition vehicle. Accordingly, both the acquisition vehicle and the entity or person who formed it to acquire the issuer would have separate filing obligations (although, as noted, a joint filing may be permitted by the staff).

III. ELECTRONIC FILING AND TECHNOLOGY

A. EDGAR

The Commission's Electronic Data Gathering, Analysis, and Retrieval ("EDGAR") system has been operational since 1992, with mandated electronic filing by those subject to the Division's review beginning in April 1993. Electronic filings are publicly available on a 24-hour delayed basis in the "EDGAR Database" area of the Commission's web site, <http://www.sec.gov>. This area also contains other information about EDGAR, including an outline entitled "Electronic Filing and the EDGAR System: A Regulatory Overview."

On June 22, 1998, the Commission awarded to TRW, Inc. a three year contract for the modernization of the EDGAR System, with options for contract extensions for up to five years. The EDGAR architecture will be converted to an Internet-based system using Hyper Text Markup language ("HTML") as the filing format, and also will support the attachment of graphical files. The new system is expected to reduce costs and efforts of preparing and submitting electronic filings, as well as permit more attractive and readable documents.

On May 17, 1999, the Commission issued Securities Act Release No. 7684 adopting new rules and amendments to existing rules and forms in connection with the first stage of EDGAR modernization. The rules became effective June 28, 1999.

On June 28, the Commission began accepting live filings submitted in HTML, as well as documents submitted in the currently required American Standard Code for Information Interchange ("ASCII") format. Filers have the option of accompanying their required filings with unofficial copies in Portable Document Format ("PDF"). Filers also are encouraged to submit test filings that include documents in HTML and PDF format.

On April 24, 2000, the Commission issued Securities Act Release No. 7855 adopting rule amendments in connection with the next stage of EDGAR modernization, which was implemented May 30, 2000. The release addresses the following new features of the system and related rule changes:

- the ability to include graphic and image files in HTML documents;
- the expanded ability to use hyperlinks in HTML documents, including links between documents within a submission and to previously filed documents on our public web site EDGAR database at www.sec.gov; and
- the addition of the Internet as an available means of transmitting filings to the EDGAR system.

The release removes the requirement for filers to submit Financial Data Schedules, effective January 1, 2001. It also removes diskettes as an available means of transmitting filings to the EDGAR system, effective July 10, 2000. All other rule changes became effective May 30, 2000.

The proposing release (Securities Act Release No. 7803, February 25, 2000) solicited comments on the concept of requiring more filings to be made electronically, such as Forms 3, 4, 5, 144, and foreign private issuer filings. The Commission will consider the comments received in connection with future rule proposals.

B. Electronic Delivery of Information

The Commission has issued a series of interpretive releases and rules addressing the use of electronic media to deliver or transmit information under the federal securities laws. These initiatives reflect the Commission's continuing recognition of the benefits that electronic technology provides to the financial markets. These releases are premised on the belief that the use of electronic media should be at least an equal alternative to the use of paper delivery.

1. 1995 Interpretive Release

The first interpretive release (Securities Act Release No. 7233 (Oct. 6, 1995)) provides guidance to issuers who use electronic media to comply with the applicable delivery requirements of the federal securities laws. Information distributed through electronic means may be viewed as satisfying the delivery requirements of the federal securities laws if it results in the delivery to the intended recipients of substantially equivalent information as they would have had if the information were delivered in paper form. The release advises issuers to consider the following:

- Has timely and adequate notice been provided to the investor that the information is available?
- Does the investor have access to the information? Specifically:
 - is it practically accessible?
 - is it available on-line for as long as a delivery requirement applies?
 - does the investor have the opportunity to retain the information or have ongoing access equivalent to personal retention?
 - is it available in paper upon request?
- Does the selected distribution method provide reasonable assurance that it will result in delivery? Examples for consideration by persons with delivery obligations include:
 - an investor has given an informed consent to receive the information through a particular electronic medium and been provided appropriate notice and access;

- there is evidence that the investor actually received the information (for example, electronic mail return receipt or confirmation of downloading);
- the information is provided by facsimile to an investor who has provided a fax machine number;
- the investor has accessed an electronic document with hypertext linking to a document required to be delivered; or
- an investor returns an order form available only through an electronically delivered document.

The release also contains numerous examples applying these concepts to specific fact situations.

2. 1996 Interpretive Release and Rulemaking

The second interpretive release primarily addresses issues associated with the electronic delivery of information by broker-dealers, transfer agents and investment advisers under certain Exchange Act and Advisers Act rules (Securities Act Release No. 7288 (May 9, 1996)). The release also contains a section following up the 1995 release with additional examples.

At the same time, the Commission also adopted a number of technical amendments to its rules and forms intended to codify some interpretations set out in the 1996 release (Securities Act Release No. 7289 (May 9, 1996)). Most changes relate to rules that require distribution of information by mail, or rules that require presentation of information in a specified type size or font, or in red ink or bold-face type. For example, if a rule requires presentation of a legend using a specified type size and font, the rule now provides that if an electronic medium is used, the legend must be presented using any means reasonably calculated to draw attention to it.

3. 2000 Interpretive Release

The most recent interpretive release addresses a number of questions concerning the use of electronic media under the federal securities laws (Securities Act Release No. 7856 (Apr. 25, 2000)).

a. Electronic Delivery

The release resolves several issues arising out of the 1995 and 1996 releases on the use of electronic media to satisfy delivery obligations under the federal securities laws. In brief, the release:

- clarifies that, in addition to written consent, investors and security holders may consent to electronic delivery of documents telephonically, as long as the consent is obtained in a manner that assures its validity and a record of the consent is retained;

- permits market intermediaries (such as broker-dealers and banks) to obtain consent to electronic delivery of documents on a “global,” multiple-issuer basis, as long as the consent is informed;
- clarifies that issuers and market intermediaries may deliver documents electronically in portable document format, or PDF, as long as investors and security holders are adequately informed of the requirements to download PDF and are provided with any necessary software and assistance;
- clarifies that a hyperlink embedded within a prospectus or any other document required to be filed or delivered under the federal securities laws causes the hyperlinked information to be a part of that document; and
- clarifies that the close proximity of information on a web site to a public offering prospectus does not, by itself, make that information an “offer to sell,” “offer for sale” or “offer” within the meaning of the federal securities laws.

b. Web Site Content

The release also provides guidance on an issuer’s responsibility under the anti-fraud provisions of the federal securities laws for information on a third-party web site to which the issuer has established a hyperlink and for its web site communications when conducting a public offering.

i. Responsibility for Hyperlinked Information

Issuers have been concerned that by establishing a hyperlink from their corporate web sites to information on a third-party web site they may be held liable for any material misstatements contained in the hyperlinked information. The release confirms that the attribution of hyperlinked information on the third-party web site to an issuer depends on the facts and circumstances of the particular situation. Hyperlinked information will be considered to be “adopted” by an issuer if the issuer, explicitly or implicitly, has endorsed or approved the hyperlinked information. The release discusses three, non-exclusive factors that are relevant in answering this question: the context of the hyperlink, the risk of investor confusion and the presentation of the hyperlinked information.

ii. Web Site Content When in Registration

The release reminds issuers that, when in registration, their web site content, like their other communications to the securities markets, is subject to Section 5 of the Securities Act. Issuers are directed to the Commission’s long-standing guidance on permissible business and financial communications while in registration and instructed on how to apply this guidance to their Internet web sites. This guidance (which was originally directed only to publicly-traded companies) is extended to non-reporting issuers conducting initial public offerings as well.

c. Registered Offerings

The release discusses two fundamental legal principles that have shaped, and will continue to shape, the Commission's view on the evolving practices for conducting online registered offerings. First, offering participants can neither sell, nor make contracts to sell, a security before effectiveness of the related registration statement. Consequently, no offer to buy may be accepted and no part of the purchase price may be received for a security until the registration statement becomes effective. Second, until delivery of the final prospectus has been completed, offers cannot be made outside of a Section 10 prospectus (except in connection with business combinations). The Commission reserves the development of detailed procedures for conducting online registered offerings to further staff interpretation and Commission regulatory action as it gains more experience through the review and comment process.

d. Private Placements Under Regulation D

The 1995 release indicated that an issuer's use of a web site in connection with a purported private offering would constitute a "general solicitation" and disqualify the offering as "private." Subsequently, the staff issued interpretive guidance to a registered broker-dealer and an affiliated entity that proposed to invite previously unknown prospective investors to complete a questionnaire posted on the affiliate's web site in order to build a database of accredited and sophisticated investors for the broker-dealer. The guidance permitted prospective investors, once qualified to access a password-restricted web page containing information about private offerings, so long as they were restricted to participating in offerings posted on the web site after they had opened an account with the broker-dealer. (See the discussion of the staff's interpretive letter to *IPONET* (July 26, 1996) in Section X.E. below.)

The release reminds issuers contemplating an online private offering and web site operators purporting to facilitate these transactions that their offering activities must not involve a "general solicitation." The release points out that one method of ensuring that a general solicitation is not involved is to establish the existence of a "pre-existing, substantive relationship" and that, generally, staff interpretations of whether a "pre-existing, substantive relationship" exists have been limited to procedures established by broker-dealers in connection with their customers. The presence or absence of a general solicitation, however, is always dependent on the facts and circumstances of each particular case.

In addition, web site operators need to consider whether the activities that they are undertaking require them to register as broker-dealers under Section 15 of the Exchange Act. Generally, broker-dealer registration is required to effect transactions in securities even where the securities are exempt from registration under the Securities Act.

e. Technology Concepts

To facilitate any necessary regulatory action in the future, the release solicits comment on a number of issues involving the use of electronic media under the federal securities laws, including:

- the circumstances, if any, under which the requirement to deliver a disclosure document could be satisfied by simply posting the document on an Internet web site;
- the circumstances, if any, under which an investor would be deemed to have consented to electronic delivery of a disclosure document because the investor did not affirmatively reject electronic delivery, so-called “implied consent”;
- the circumstances, if any, under which the posting, rather than the direct delivery, of electronic notice might constitute adequate notice of the availability of electronic disclosure documents;
- issues that arise in the context of “electronic-only” offerings;
- the factors, if any, to be considered in determining anti-fraud liability for outdated information on an issuer’s web site;
- permissible communications when in registration by businesses that operate solely through their web sites; and
- issues associated with Internet discussion forums.

4. Additional Guidance

Interpretive letters addressing particular issues regarding electronic dissemination also provide guidance in this area. See Section X of this outline. See also Section VIII.A.5. for guidance concerning on-line offerings and related communications.

C. Interpretive Release Relating to Use of Internet Web Sites to Offer Securities, Solicit Securities Transactions or Advertise Investment Services Offshore

The Commission issued an interpretive release on March 23, 1998, that provides guidance on the application of the registration requirements of the U.S. securities laws to offers of securities or investment services made on Internet Web sites by foreign issuers, investment companies, investment advisers, broker-dealers and exchanges. In the release (Securities Act Release No. 7516), the Commission expresses its views on when the posting of offering or solicitation materials on Internet Web sites would not be considered to be an offering “in the United States.”

The release states that, for purposes of the registration requirements only, offshore Internet offers and solicitation activities would not be considered to be made “in the United States” if Internet offerors implement measures that are reasonably designed to ensure that their offshore Internet offers are not targeted to the United States or to U.S. persons. In the Commission’s view, offshore Internet offers that are not targeted to the United States would not trigger the registration requirements of the U.S. securities laws, even if U.S. persons are able to access the Web site offers.

The interpretation suggests measures that Web site offerors could implement to guard against targeting their offers to the United States. The measures outlined in the release are not exclusive. Other procedures may suffice to guard against sales to U.S. persons. Under the interpretation’s general approach, a foreign offeror could post an offer on its Web site without registering the offer, if: i) the offeror puts a meaningful disclaimer on the Web site that would specify intended offerees by identifying the jurisdictions in which the offer is or is not being made; and ii) the offeror implements measures reasonably designed to prevent sales to U.S. persons.

The release explains that the measures suggested under the general approach may not be adequate for U.S. offerors making offshore Internet offers. Because domestic offerors are very likely to have significant contacts with the United States, and because investors may reasonably assume SEC regulation of the Internet offers of domestic entities, the Commission believes that U.S. offerors making offshore Internet offers should, in addition to following the general approach, password protect their Web sites to ensure that only non-U.S. persons may access their unregistered Web site offers.

Offerors may wish to post their offerings on third-party Internet sites or communicate with offerees through forms of Internet communication that are more directed than through an Internet Web site posting. Depending on the activities and status of the offerors, implementation of the measures described under the general approach may not be adequate to guard against targeting the United States. For example:

- If an offeror seeks to have its offshore offer posted on the Web sites of third parties that are acting on its behalf, such as Web site service providers or underwriters, the offeror should only use third parties that employ at least the same level of precautions against targeting the United States as would be adequate for the offeror to employ.
- If, to generate interest in their offshore Internet offers, offerors use the services of investment-oriented Web site sponsors that have a significant number of U.S. clients or subscribers, then those offerors should employ measures to ensure that only non-U.S. persons may access the offering materials on their Web sites.
- Offerors that address or direct communications, such as e-mail, about their offers to particular U.S. persons or groups must assume the responsibility of determining when their offering communications are being sent to persons in the United States, and must fully comply with U.S. securities laws.

The release discusses issues that arise under the Securities Act of 1933 when foreign issuers make offshore Internet offers at the same time they make other offers in the United States. Offerors of concurrent offerings should consider whether, in addition to following the general approach, they should implement more restrictive measures to avoid targeting the United States. The release indicates that:

- Offerors of concurrent offshore Internet and U.S. private offers may not use their Web site offers as a means to solicit investors for their U.S. private offerings. The release suggests two non-exclusive ways to reach that result. These offerors could either: i) allow unrestricted access to their offshore Internet offers, but implement procedures to identify respondents to their Web site offers and restrict them from participating in their U.S. private offers; or ii) limit access to their offshore Internet offers to only those respondents who first provide the offerors with information indicating that they are not U.S. persons.
- Offerors of concurrent offshore Internet and U.S. registered offers should keep in mind U.S. securities laws limitations on pre-filing and waiting period communications.

In addition to addressing issues under the Securities Act of 1933, the release provides guidance on the application of the general approach to the registration obligations under the Investment Company Act of 1940, the Investment Advisers Act of 1940, and the broker-dealer and exchange registration provisions under the Securities Exchange Act of 1934.

D. Roadshows

Please see Section VI.A. of this outline. The significant no-action letters that the Division has issued regarding the electronic transmission of roadshow presentations are summarized in Section X.C. of this outline. In light of the pending rulemaking, the Division will no longer respond to interpretive or no-action requests about roadshows.

IV. SMALL BUSINESS ISSUES

A. Small Business Initiatives

The Commission has undertaken several initiatives to help small businesses, including the following:

- A special Corporation Finance headquarters unit specializes in small company filings and the needs of small businesses, including crafting rules to lessen the burden of Commission's regulation on these issuers. The telephone number for the unit is (202) 942-2950.

- The Commission's Internet site (<http://www.sec.gov>) has been enhanced to provide information specifically designed for small business and access to such Commission publications as "Q & A: Small Business and the SEC."
- The Division has added a new section to the Small Business Information page on the Commission's Internet site. The new section, Small Business Forms and Associated Regulations, provides guidance to small businesses as they prepare their SEC filings under the Securities Act of 1933 and Securities Exchange Act of 1934. The new section contains the text of a number of forms and regulations of interest to small businesses. Hypertext links between the forms and the regulations are provided, and updates will be made to reflect the adoption of new rules or changes to existing rules. More forms and rules will be added in the future.
- Since 1996, a number of town hall meetings between the Commission and small businesses have been conducted throughout the United States. These town hall meetings convey basic information to small businesses about fundamental requirements that must be addressed when they wish to raise capital through the public sale of securities. In addition, the Commission hopes to learn more about the concerns and problems facing small businesses in raising capital so that programs can be designed to meet their needs, consistent with the protection of investors.
- The 19th annual Government-Business Forum on Small Business Capital Formation was held in San Antonio, Texas on September 11-12, 2000. This platform for small business is the only governmentally-sponsored national gathering for small business, which offers annually the opportunity for small businesses to let government officials know how the laws, rules and regulations are affecting their ability to raise capital. The next Government-Business Forum will be in Colorado in September of 2001.

B. Small Business Rulemaking

1. Rule 504 of Regulation D

On February 25, 1999, the Commission issued a release (Securities Act Release No. 7644) adopting amendments to Rule 504, the limited offering exemption under Regulation D. Rule 504 permits non-reporting issuers to offer and sell securities to an unlimited number of persons without regard to their sophistication or experience and without delivery of any specified information. The aggregate offering price of this exemption is limited to \$1 million in any 12-month period, and certain other offerings must be aggregated with the Rule 504 offering in determining the available sales amount. Before these amendments were adopted, general solicitation and advertising was permitted and the securities sold under this exemption could be resold freely by non-affiliates of the issuer.

Unfortunately, there have been some disturbing developments in the secondary markets for some securities initially issued under Rule 504, and to a lesser degree, in the initial Rule 504 issuances themselves. These offerings generally

involve the securities of “microcap” companies. Recent market innovations and technological changes, most notably, the Internet, have created the possibility of nation-wide Rule 504 offerings for securities of non-reporting companies that were once thought to be sold locally.

As part of the Commission’s comprehensive agenda to deter registration and trading abuses, particularly by microcap issuers, in May 1998, the Commission proposed amendments to Rule 504 to eliminate the freely tradable nature of the securities issued under the exemption (Securities Act Release No. 7541). Under the proposals, these securities could only have been resold only after the one-year holding period of Rule 144, through registration, or through another exemption (such as Regulation A) if available. The Commission also solicited comment on an alternative to revise Rule 504 so it would be substantially similar to its pre-1992 format, permitting public offerings only where the issuer complies with state registration processes that require the preparation and delivery of a disclosure document to investors before sale of the securities. Comment also was solicited on the appropriate treatment for offerings made under certain state exemptions, such as the one recently developed for sales to accredited investors (e.g., the Model Accredited Investor Exemption).

Almost all commenters objected to the proposal to make all securities issued in a Rule 504 transaction restricted, since it would require issuers to offer a substantial liquidity discount in all Rule 504 issuances, even fully state registered ones, causing a significant reduction of capital. Commenters believed that the alternative approach, which was to reinstitute the rule largely as it had been in effect for a number of years before 1992, would be equally, if not more, effective. If an issuer goes through state registration and must deliver a disclosure document to investors, sufficient information ought to be available in the markets to permit investors to make more informed investment decisions and thus deter manipulation of Rule 504 securities.

After consideration of the comments, the Commission decided to return to the pre-1992 approach, which should deter microcap fraud without unduly penalizing small businesses. As amended, Rule 504 establishes the general principle that securities issued under the exemption, just like the other Regulation D exemptions, will be restricted, and prohibits general solicitation and general advertising, unless the specified conditions permitting a public offering are met. These conditions are:

- the transactions are registered under a state law requiring public filing and delivery of a substantive disclosure document to investors before sale. For sales to occur in a state without this sort of provision, the transactions must be registered in another state with such a provision and the disclosure document filed in the state must be delivered to all purchasers before sale in both states; or
- the securities are issued under a state law exemption that permits general solicitation and advertising, so long as sales are made only to accredited investors as that term is defined in Regulation D.

Most Rule 504 offerings are private. Private Rule 504 offerings are still permitted for up to \$1 million in a 12-month period, under the same terms and conditions, except for the specific disclosure requirements, as offerings under Rules 505 and 506. Securities in these offerings would be restricted, and these offerings would no longer involve general solicitation and advertising.

In response to questions the staff has received about the Rule 504 amendments, we would like to point that for public offerings registered under the provisions of a complying state registration system (New York and the District of Columbia do not have such a system), such offerings must be made exclusively to the citizens of the state(s) of registration. Registration in one state and attempted sale to the citizens of another state (except for New York and the District of Columbia) would not meet the public offering requirements and also may violate the law of the state where registration was not effected. Registration under a state law with sales to citizens of a foreign jurisdiction would not meet the standards for a public offering under revised Rule 504.

2. Rule 701

On February 25, 1999, the Commission issued a release (Securities Act Release No. 7645) adopting amendments to Rule 701 under the Securities Act of 1933, which allows private companies to sell securities to their employees without the need to file a registration statement, as public companies do. Rule 701 provides an exemption from the registration requirements of the Securities Act for offers and sales of securities under certain compensatory benefit plans or written agreements relating to compensation. The exemptive scope covers securities offered or sold under a plan or agreement between a non-reporting company (or its parents or majority-owned subsidiaries) and the company's employees, officers, directors, partners, trustees, consultants and advisors. Before these amendments were adopted, the total amount of securities that could be offered in the preceding 12 months could not exceed the greater of \$500,000 or an amount determined under one of two formulas (i.e., 15% of the issuer's total assets or 15% of the outstanding securities of the class being offered), but in no event more than \$5 million.

In February 1998, the Commission proposed a number of revisions to increase the flexibility and usefulness of Rule 701, as well as to simplify and clarify the rule (Securities Act Release No. 7511). On February 25, 1999, the Commission issued an adopting release that:

- removes the \$5 million aggregate offering price ceiling and, instead, sets the maximum amount of securities that may be sold in a year at the greatest of:
 - \$1 million (rather than the current \$500,000);
 - 15% of the issuer's total assets; or
 - 15% of the outstanding securities of the class;

- requires issuers to provide specific disclosure if more than \$5 million worth of securities are to be sold (i.e., a copy of the compensatory benefit plan or contract; a copy of the summary plan description required by the Employee Retirement Income Security Act of 1974 (“ERISA”), or if the plan is not subject to ERISA, a summary of the plan’s material terms; risk factors associated with investment in the securities under the plan or agreement; and the financial statements required in an offering statement on Form 1-A under Regulation A);
- does not count offers for purposes of calculating the available exempted amounts;
- harmonizes the definition of consultants and advisors permitted to use the exemption to the narrower definition of Form S-8, thereby narrowing the scope of eligible consultants and advisors;
- amends Rule 701 to codify current and more flexible interpretations; and
- simplifies the rule by recasting it in plain English.

Non-reporting foreign private issuers will be required to provide the same disclosure as non-reporting domestic issuers if sales under Rule 701 exceed \$5 million in a 12-month period. When, and if, the Commission accepts international accounting standards or guidelines for filing and reporting purposes, Rule 701 will be amended to allow these standards to satisfy Rule 701’s financial statement disclosure obligations for foreign private issuers. For issuers making smaller offerings, the foreign companies may continue to follow the rule as they have in the past, which means that “home country” reports may be used, as necessary, to satisfy the antifraud standards. However, both domestic and foreign private issuers that cross the \$5 million barrier will have to provide the disclosure required under Regulation A, which includes unaudited financial statements. Where the foreign private issuer does not provide financial statements prepared in accordance with U.S. GAAP, a reconciliation to such principles must be attached.

These amendments to Rule 701 became effective on April 7, 1999. The changes to the rule are not retroactive. Offers and sales made in reliance before the effective date will continue to be valid if they meet the conditions of the rule before its revision.

Because of errors in the Federal Register version of the adopting release, a different way of calculating the amount of the exempt offering appears in the Code of Federal Regulations than that approved by the Commission. On November 5, 1999, the Secretary of the Commission issued a release (Securities Act Release No. 7645A) to correct the errors. The correction deletes a reference to the necessity of only making calculations based upon an annual balance sheet. The original intention was to permit calculations to be made on the basis of interim balance sheets as long as they were no older than the issuer’s most recent fiscal year end.

V. INTERNATIONALIZATION OF THE SECURITIES MARKETS

A. Foreign Issuers in the U.S. Market

Foreign companies raising funds from the public or having their securities traded on a national exchange or the Nasdaq Stock Market are generally subject to the registration requirements of the Securities Act and the registration and reporting requirements of the Exchange Act. The Commission has provided a separate integrated disclosure system for foreign private issuers that provides a number of accommodations to foreign practices and policies. These accommodations include:

- interim reporting on the basis of home country and stock exchange practice rather than quarterly reports;
- exemption from the proxy rules and the insider reporting and short swing profit recovery provisions of Section 16;
- aggregate executive compensation disclosure rather than individual disclosure, if so permitted in an issuer's home country;
- acceptance of three International Accounting Standards relating to cash flow statements (IAS # 7), business combinations (IAS # 22) and operations in hyperinflationary economies (IAS # 21);
- offering document financial statements updated principally on a semi-annual, rather than a quarterly basis; and
- an exemption from Exchange Act registration under Section 12(g) for foreign private issuers that have not engaged in a U.S. public offering or whose securities are not traded on a national exchange or the Nasdaq Stock Market.

Additionally, the Commission staff has implemented procedures to review foreign issuers' disclosure documents on an expedited basis and in draft form, if requested by the issuer. This helps to facilitate cross-border offerings and listings in light of potentially conflicting home-country schedules and disclosure requirements.

Over the last five years, the number of foreign companies accessing the U.S. public markets has increased dramatically. As of October 1, 2000, there were over 1300 foreign companies from over 58 countries filing periodic reports with the Commission.

In addition to the topics discussed below in this "Internationalization" section, the Commission has issued an interpretive release on offshore Internet offerings; see Section III.C.

B. Abusive Practices under Regulation S and Amendments to Regulation S

The Commission adopted Regulation S in 1990 to clarify the applicability of the Securities Act registration requirements to offshore transactions. Since the adoption of Regulation S, a number of abusive practices have developed involving unregistered sales of equity securities by U.S. companies purportedly in reliance upon Regulation S. These transactions have resulted in indirect distributions of those securities into the United States without the investor protection provided by registration.

Regulation S has been used as a means of perpetrating fraudulent and manipulative schemes. In these schemes, the securities are being placed offshore temporarily to evade U.S. registration requirements, but the ownership of the securities never leaves the U.S. market, or a substantial portion of the economic risk is left in or is returned to the U.S. market during the restricted period, or there is no reasonable expectation that the securities could be viewed as coming to rest abroad.

In June 1995, the Commission issued an interpretive release that described certain abusive practices under Regulation S and requested comment on whether the regulation should be revised to limit its vulnerability to abuse, Securities Act Release No. 7190 (June 27, 1995). To address continued abuses of this rule, the Commission published for comment a proposal to amend Regulation S, Securities Act Release No. 7392 (February 20, 1997). In February 1998, the Commission adopted most of these proposed amendments, Securities Act Release No. 7505 (Feb. 17, 1998).

The amendments are designed to eliminate abusive practices under Regulation S, while preserving the benefits of the rule for capital formation. As a result of these amendments, securities offered and sold by domestic issuers pursuant to the Regulation S exemption will be treated in a manner similar to securities sold under the Regulation D exemption from registration.

The amendments to Regulation S affect offshore offerings of equity securities, including convertible securities, by U.S. companies. The amendments are as follows:

- Equity securities of domestic issuers placed offshore pursuant to Regulation S are classified as "restricted securities" within the meaning of Rule 144, so that resales without registration or an exemption from registration will be restricted;
- To avoid confusion between the holding period for "restricted securities" under Rule 144 and the "restricted period" under Regulation S, the term "restricted period" is renamed the "distribution compliance period;"
- The distribution compliance period for these securities is lengthened from 40 days to one year;

- Certification, legending and other requirements, which were applicable only to sales of equity securities by non-reporting issuers, are imposed on these equity securities;
- Purchasers of these equity securities are required to agree that their hedging transactions with respect to these securities will be conducted in compliance with the Securities Act, such as Rule 144 thereunder; and
- Domestic issuers are able to report sales of equity securities pursuant to Regulation S on a quarterly basis, rather than on Form 8-K. This change in reporting requirement was not effective until January 1, 1999, to allow Commission staff to monitor developments under the new amendments.

In addition, the amendments codify an existing Commission interpretive position that resales of these equity securities offshore do not "wash off" the restrictions applicable to these securities.

C. International Accounting Standards

The Commission has been working with the International Accounting Standards Committee (IASC) through the International Organization of Securities Commissions (IOSCO) since 1987 in an effort to develop a set of accounting standards for cross-border offerings and listings. The IASC is an independent, private sector body that was formed in 1973 by the professional accounting bodies in the U.S. and eight other industrialized countries to improve and harmonize accounting standards.

In July 1995, IOSCO and the IASC joined in an announcement that the IASC had developed a work program focusing on a core set of standards previously identified by IOSCO as being the necessary components of a reasonably complete set of accounting standards. The announcement noted that completion of comprehensive core standards that are acceptable to the IOSCO Technical Committee would allow the Technical Committee to recommend endorsement of the standards for cross-border capital raising and listing purposes in all global markets.

In April 1996, the IASC announced that it had accelerated its work program, and the Commission responded with a press release expressing support for the IASC's objective. The Commission's statement noted that the standards should include a core set of accounting pronouncements that constitute a comprehensive, generally accepted basis of accounting; that the standards be of high quality, i.e., they must result in comparability and transparency, and they must provide for full disclosure; and that the standards must be rigorously interpreted and applied. In October 1997, the Commission published a report to Congress that discussed the progress of the IASC. The report is available on the Commission's web site.

The IASC has completed substantially all the components of its core standards project, and both IOSCO and the Commission currently are engaged in a detailed assessment of the completed standards. On February 16, 2000, the Commission issued a concept release on the elements of a high quality financial

reporting framework, one of which is high quality accounting standards (Securities Act Release No. 7801). The release solicits comment about the quality of the IASC standards and frames the discussion in the context of a number of related issues that will affect how the IASC standards are interpreted and applied in practice. The deadline for comments is May 23, 2000.

D. International Disclosure Standards – Amendments to Form 20-F

On September 28, 1999, the Commission adopted changes to its non-financial statement disclosure requirements for foreign private issuers, to conform those requirements more closely to the International Disclosure Standards endorsed by IOSCO in September 1998 (Securities Act Release No. 7745). The changes are intended to harmonize disclosure requirements on fundamental topics among the securities regulations of various jurisdictions.

1. Background

The Commission has long supported the concept of a harmonized international disclosure system, and for a number of years has been working with other members of IOSCO to develop a set of international standards for non-financial statement disclosures that could be used in cross border offerings and listings. The International Disclosure Standards developed by IOSCO reflect a consensus among securities regulators in the major capital markets as to the types of disclosures that should be required for cross border offerings and listings. The Standards cover fundamental disclosure topics such as the description of the issuer's business, results of operations and management and the securities it plans to offer or list.

2. Changes to Foreign Integrated Disclosure System

The Commission amended Form 20-F, the basic Exchange Act registration statement and annual report form used by foreign issuers, to incorporate the International Disclosure Standards. The Commission also revised the Securities Act registration forms designated for use by foreign private issuers, and related rules and forms, to reflect the changes in Form 20-F. The amendments do not change the financial statement reconciliation requirements for foreign issuers, and the Commission will continue to require disclosure on topics not covered by the International Disclosure Standards, such as disclosures relating to market risk and specialized industries such as banks. Unlike the IOSCO International Disclosure Standards, which were intended to apply only to offerings and listings of common equity securities and only to listings and transactions for cash, the amendments to Form 20-F apply to all types of offerings and listings and to annual reports. The Commission also revised the definition of "foreign private issuer," which determines an issuer's eligibility to use certain Commission forms and benefit from certain accommodations under Commission rules, to clarify how issuers should calculate their U.S. ownership for purposes of the definition.

The changes to Form 20-F, the Securities Act registration forms and the "foreign private issuer" definition became effective in September 2000.

VI. OTHER PENDING RULEMAKING AND RECENT RULE ADOPTIONS

A. Roadshows

The Division's staff has begun to work on rule proposals regarding presentations by issuers or underwriters intended to develop potential investors' interest in registered public offerings ("roadshows"). The proposals may address topics such as access to roadshows and roadshow information, whether the roadshow itself or roadshow information should be filed with the Commission, and the application of liability provisions to issuers and underwriters with respect to a roadshow. The significant no-action letters that the Division has issued regarding the electronic transmission of roadshow presentations are summarized in Section X.C. of this outline. In light of the pending rulemaking, the Division will no longer respond to interpretive or no-action requests about roadshows.

B. Proposed Amendment to Options Disclosure Document Rule

On June 25, 1998, the Commission issued a release soliciting comments on a proposal to revise Rule 135b (Securities Act Release No. 7550). The proposal provides that an options disclosure document prepared in accordance with Rule 9b-1 under the Securities Exchange Act of 1934 is not a prospectus, and accordingly is not subject to civil liability under Section 12(a)(2) of the Securities Act. The proposal is intended to codify a long-standing interpretive position that was issued immediately after the Commission adopted the current registration and disclosure system applicable to standardized options. The proposed revision is intended to eliminate any legal uncertainty in this area.

C. Financial Statements and Periodic Reports For Related Issuers and Guarantors

On August 24, 2000, the Commission adopted rules concerning the financial statements and Exchange Act reporting requirements for subsidiary guarantors and subsidiary issuers of guaranteed securities (Securities Act Release No. 7878). These rules include revisions to Rule 3-10 of Regulation S-X and new Rule 12h-5 under the Exchange Act. The rules supersede Staff Accounting Bulletin 53 (SAB 53).

The amendments to Rule 3-10 codify the staff's current positions as articulated in SAB 53 and the interpretive positions that the staff has taken with respect to SAB 53, with one principal difference. The rule does not permit the presentation of summarized financial information in lieu of separate financial statements of a subsidiary issuer or guarantor. Rather, it requires condensed consolidating financial information in all situations where SAB 53 permitted summarized financial information.

Amended Rule 3-10 retains the general requirement that each subsidiary issuer or guarantor must file the same financial statements specified by Regulation S-X for a registrant. It then identifies exceptions where more limited financial information is permitted. To qualify for an exception, the guarantee must be full and

unconditional, the subsidiary must be 100% owned by its parent company, the parent company must file consolidated financial statements meeting the requirements of Rules 3-01 and 3-02 of Regulation S-X, and the parent company's consolidated financial statements must include condensed consolidating financial information reflecting in separate columns the parent company, the subsidiary issuer(s), the subsidiary guarantors(s), any non-guarantor subsidiaries, consolidating adjustments, and the consolidated totals. This information is required in the registration statement and in the parent company's subsequent annual and quarterly reports under the Exchange Act. In certain limited cases, narrative disclosure about the guarantees is permitted in lieu of the condensed consolidating information. These limited circumstances include "plain vanilla" finance subsidiary issuers guaranteed solely by the parent company, and parent company issuers with no independent assets or operations where all the subsidiaries are guarantors. The exceptions described above also apply to parent companies and subsidiaries that co-issue debt, provided that all other qualifying conditions are met.

Amended Rule 3-10 includes specific requirements applicable to recently acquired guarantors. If a significant recently acquired guarantor has not been included in the parent company's consolidation for at least nine months, one year of audited pre-acquisition financial statements of that guarantor is required in any registration statement for guaranteed securities. A recently acquired guarantor is significant if the greater of its pre-acquisition net book value or purchase price exceeds 20% of the principal amount of the securities being registered. Financial statements of recently acquired guarantors are not required in periodic reports under the Exchange Act.

New Rule 12h-5 exempts from Exchange Act reporting any subsidiary issuer or guarantor permitted by Rule 3-10 to omit financial statements. Thus Rule 12h-5 eliminates the need for subsidiary issuers or guarantors to request exemptive or no-action relief from Exchange Act reporting.

The rule revisions did not change the financial statement requirements for affiliates whose securities are pledged as collateral for a registered security, but those requirements have been relocated to new Rule 3-16 to distinguish them from the subsidiary issuer and guarantor requirements. Revisions to Item 310 of Regulation S-B clarify that the requirements of amended Rule 3-10 and Rule 3-16 apply to small business issuers. Appendices to the adopting release provide implementation guidance regarding the 100%-owned test, the identification of the parent company, and the financial statement requirements for recently acquired guarantors.

The rules became effective September 25, 2000. Registrants must apply the new rules in registration statements and post-effective amendments first filed after September 25, 2000, and in all subsequent Exchange Act periodic reports. Registrants that have existing Exchange Act reporting obligations with respect to guaranteed securities must apply the new rules beginning with their annual report for their first fiscal year ending after September 25, 2000.

D. Delivery of Disclosure Documents to Households

On October 27, 2000, the Commission issued a release concerning the delivery of proxy statements and information statements to two or more investors sharing the same address. This method of delivery is referred to as householding. The release sets forth final rules regarding the householding of proxy statements, information statements, and annual reports. (Securities Act Release 33-7912).

Under the amended Exchange Act rules, companies may satisfy proxy statement, information statement and annual report delivery requirements by sending a single copy of the relevant document to two or more security holders residing at the same address if the security holders have consented to householding on a written or implied basis. Consent can be implied if four conditions are met:

- the security holders have the same last name or the company reasonably believes that they are members of the same family;
- security holders are given 60 days advance notice of householding and an opportunity to opt out;
- the security holders do not opt out of householding; and
- the prospectus or shareholder report is delivered to a residential street address or a post-office box.

A separate proxy card or form of voting instructions still will need to be delivered to each security holder in the household. Banks and broker-dealers may also rely on the rules to household proxy statements, information statements and annual reports, unless the company whose document is to be householded objects.

In addition to the amendments regarding householding of proxy statements, information statements and annual reports, the Commission amended Securities Act Rule 154 to permit the householding of combined proxy statement-prospectuses.

The adopted householding amendments are intended to reduce the amount of duplicative information that investors receive, and to lower printing and mailing costs to companies that ultimately are borne by investors.

E. Selective Disclosure and Insider Trading Rules

Effective October 23, 2000, the Commission adopted Regulation FD and Rules 10b5-1 and 10b5-2. These rules are designed to

- eliminate selective disclosure of material nonpublic information by public companies;
- clarify, for insider trading liability purposes, that someone trading while **aware** of material nonpublic information is trading **on the basis of** that information unless trading is done under one of the newly created affirmative defenses; and

- clarify, for insider trading liability purposes, in what family and other non-business relationships a person is presumed to have a duty of trust and confidence.

1. Regulation FD (Fair Disclosure)

Regulation FD provides that whenever a reporting company or a person acting on its behalf discloses material nonpublic information to specified securities market professionals or shareholders, the issuer must make the same information public. If the person making the disclosure to those persons knows at that time (or is reckless in not knowing) that the information is both material and nonpublic, the disclosure is “intentional.” If the disclosure is intentional, then the public disclosure must be simultaneous. In all other cases, the public disclosure must be made “promptly.” Promptly means as soon as practicable (but in no event after the later of 24 hours or the commencement of the next day of trading on the New York Stock Exchange) after a senior official of the company learns that there has been a selective disclosure of material nonpublic information.

a. Covered securities market professionals and shareholders

Regulation FD only covers selective disclosure to specified persons that are outside the issuer. They are

- a broker or dealer, or a person associated with a broker or dealer;
- an investment adviser, or a person associated with one;
- an institutional investment manager reporting on Form 13F or a person associated with one;
- an investment company, a hedge fund, or an affiliated person of either one; or
- a holder of the issuer's securities, under circumstances in which it is reasonably foreseeable that the person will purchase or sell the issuer's securities on the basis of the information.

b. Persons acting on behalf of the issuer

“Person acting on behalf of an issuer” means any

- director;
- executive officer (as defined in Exchange Act Rule 3b-7);
- investor relations or public relations officer;

- other person with functions similar to a director, executive officer or investor relations or public relations officer; or
- other officer, employee, or agent of an issuer who regularly communicates with the covered securities market professionals or with holders of the issuer's securities.

A director, officer, employee or agent of an issuer who discloses material nonpublic information in breach of a duty of trust or confidence to the issuer, however, is not treated as a person acting on behalf of the issuer for purposes of Regulation FD. Such a person would, nonetheless, face liability for insider trading under Rule 10b-5.

c. Methods of public disclosure

An issuer may satisfy its obligation to make public disclosure under Regulation FD by including the information in a Form 8-K. The issuer may choose whether to “furnish” that Form 8-K under new Item 9 or file it under Item 5. Only a “filed” Form 8-K is subject to Section 18 of the Exchange Act and automatically incorporated by reference into short-form filings under the Securities Act. Form 8-K now provides that issuers making disclosure under Item 5 or 9 are not admitting that the information is material if the disclosure is required solely by Regulation FD.

An issuer is exempt from the requirement to furnish or file a Form 8-K if it instead disseminates the information through another method (or combination of methods) of disclosure that is reasonably designed to provide broad, non-exclusionary distribution of the information to the public.

Upon adoption of Regulation FD, the Commission described a three-step best practices model for making a planned public disclosure of material information under Regulation FD other than through a Form 8-K filing. It includes

- distributing a press release through regular channels that contains the information;
- providing adequate notice, by a press release or a website posting, of a scheduled conference call to discuss the information; and
- holding the call in an open manner, either allowing investors access through the telephone or through webcasting.

d. Material Nonpublic Information

Regulation FD relies on definitions of “material” and “nonpublic” established in the case law. Information is material if “there is a substantial likelihood that a reasonable shareholder would consider it important” in making an investment decision. To fulfill the materiality requirement, there must be a substantial likelihood that a fact “would have been viewed by the reasonable investor as having significantly

altered the 'total mix' of information made available." Information is nonpublic if it has not been disseminated in a manner making it available to investors generally.

An issuer would not be conveying material nonpublic information if it shared seemingly inconsequential data which, pieced together with public information by a skilled analyst with knowledge of the issuer and the industry, helps form a mosaic that reveals material nonpublic information. Provided that the issuer is not simply breaking material information into pieces to evade the regulation, it would not violate Regulation FD by revealing this type of data even if, when added to the analyst's own fund of knowledge, it is used to construct his or her ultimate judgments about the issuer.

e. Exclusions to Regulation FD

Regulation FD does not apply to issuers that

- are not required to file reports under Exchange Act Section 12 or 15(d);
- are foreign governments;
- are foreign private issuers; or
- are investment companies other than closed-end mutual funds.

Regulation FD does not apply to a disclosure made

- to a person who owes a duty of trust or confidence to the issuer (a temporary insider, such as an attorney, investment banker, or accountant);
- to a person who expressly agrees to maintain the disclosed information in confidence;
- to a credit rating agency that makes its ratings public, provided the information is disclosed solely for the purpose of developing a credit rating; or
- in connection with a securities offering registered under the Securities Act, other than an offering of the type described in any of Rule 415(a)(1)(i) - (vi).

To clarify the scope of the registered securities offering exception, Regulation FD states when registered offerings of various types begin and end. They begin and end as follows:

<u>Type of Offering</u>	<u>Begins</u>	<u>Ends</u>
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<u>Underwritten Offering</u>	When the issuer reaches an understanding with the broker-dealer that is to act as managing underwriter	Unless terminated sooner, at the later of the end of the period during which dealers must deliver a prospectus, or the sale of the securities
<u>Non-Underwritten Offering</u>		
<ul style="list-style-type: none"> • Delayed shelf takedown 	When the issuer makes its first bona fide offer in the takedown	Unless terminated sooner, at the later of the end of the period during which dealers must deliver a prospectus, or the sale of the securities in that takedown
<ul style="list-style-type: none"> • All others 	When the registration statement is filed	Unless terminated sooner, at the later of the end of the period during which dealers must deliver a prospectus, or the sale of the securities
<u>Business Combination</u>	When the first public announcement of the transaction is made	When the vote is completed or the tender offer expires, as applicable

f. Impact of a Violation of Regulation FD

Regulation FD provides that an issuer's failure to make a public disclosure required solely by the regulation will not be deemed a violation of Rule 10b-5. Thus, while the Commission could proceed against an issuer for a violation of Regulation FD, private parties would not have a cause of action under Rule 10b-5 based solely on a failure to disclose under Regulation FD.

A failure to make a public disclosure required by Regulation FD does not affect whether the issuer is timely or current in its reporting for purposes of Forms S-2, S-3 and S-8 or whether there is adequate current public information about the issuer for purposes of Rule 144(c).

2. Rule 10b5-1: Trading While Aware of Material Non-Public Information

For purposes of insider trading liability, Rule 10b5-1 provides that a person who buys or sells securities while aware of material nonpublic information about the issuer or those securities trades “on the basis of” that information. The rule also provides, however, affirmative defenses to that general rule. The affirmative defenses allow persons, including corporate officers and directors, to buy and sell the issuer’s securities without liability under Rule 10b-5 while aware of material nonpublic information if the transaction was arranged before the person became aware of the information. In order to claim an affirmative defense, a person must

- enter into a binding contract to buy or sell;
- instruct another person to buy or sell for him, her or it; or
- adopt a written trading plan.

The contract, instruction or plan must be entered into in good faith and not be a scheme to evade the prohibitions of Rule 10b5-1. At the time of establishing the contract, instruction or plan, a person must set the amount to buy or sell, the price at which to buy or sell, and the date at which to buy or sell. (The price may be a market price on a particular date, a limit price or a particular dollar price.) A person may specify these terms or set forth in the contract, instruction or plan a written formula, algorithm or computer program that makes those determinations. Alternatively, a person may specify in the contract, instruction or plan that he, she or it may not have any subsequent influence over the sales or purchases, and grant the power to determine how, when and whether to buy or sell to another person. The other person must not be aware of material nonpublic information when doing so.

For the affirmative defense to apply, the purchase or sale must occur pursuant to the contract, instruction or plan. A transaction is not pursuant to the contract, instruction or plan if the person altered or deviated from the contract, instruction or plan by changing the amount, price or timing or entered into or altered a corresponding or hedging transaction.

For a buyer or seller that is not a natural person, there is an additional affirmative defense under Rule 10b5-1. It may show that it is not selling or buying on the basis of material nonpublic information if

- the person making the investment decision on behalf of it was not aware of any material nonpublic information; and
- it implemented reasonable policies and procedures to ensure that individuals making investment decisions would not violate insider trading laws.

3. Rule 10b5-2: Insider Trading and Families

Rule 10b5-2 defines some of the circumstances in which a duty of trust and confidence exists for purposes of insider trading under Rule 10b-5. The duty exists when

- the person agrees to maintain information in confidence;
- there is a history, pattern or practice of sharing confidences such that the recipient knows or should know that the person communicating the material nonpublic information expects the recipient to maintain its confidentiality; or
- a person receives or obtains material nonpublic information from his or her spouse, parent, child or sibling.

Rule 10b5-2 provides, however, that the presumption that a duty of trust of confidence exists within the identified family relationships may be rebutted. A person who receives information from a spouse, parent, child or sibling could show that the requisite duty did not exist in his or her particular family relationship.

VII. STAFF LEGAL BULLETINS FOR DIVISION OF CORPORATION FINANCE

The Division of Corporation Finance publishes Staff Legal Bulletins to provide advice to the public on frequently recurring issues. Copies of the bulletins may be obtained from the Commission's web site (<http://www.sec.gov>) or by writing to, or making a request in person at, the Public Reference Room, Securities and Exchange Commission, 450 5th Street, N.W., Room 1024, Washington, DC, 20549 ((202) 942-8090). These are the Staff Legal Bulletins the Division has issued to date:

- Staff Legal Bulletin No. 1 (CF) - Confidential Treatment Requests
- Staff Legal Bulletin No. 2 (CF) - Modified Exchange Act Reporting for Companies in Bankruptcy
- Staff Legal Bulletin No. 3 (CF) - Reliance on the Section 3(a)(10) exemption from the Securities Act of 1933 registration requirements (updated October 20, 1999)
- Staff Legal Bulletin No. 4 (CF) - Spin-Offs
- Staff Legal Bulletin No. 5 (CF/IM) - Year 2000 Disclosure Issues (Superseded by Securities Act Release No. 7558)
- Staff Legal Bulletin No. 6 (CF/MR/IM) - Euro Conversion Issues
- Staff Legal Bulletin No. 7 (CF) - Plain English (Updated June 7, 1999)

VIII. CURRENT DISCLOSURE, LEGAL AND PROCESSING ISSUES

A. Disclosure, Legal and Processing Issues

1. Disclosures about "Targeted Stock"

a. Overview

Some registrants have issued classes of stock that they characterize as “targeted” or “tracking” stock because they are referenced in some manner to a specific business unit, activity or assets of the registrant. The staff is concerned that the style and content of disclosures about the operations referenced by a class of common stock may give the inaccurate impression that the investor has a direct or exclusive financial interest in that unit.

Notwithstanding the title given to a particular class of stock, an investor in any of a registrant’s classes of common stock has a financial interest only in the residual net assets of the registrant, allocated among the shareholder classes in accordance with the formulae stipulated in the corporate charter. Assets and income attributed to units referenced by each class typically are available to all of the registrant’s creditors, and even other classes of shareholders, in the event of liquidation. While dividends declared on each class may not exceed some measure of the performance of the referenced business unit, no dividends need be declared at all. Moreover, the dividend declaration policies typically are subject to change and need bear no relationship to the relative performance of the referenced businesses. Methods and assumptions that can significantly affect measurement of the referenced unit’s performance typically can be changed at any time without the consent of the security holders.

b. Characterizations of the security as “tracking” a business unit

If no term of the targeted stock requires or assures that potential distributions will correlate with the performance of the business unit nominally associated with the security, implications that the market value of the security will “track,” or is otherwise linked with, a business unit are subject to challenge. The staff has asked registrants to explain in their filings why the formula for determining the amount available for dividends (or any other term or feature of the security) can be expected to link in some fashion the market value of a class of common stock with the value or performance of any subpart of the registrant, or state clearly that management does not intend to imply such a linkage.

c. Recommended approach to disclosure about targeted stock

While the staff encourages robust disclosure about the registrant’s operating segments, presenting information about the referenced businesses as if distinct from the registrant may confuse investors about the nature of the security. We believe companies should integrate discussions and quantitative data about the referenced

business units more closely within a comprehensive discussion of the registrant's financial condition and operating results. While schedules or condensed financial information demonstrating the calculation of earnings available for each class of the registrant's common stock are relevant, more extensive presentations can be misunderstood and should be reconsidered. If a company chooses to present more than condensed financial data, the staff has recommended that companies present no greater detail than "consolidating financial statements" that include the referenced businesses together with the financial statements of the registrant. That presentation would show explicitly how management and the board have allocated and attributed revenues, expenses, assets, liabilities, and cash flows, but will not necessarily reflect earnings applicable to the different classes of stock due to features of the allocation formula that are incompatible with GAAP.

d. Use of separate full financial statements for a referenced business unit

Notwithstanding our recommendation to the contrary, some issuers of targeted stock have chosen to present complete separate audited financial statements of the referenced units. In this case, the staff believes that financial statements of the referenced unit furnished to investors should be accompanied always by financial statements of the registrant, as issuer of the security. Most auditors will permit use of their report on the financial statements of the referenced business only in those circumstances. EPS of one class of stock should not be presented alone or within the separate financial statements of the referenced business security because that business did not issue the security. EPS with respect to any class of the issuer's securities should be presented only with the issuer's consolidated financial statements or with its related consolidated information.

e. Consequences of formula-based financial statements

In some cases, separate financial statements presented in an issuer's filing do not appear to be an actual business or division, but rather an elaborate depiction of the earnings allocation formula for a class of stock, as if those legal terms defined an accounting entity. For example, sometimes that formula results in the depiction of one of the issuer's businesses as if it had a financial interest in another of its businesses. Financial statements prepared in accordance with the dictates of management, the board and the corporate charter for the purpose of measuring earnings available to a class of shareholders do not necessarily present fairly the financial condition, cash flows and operating results of an actual business unit within the registrant.

The staff has raised a number of questions in these circumstances: Do financial statements based on these formulae comply with GAAP? Does the association of the auditor with these presentations give unwarranted comfort to investors about the fairness to the different shareholder groups of management's assignment of revenues and expenses and its allocation of capital and other costs? Are the financial statements "special purpose" financial statements that are prepared

on a basis of accounting prescribed in a contractual agreement, requiring special considerations for disclosure and auditor association?

f. Non-GAAP measures of performance

In some cases, the terms of the targeted stock stipulate explicitly that the performance of the unit will be measured on a basis that departs from GAAP. Any measurement, classification, allocation or disclosure that departs from GAAP but is necessary to measure or explain amounts available for dividends on stock referenced to the unit should be depicted separately from presentations that are purported to be in accordance with GAAP. An amount should not be labeled as "net income" unless it is calculated in accordance with GAAP. If the financial statements of the unit are purported to be in accordance with GAAP, management should ensure that all information essential for a fair presentation of the entity's financial position, results of operations, and cash flows in conformity with GAAP is set forth in the financial statements. Failure to include all such information should result in a qualification of the auditor's report on the unit's financial statements.

g. Cost allocations

The units referenced by the targeted stock may share many common costs, such as general and administrative and interest costs. As required by SAB Topic 1B, a complete description of any allocation methods used for cash, debt, related interest and financing costs, corporate overhead, and other common costs should be provided in the notes to the financial statements that purport to be prepared in accordance with GAAP. The amounts likely to be reported by the entity were it a stand-alone entity should be disclosed. In some cases, the staff has questioned whether allocations have been biased. For example, operating results and EPS of operations that are valued on the basis of earnings could be unfairly inflated as a result of excessive allocations of common costs to operations that are valued on the basis of revenue growth. If the methodologies and assumptions underlying the allocations of debt and corporate expenses may change without security holder approval, that fact should be stated clearly. If the financial statements of the business unit before and after the issuance of the tracking stock will not be comparable, that fact should be disclosed. On occasion, the staff has questioned whether a change in the method of attributing revenue or expense from one shareholder group to another would be reported as a change in reporting entity or, if deemed a change in estimate or principle, how the auditor will determine whether a change is a "better" method of calculating earnings attributable to a particular shareholder group.

h. Other disclosure issues

Other areas of disclosure that are of particular significance for issuers of targeted stock include the following:

- Policies for the management of cash generated by and capital investment in the referenced units, and for the pricing of "transactions" between the referenced units.

- Conflicts of interest.
- Effects of corporate events (mergers, tender offers, changes in control, adverse tax rulings, liquidation) on rights of the security holders.
- Terms under which one class may be converted into another class.
- Effects of changes in relative market values of the registrant's outstanding classes of stock on rights of the security holders.

2. "Blank Check" Companies

Where a reporting "blank check" company, as defined in Rule 419(a)(2) of Regulation C, merges into a non-reporting operating company, Rule 12g-3(a) is not available unless complete audited financial statements of the operating company, as well as pro formas, are provided at the effective date of the "succession transaction." This information should be filed under cover of Form 8-K. For additional information concerning "back door" registration on Form 8-K, see *National Association of Securities Dealers* (April 7, 2000) at www.otcbb.com/news/EligibilityRule/8kreg.stm. For Section 5 issues related to "blank check" companies, see *NASD Regulation, Inc.* (January 21, 2000) located in Section X.E. of this outline. See also Rule 419 of Regulation C, which applies generally to offerings by "blank check" companies.

3. Syndicate Short Sales

a. What are "syndicate short sales"?

In a registered IPO or follow-on offering of equity and equity-related securities, the Agreement among Underwriters customarily will authorize the lead manager to sell securities in excess of the number of securities included in the firm commitment underwriting for the account of the syndicate. This "syndicate short position" could include:

- a "covered" short position equal to the securities registered to cover the underwriters' option to purchase additional securities from the issuer -- this option to purchase additional shares is called the "overallotment option" or "green shoe," and
- a "naked" short position equal to a specified percentage of the securities included in the firm commitment underwriting -- the AAU specifies the extent of the permissible naked short.

The "covered" short position customarily is 15% of the amount of the firm commitment underwriting. This limit is related to the limit on the size of the overallotment option set forth in National Association of Securities Dealers rules. In recent years, the "naked" short position has customarily been up to either 15% or 20% of the amount of the firm commitment underwriting. The size of the "naked" short position is not addressed in the NASD rules.

b. When is a syndicate short position established and how is it covered?

The short position is created at the same time securities in the firm commitment underwriting are allocated -- after effectiveness and pricing of the transaction. The syndicate short shares are sold at the public offering price. All purchasers of securities sold by the underwriting syndicate receive final prospectuses and identical forms of Exchange Act Rule 10b-10 confirmations reflecting the prospectus delivery requirement. No distinction is made between the firm commitment and short sale securities on the books and records of the underwriters, the transfer agent or any clearing agency. For all intents and purposes, the syndicate short shares are indistinguishable from all other shares sold under the registration statement.

The decision to create a syndicate short position (both "covered" and "naked") is made by the lead manager, in its sole discretion, at the time of pricing. Most offerings have a short position at least equal to the underwriters' over-allotment option or "green shoe." The decision to exercise the green shoe to cover a syndicate short position, if any, must be made within the period specified in the Underwriting Agreement, typically 30 days. The green shoe is often exercised almost immediately in transactions that trade at price levels significantly in excess of the public offering price in order to obviate the need to have a second "closing" with respect to the green shoe shares. However, in some transactions the decision to exercise the green shoe is not made until nearly the end of the 30-day period.

While there is usually a covered syndicate short, the creation of a naked syndicate short is less common. The naked short is more likely to be created in a transaction where the lead manager has reason to be concerned that the supply of securities offered for sale in the secondary market after the commencement of trading in the securities will significantly exceed the demand to purchase such securities, thereby creating downward pressure on the price of the securities that could adversely affect the investors who have purchased in the offering. These concerns may be based on the volatility of the overall market or the level or quality of demand for the securities being offered. The level or quality of demand refers to the ratio of indications of interest or conditional offers to the number of securities being offered and the extent to which the lead manager perceives that if the buyers receive allocations of securities they will be long term holders of all or a significant portion of those securities.

The "naked short shares" are delivered and paid for by investors at the same time as the firm commitment and covered short shares. In order to deliver the naked short shares, the underwriters may borrow shares which, in the case of an IPO, may be shares issued in the offering. In a follow-on offering, the underwriters may borrow either shares that were issued in the offering or shares that were outstanding before the offering. The syndicate bears the cost of borrowing those shares.

c. What prospectus disclosure is required with regard to the syndicate short position and the manner in which it is covered?

The fact that the underwriters may make short sales and may engage in short covering transactions must be disclosed in the “Plan of Distribution” or “Underwriting” section of the prospectus. The staff will raise comments if this disclosure does not address the following material points regarding any applicable short sale transactions. The disclosure may use the language set forth following each point or may be in other clear, plain language.

- *The potential for underwriter short sales in connection with the offering* -- for example, the disclosure may state: “In connection with the offering, the underwriters may make short sales of the issuer’s shares and may purchase the issuer’s shares on the open market to cover positions created by short sales.”
- *What short sales are* -- for example, the disclosure may state: “Short sales involve the sale by the underwriters of a greater number of shares than they are required to purchase in the offering.”
- *What covered short sales are* -- for example, the disclosure may state: “‘Covered’ short sales are sales made in an amount not greater than the underwriters’ ‘overallotment’ option to purchase additional shares in the offering.”
- *How underwriters close out covered short sale positions* -- for example, the disclosure may state: “The underwriters may close out any covered short position by either exercising their overallotment option or purchasing shares in the open market.”
- *How underwriters determine the method for closing out covered short sale positions* -- for example, the disclosure may state: “In determining the source of shares to close out the covered short position, the underwriters will consider, among other things, the price of shares available for purchase in the open market as compared to the price at which they may purchase shares through the overallotment option.”
- *What naked short sales are* -- for example, the disclosure may state: “‘Naked’ short sales are sales in excess of the overallotment option.”
- *How underwriters close out naked short sale positions* -- for example, the disclosure may state: “The underwriters must close out any naked short position by purchasing shares in the open market.”
- *When a naked short position will be created* -- for example, the disclosure may state: “A naked short position is more likely to be created if the underwriters are concerned that there may be downward pressure on the

price of the shares in the open market after pricing that could adversely affect investors who purchase in the offering.”

- *The potential effects of underwriters’ short sales and underwriters’ transactions to cover those short sales* -- for example, the disclosure may state: “Similar to other purchase transactions, the underwriters’ purchases to cover the syndicate short sales may have the effect of raising or maintaining the market price of the [issuer’s] stock or preventing or retarding a decline in the market price of [issuer’s] stock. As a result, the price of the [issuer’s] stock may be higher than the price that might otherwise exist in the open market.”

This disclosure is, of course, in addition to the other disclosure included in that section of the prospectus regarding stabilizing transactions. The disclosure addressing the foregoing points may be combined with that other disclosure.

d. Is the offer and sale of the “naked short shares” registered under the Securities Act?

Yes. It is the Division’s view that the offer and sale of all shares in the registered offering are registered under the registration statement. In this regard, “all shares in the registered offering” refers to

- the firm commitment shares,
- the covered short - or green shoe - shares, and
- the naked short shares.

Although the naked short shares are included in “all shares in the registered offering,” the number of shares specified on the cover page of the registration statement need only include the number of firm commitment shares and the green shoe shares. The number of shares specified on the cover page of the registration statement is understood to include an indeterminate number of naked short shares up to the extent permitted by the AAU. The “Plan of Distribution” or “Underwriting” section of the prospectus must describe the offer and sale of all shares in the registered offering.

The treatment of the naked short shares on the cover page of the registration statement set forth above differs from the method in which registrants register shares to be sold in “market making” transactions. With respect to “market making shares,” the registrant must include an indeterminate number of those shares on the cover page of the registration statement.

e. How do the anti-fraud and civil liability provisions of the federal securities laws apply to the offer and sale of the naked short shares?

In a registered offering, the anti-fraud and civil liability provisions of the federal securities laws apply to the offer and sale of the naked short shares in the same manner as the offer and sale of other shares in that registered offering.

4. Third-Party Derivative Securities

In *Morgan Stanley & Co., Inc.* (June 24, 1996), the Division addressed disclosure issues relating to Securities Act Section 5 registered offerings of securities that are exchangeable, on either an optional or a mandatory basis ("Exchangeable Securities"), for the equity securities (or the cash value thereof) of another issuer ("Underlying Securities").

The Division took the position that complete disclosure regarding the issuer of the Underlying Securities is material to investors at the time of both the initial sale of the Exchangeable Securities and on a continuous basis thereafter until the Underlying Securities (or the cash value thereof) have been exchanged for the Exchangeable Securities and other payment obligations on the Exchangeable Securities, if any, have been satisfied. The Division also took the view that this complete disclosure is not required to be set forth in the filings of the issuer of the Exchangeable Securities where there is sufficient market interest and publicly available information regarding the issuer of the Underlying Securities.

The Division stated that sufficient market interest and publicly available information will be deemed to exist where the issuer of the Underlying Securities

- has a class of equity securities registered under Exchange Act Section 12; and
- is either
 - eligible to use Securities Act Form S-3 or F-3 for a primary offering of non-investment grade securities pursuant to General Instruction B.1 of such forms; or
 - meets the listing criteria that an issuer of the Underlying Securities would have to meet if the class of Exchangeable Securities was to be listed on a national securities exchange as equity linked securities, such as American Stock Exchange Rule 107.B.

The Division also stated that where there is sufficient market interest and publicly available information, as described above, the issuer of the Exchangeable Securities may include abbreviated disclosure about the issuer and terms of the Underlying Securities in its Securities Act registration statement and Exchange Act periodic reports. Abbreviated disclosure in a report is adequate only where there is sufficient market interest and publicly available information at the time the report is filed.

Finally, the Division stated that the abbreviated disclosure would include at least:

- a brief discussion of the business of the issuer of the Underlying Securities;
- disclosure about the availability of information with respect to the issuer of the Underlying Securities similar to that required by Regulation S-K Item 502(a); and
- information concerning the market price of the Underlying Securities similar to that called for Regulation S-K Item 201(a).

EITF Issues Nos. 86-28 and 96-12 address certain aspects of the accounting for third-party derivative securities.

5. Section 5 Issues Arising from On-line Offerings and Related Communications, Including Offers to Buy

Many underwriters have begun using the Internet to offer and sell securities in registered public offerings. These e-brokers post preliminary prospectuses, and sometimes other material, on their web sites and many solicit conditional offers to buy securities rather than the more customary indications of interest.

In connection with our review of registration statements, we have been issuing comments to get information on what procedures the different e-brokers are using to assure compliance with Section 5 of the Securities Act, and specifically, to avoid pre-effective sales of securities violative of Section 5(a). In addition, we have been actively contacting e-brokers to review their procedures outside the context of a particular offering to avoid timing concerns. In our review of the offering procedures of e-brokers, we examine how conditional offers to buy securities are solicited, how and when they are accepted, and how these purchases are funded. To the extent e-brokers take indications of interest, we also check to ensure that they have procedures in place to obtain reconfirmations from customers after effectiveness.

The following discussion principally relates to our experience in examining e-brokers' practices in IPOs. We may issue additional guidance with respect to follow-on offerings as we gain more experience in that area.

a. Communications during the offering process

Before effectiveness, communications on an e-broker's (as well as on the issuer's) web site that make an offer to sell or solicit an offer to buy may only be made by means of a prospectus complying with Section 10 or by communications that come within the safe harbor of Rule 134. Communications that are merely instructional and are not designed to generate interest in a particular offering typically are unobjectionable even if they do not fall within the safe harbor of Rule 134. See, for example, *Wit Capital* (July 14, 1999), such as general information on how to use the web site, how the brokerage service operates and how to open an account.

b. How the offer and sale of the security are conducted

We want to make sure that each e-broker has procedures in place to assure compliance with Section 5.

i. When may an e-broker take a conditional offer to buy?

We ask e-brokers not to take conditional offers to buy from prospective investors more than seven days before the offer is accepted — which acceptance cannot occur until after effectiveness, pricing and a meaningful opportunity to withdraw. If they do take conditional offers more than seven days before acceptance of the offers, the conditional offers must be reconfirmed no more than seven days before acceptance. If the deal is delayed or, for whatever reason, the offer is not accepted within seven days, we ask e-brokers to obtain new conditional offers to buy or to get reconfirmations of the expired conditional offers to buy.

ii. When must an e-broker resolicit a conditional offer to buy from a customer during the seven day period?

E-brokers must notify customers and get new conditional offers to buy or reconfirmations of prior conditional offers to buy if:

- there is a material change in the prospectus that requires recirculation;
- the offering price range changes pre-effectively; or
- the offering prices outside the range.

iii. May customers make conditional offers to buy at a price above the range in the prospectus?

Yes, but we have asked e-brokers to treat these offers as limit orders at the top of the range disclosed in the preliminary prospectus. If the price range changes pre-effectively or the offering prices outside of the disclosed range, customers must be contacted and must reconfirm their offers to buy at the new price.

iv. When may an e-broker accept a conditional offer to buy?

Offers to buy must be conditioned upon the occurrence of each of the following steps and cannot be accepted by e-brokers until each step occurs:

- the registration statement is declared effective;

- customers are given notice of effectiveness after the registration statement is declared effective (this notice can be before or after pricing);
- customers are given a meaningful opportunity -- at least one hour -- to withdraw their offers to buy between the notice of effectiveness (or notice of pricing) and acceptance of the offer to buy;
- the offering must price before offers are accepted;
- the offering must price within the customer's range and the range in the preliminary prospectus or the e-broker must receive affirmative confirmations of conditional offers to buy at the revised price; and
- customers must be able to withdraw their offers to buy **at any time** up to notice of acceptance.

v. Before effectiveness, may e-brokers make offers to sell or solicit offers to buy by means of a prospectus that does not comply with Section 10?

No. A preliminary prospectus that omits required information does not comply with Section 10. An offer to sell, a solicitation of an offer to buy, or solicitation of a written indication of interest by means of a prospectus that does not comply with Section 10 would violate Section 5. Similarly, we have taken the position that brokers may not rely on the safe harbor of Rule 134 if a prospectus that complies with Section 10 is unavailable.

The practice of filing the registration statement for an initial public offering without a bona fide estimated offering price range has created concerns with respect to some e-brokers' compliance with Section 5. Because a bona fide estimated range is required in a prospectus used for an IPO, the use of a prospectus without a price range would not comply with Section 5. Similarly, brokers cannot rely on the safe harbor of Rule 134 until the prospectus includes a bona fide estimated range. Therefore, brokers should be careful when communicating in writing before a prospectus that complies with Section 10 is available, and take appropriate steps to ensure that no such communications constitute an "offer" within the meaning of Section 2(a)(3).

vi. May e-brokers require customers to certify that they have read the prospectus?

No. We have found that some e-brokers require prospective investors to certify that they have read the prospectus before these investors can give indications of interest or make conditional offers to buy. This is not acceptable because the issuer, underwriters and brokers may not use language that could induce investors to believe that they have waived any rights that they have under the securities laws. We would not object, however, to language that encourages investors to read the

prospectus, but that does not require investors to certify that they have read the prospectus. In addition, we have not objected when brokers ask for certification that investors have accessed or received the prospectus.

c. Payment of the purchase price

We also want to make sure that e-brokers do not require any part of the purchase price to be paid before effectiveness. We have not objected when brokers have required new customers to make a small deposit in order to open an account, but this amount cannot be tied in any way to the purchase price of the securities. In most cases, this amount is \$2,000. Funds in the account must remain in the control of the customer at least until his or her conditional offer to buy is accepted after effectiveness and pricing. Also, funds in any account cannot be earmarked for the purchase of securities in any particular offering before effectiveness.

We have found that the procedures followed by individual e-brokers vary from firm to firm. The *Wit Capital* no-action letter (July 14, 1999) describes only one set of acceptable procedures. These are not the only procedures that may be acceptable and e-brokers do not need to follow Wit Capital in order to comply with Section 5.

6. Presentation of live electronic auctions

a. Interpretive letters

Three interpretive letters address “live” online auctions in offerings registered under the Securities Act. *W.R. Hambrecht & Co.* (July 12, 2000), *Wit Capital Corporation* (July 20, 2000) and *Bear, Stearns & Co., Inc.* (July 20, 2000) describe systems by which the underwriters will conduct auctions on the Internet and allow investors to view the auction as they progress. The auctions follow the effectiveness of the registration statement.

b. Concern that the auction screens would be non-conforming prospectuses

The auctions establish the price that investors will pay for the securities. Because price is an important factor in a decision to buy a security, the presentation of the live, transparent auction created the concern that the auction screens would be offers to sell or solicitations of offers to buy the securities within the meaning of Section 2(a)(3) of the Securities Act. A written offer for a security is a prospectus as defined by Section 2(a)(10). Section 5(b)(1) prevents the use of any prospectus not allowed by Section 10 of the Securities Act. The auction screens would not, by themselves, comply with Section 10. Therefore, as permitted by Section 2(a)(10)(a), they could only be used if they were accompanied or preceded by a final prospectus that complies with Section 10(a) of the Securities Act. This is not possible, as the price has not yet been determined at the time of the auction presentation and, therefore, there cannot yet be a final prospectus that complies with Section 10(a).

c. Inclusion of the auction screens as part of the electronic prospectus

To resolve the issue under Section 5(b)(1), the electronic auction presentations described in the letters are made part of a prospectus permitted by Section 10. The letters state that the auction screens must be made accessible only “through” the electronic prospectus. This means that an investor would be able to access the auction screens only by entering the electronic prospectus and clicking a button from within the prospectus that leads to the auction. This method makes the auction screens part of the electronic prospectus and is consistent with the guidance the Commission gave in the electronic media release. Securities Act Release No. 7856 (April 28, 2000). In the release, the Commission stated that

“Information on a web site would be part of a Section 10 prospectus only if an issuer (or person acting on behalf of the issuer, including an intermediary with delivery obligations) acts to make it part of the prospectus. For example, if an issuer includes a hyperlink within a Section 10 prospectus, the hyperlinked information would become a part of that prospectus. When embedded hyperlinks are used, the hyperlinked information must be filed as part of the prospectus in the effective registration statement and will be subject to liability under Section 11 of the Securities Act. In contrast, a hyperlink from an external document to a Section 10 prospectus would result in both documents being delivered together, but would not result in the non-prospectus document being deemed part of the prospectus.”

Access to the auction screens from a hyperlink within the electronic prospectus makes the auction site part of the permitted prospectus. In contrast, a hyperlink from a separately accessible auction site to the electronic prospectus would merely cause the documents to be *delivered* together. Without additional steps to make it clear that the auction screens are part of the prospectus, the auction screens would not be part of the electronic prospectus. Making the auction screens available separate from the electronic prospectus and simply hyperlinking to the prospectus, therefore, will not alleviate the concern that the auction screens are non-conforming prospectuses, the use of which violates Section 5(b)(1).

The method described, where the underwriter makes the auction site accessible *through* the electronic prospectus, is not the exclusive method to make a document part of the electronic prospectus. For example, the electronic prospectus could be represented by means of its table of contents, with each item in the table presented as an active hyperlink to the section of the prospectus that the item represents. If the auction site is presented as an item in the table of contents, the hyperlink to the auction site from the table of contents generally would make the auction site a part of the prospectus. Similarly, we believe that the electronic auction could be presented on a web page next to the electronic prospectus along with a statement that the auction web page is part of the prospectus. Our central concerns are that the information be presented in a manner that makes it clear that the information is part of the electronic prospectus and that makes the remainder of the prospectus disclosure easily accessible to investors. We invite issuers and underwriters to consult with us about other means of making an electronic presentation part of the electronic prospectus.

d. Description of the auction in the preliminary prospectus

Any prospectus used by the issuer or the underwriter must meet the requirements of Section 10. For example, the plan of distribution disclosure must describe the auction process in a manner sufficient to satisfy Item 508 of Regulation S-K. The preliminary prospectus should include

- a description of the terms to be established by the auction, such as price,
- a summary of the auction process, and
- a fair and accurate description, or screen shots, of the Internet web pages that investors participating in the auction will see prior to the auction.

The issuer and the underwriter must evaluate whether they need to update the preliminary prospectus. Whether the prospectus may be updated through a prospectus supplement or through a post-effective amendment will depend upon the circumstances. For example, if the securities are offered and sold pursuant to an effective shelf registration statement and the base prospectus does not describe the auction process, the issuer would file a post-effective amendment to amend the plan of distribution section to satisfy the requirements of Item 508.

e. Filing the auction screens as part of the final prospectus

After the auction, the issuer must file a final prospectus that includes the results of the auction and that provides a fair and accurate representation of the electronic auction presentation. Rule 424(b) requires an issuer to file with the Commission every prospectus with substantive changes from a previously filed prospectus. The auction screens are continually changing during the auction, and every different view of the auction screens is a separate prospectus. Nevertheless, we do not believe it is necessary to file separate prospectuses under Rule 424 for each change to the screens shown during the auction. Instead, the issuer can file a final prospectus that contains a fair and accurate representation of the auction process, including all substantive changes that occurred during the course of the auction.

The final prospectus should, at a minimum, describe the final terms of the offering, interim auction bidding activity, and any other substantive change from information already filed with the Commission. Auction screens, or summaries of the auction screens, at sufficiently small intervals to capture all substantive changes in the bidding process should be filed.

7. Coordination with Other Government Agencies

On occasion, the staff communicates with other government agencies when disclosure indicates that the rules and regulations enforced by that government entity may materially effect the issuer's operations. For example, the staff continues to have an informal understanding with the staff of the Environmental Protection Agency ("EPA") whereby the Commission staff receives from the EPA lists of companies identified as potentially responsible parties on hazardous waste sites; companies

subject to cleanup requirements under Resource Conservation and Recovery Act; and companies named in criminal and civil proceedings under environmental laws. The staff uses this information in its review process.

8. Monitor of Form 12b-25 Notices

The staff has implemented procedures to strengthen its monitoring efforts of all Forms 12b-25 notices of late filing. Notices are being monitored, with appropriate action taken depending upon the issuer's reason for delay and whether the subject filing is subsequently filed during the extension period. Possible staff action includes referral to the Division of Enforcement and prioritization of the subject report for staff review.

9. Related Public and Private Offerings

Some companies with pending registration statements have advised the staff that they intend to withdraw the registration statement and shortly thereafter complete the offering without registration in reliance upon the Section 4(2) private offering exemption. This appears to be proposed for both timing and disclosure reasons. In the staff's view, this procedure ordinarily would not be consistent with Section 5 of the Securities Act. The filing of a registration statement for a specific securities offering (as contrasted with a generic shelf registration) constitutes a general solicitation for that securities offering, thus rendering Section 4(2) unavailable for the same offering. In addition, the procedure raises significant integration issues under the traditional five factor test (Securities Act Release No. 4552 (November 6, 1962)) and the staff's integration policy positions, because the subsequent private offering does not appear to be a separate offering.

A related issue arises when a company files a registration statement to register issuances of securities to purchasers who committed to purchase securities from the issuer before the filing of the registration statement on the condition that the securities be registered before issuance. It appears that the purpose of this procedure is to provide the purchasers with registered (rather than restricted) securities. The staff does not believe that this procedure is consistent with the registration provisions of the Securities Act, which cover offers and sales of securities, not issuances. In this situation, it appears that the offers were made and the commitments obtained before filing in reliance upon the Section 4(2) private placement exemption. If so, the registration statement should cover resales by the purchasers, not issuances to the purchasers.

The use of "lock-up agreements" in business combination transactions is common. What is not common or consistent is the extent to which these agreements may be used to lock up target shareholders beyond key executives and "blocking" shareholders of the target. While the signing of a lock-up agreement may constitute the making of an investment decision, the staff, noting the realities of these transactions, traditionally has not raised issues with respect to these agreements in connection with acquisitions of public companies. However, the staff has raised issues concerning recently filed acquisition registration statements where 100% of the target shares are locked up or the "lock-up" group is expanded to

include non-traditional "members" such as middle management. [Note that the Commission has proposed to address lock-up agreements and related public and private offerings in Securities Act Release No. 7606A (November 13, 1998).]

10. Equity Swap Arrangements

Equity swap arrangements (including the related equity security) and similar devices typically shift some or all of the economic interests and risks of an equity security. These arrangements raise a number of legal and regulatory issues under the federal securities laws. Application of Exchange Act Section 16 to these arrangements is addressed in Exchange Act Releases No. 34514 and 37260. Those releases stated that equity swaps and similar transactions are subject to Section 16, and discussed the manner in which they should be reported. The staff continues to consider the issues raised by equity swaps and other risk-shifting transactions in other areas, including disclosure of security holdings and executive compensation, Schedule 13D reporting and transactions subject to Rule 144, Rule 144A and Regulation S. See also *Goldman Sachs* (December 20, 1999), located in Section X.F. of this outline. The treatment of these transactions under Rule 144 is addressed in Securities Act Release No. 7391 (February 20, 1997). The treatment of these transactions under Regulation S is addressed in Securities Act Release Nos. 7392 and 7505; see Section V.B.

11. "Gypsy Swaps"

A private purchaser wishes to invest directly in an issuer but hopes to acquire unrestricted securities. Through arrangements and understandings with the issuer, a stockholder with shares that are either restricted securities currently eligible for sale under Rule 144 or unrestricted securities sells the shares to the private purchaser. At about the same time, the issuer sells an equivalent number of shares to the stockholder. The Division's view is that the shares taken by the private purchaser from the stockholder will be restricted securities within the meaning of Rule 144(a)(3). The holding period will date to the private acquisition. A public resale of the shares acquired from the stockholder without regard to the conditions of Rule 144 would raise serious issues under Section 5 of the Securities Act for all parties to the transactions.

12. Non-Qualified Deferred Compensation Plans

A typical non-qualified deferred compensation plan permits an employee to defer compensation over a set dollar amount. The employer retains those monies. The employee will then either receive a fixed rate of return on the deferred monies or the employer may permit the employee to index the return on those monies off of a number of investment return alternatives.

In a number of no-action positions, the Division has indicated that it would not recommend enforcement action if transactions in non-qualified deferred compensation plans were not registered. The requests in those instances set forth two bases for the determination that registration under the Securities Act was not required. First, those requests set forth the argument that the offer and sale of

interests in the deferred compensation plan did not involve the offer or sale of a security because the decision to participate in those plans was based primarily on tax management, not investment, purposes. Second, the requests contained the argument that the employees participating in the plan were top-level executives who did not need the protections provided by registration under the Securities Act. In providing the no-action position requested, the Division's responses state that, while not agreeing with the analysis in the request, it would not recommend enforcement action if transactions under the plans were not registered. The Division has not taken such a no-action position since 1991.

Due to a number of market and regulatory factors, non-qualified deferred compensation plans have greatly proliferated, both with respect to the number of employers offering such plans and the number of employees participating. At this time, the Division is not prepared to disregard the argument that the debt owing to plan participants is analogous to investment notes, which typically are viewed as debt securities. Further, the staff is not persuaded that there is a meaningful distinction between those plans that offer returns tied to different investment alternatives and those that offer only a fixed rate. The Division, therefore, will not grant requests for no-action with respect to any non-qualified deferred compensation plan, including those that have an interest only return. The Division has not stated affirmatively, however, that all interest only deferred compensation plans involve securities. Instead, the Division currently is leaving that question for counsel's analysis of the facts and circumstances. To the extent that interests in a non-qualified deferred compensation plan are securities, registration would be required unless the offerings under the plan would qualify for an exemption, e.g., Section 4(2).

Form S-8 would be available when an employer registers the offer and sale of interests in the deferred compensation plan under the Securities Act. The filing fee should be based on the amount of compensation being deferred, not on the ultimate investment return. As the "deferred compensation obligations" to be registered are obligations of the issuer/employer, not interests in the plan, the registration of the "deferred compensation obligations" would not result in a requirement that a deferred compensation plan file a Form 11-K with respect to those securities. Further, based on the unique terms of the "deferred compensation obligations" (both with respect to interest and maturity), compliance with the Trust Indenture Act of 1939 has not been required.

13. Trust Indenture Act Issues Arising in Certain Transactions Exempt from Securities Act Registration

Offerings exempt from registration under Sections 3(a)(9) and 3(a)(10) of the Securities Act and Section 1145(a) of the Bankruptcy Code are not exempt from qualification under the Trust Indenture Act. Like Section 5 of the Securities Act, Section 306 of the Trust Indenture Act works transactionally. Unless the indenture for a debt security is qualified under Section 305 of the Trust Indenture Act, which covers registered offerings, or exempt from qualification under Section 304, the sale of the debt security violates Section 306 of the statute. Section 306(c) forbids any offer of the debt security until an application for qualification of the related indenture has been filed with the Commission.

The Division has recently noted a number of offerings of debt securities for issuers in Chapter 11 proceedings where the applications for qualification on Form T-3 were not filed until after approval of the plans of reorganization by both creditors and other claimants and the bankruptcy courts. The Division's view is that the offering event in bankruptcy is the solicitation of plan approval from creditors and other claimants. Accordingly, the application for qualification in these cases should be filed before such approval is sought.

14. Legality Opinion Issues

It is customary practice for counsel drafting legality opinions regarding securities whose issuer is incorporated in Delaware to limit their opinion to “the Delaware General Corporation Law.” In these situations, we ask that counsel revise its opinion to make clear that the law covered by the opinion includes not only the Delaware General Corporation Law, but also the applicable provisions of the Delaware Constitution and reported judicial decisions interpreting these laws.

Recently, we discussed this limitation with the Ad Hoc Committee on Legal Opinions in SEC Filings of the Federal Regulation of Securities Committee of the Business Law Section of the American Bar Association. In those discussion, the Ad Hoc Committee emphasized that the reference to the “Delaware General Corporations Law” was an opinion drafting convention and that the practicing bar understood this phrase to mean the Delaware General Corporation Law, the applicable provisions of the Delaware Constitution, and reported judicial decisions interpreting these laws.

Based on these discussions, we have revised our procedures for reviewing a legality opinion filed as an exhibit to a registration that includes a statement that it is “limited to the Delaware General Corporation Law.” Our new procedures are as follows:

- We will issue a comment asking counsel to confirm to us in writing that it concurs with our understanding that the reference and limitation to “Delaware General Corporate Law” includes the statutory provisions and also all applicable provisions of the Delaware Constitution and reported judicial decisions interpreting these laws. As part of this standard comment, we will ask that counsel file this written confirmation as correspondence on the EDGAR system. As such, it will be part of the Commission’s official file regarding the related registration statement.
- Once we receive this written confirmation from counsel, we will not comment further on the inclusion of this language in the opinion for that registration statement.

15. Plain English Initiative

On January 22, 1998, the Commission adopted the final plain English rules (Securities Act Release No. 7497). See also the proposed rules at Securities Act Release No. 7380 (January 14, 1997). These rules apply to public companies and mutual funds. The Division of Corporation Finance has also issued Staff Legal Bulletin No. 7 on the new rules, and updated it on June 7, 1999.

“A Plain English Handbook--How to Create Clear SEC Disclosure Documents,” issued by the Office of Investor Education and Assistance, is available. You can download a copy from our web site at <http://www.sec.gov> or request a paper copy by calling 1-800-SEC-0330.

16. Clarification of Oil and Gas Reserve Definitions and Requirements

Over the last several years, the estimation and classification of petroleum reserves has been impacted by the development of new technologies such as 3-D seismic interpretation and reservoir simulation. Computer processor improvements have allowed the increased use of probabilistic methods in proved reserve assessments. These have led to issues of consistency and, therefore, some confusion in the reporting of proved oil and gas reserves by public issuers in their filings with the Commission. The following discussion addresses some issues the Division of Corporation Finance’s engineering staff has detected in its review of these filings.

The definitions for proved oil and gas reserves for the SEC are found in Rule 4-10(a) of Regulation S-X of the Securities Exchange Act of 1934. The SEC definitions are below in bold italics. Under each section we have tried to explain the SEC staff’s position regarding some of the more common issues that arise from each portion of the definitions. As most engineers who deal with the classification of reserves have come to realize, it is difficult, if not impossible, to write reserve definitions that easily cover all possible situations. Each case has to be studied as to its own unique issues. This is true with the Society of Petroleum Engineers’ and others’ reserve definitions as well as the SEC’s definitions.

- a. **Proved oil and gas reserves are the estimated quantities of crude oil, natural gas, and natural gas liquids which geological and engineering data demonstrate with reasonable certainty to be recoverable in future years from known reservoirs under existing economic and operating conditions, i.e., prices and costs as of the date the estimate is made. Prices include consideration of changes in existing prices provided by contractual arrangements, but not on escalations based upon future conditions.**

The determination of **reasonable certainty** is generated by supporting geological and engineering data. There must be data available which indicate that assumptions such as decline rates, recovery factors, reservoir limits, recovery mechanisms and volumetric estimates, gas-oil ratios or liquid yield are valid. If the area in question is new to exploration and there is little supporting data for decline rates, recovery factors, reservoir drive mechanisms etc., a conservative approach is appropriate until there is enough supporting data to justify the use of more liberal parameters for the estimation of proved reserves. **The concept of reasonable certainty implies that, as more technical data becomes available, a positive, or upward, revision is much more likely than a negative, or downward, revision.**

Existing economic and operating conditions are the product prices, operating costs, production methods, recovery techniques, transportation and marketing arrangements, ownership and/or entitlement terms and regulatory requirements that are extant on the effective date of the estimate. An anticipated change in conditions must have reasonable certainty of occurrence; the corresponding investment and operating expense to make that change must be included in the economic feasibility at the appropriate time. These conditions include estimated net abandonment costs to be incurred and duration of current licenses and permits.

If oil and gas prices are so low that production is actually shut-in because of uneconomic conditions, the reserves attributed to the shut-in properties can no longer be classified as proved and must be subtracted from the proved reserve data base as a negative revision. Those volumes may be included as positive revisions to a subsequent year's proved reserves only upon their return to economic status.

- b. Reservoirs are considered proved if economic producibility is supported by either actual production or conclusive formation test. The area of a reservoir considered proved includes that portion delineated by drilling and defined by gas-oil and/or oil-water contacts, if any, and the immediately adjoining portions not yet drilled, but which can be reasonably judged as economically productive on the basis of available geological and engineering data. In the absence of information on fluid contacts, the lowest known structural occurrence of hydrocarbons controls the lower proved limits of the reservoir.**

Proved reserves may be attributed to a prospective zone if a conclusive formation test has been performed or if there is production from the zone at economic rates. It is clear to the SEC staff that wireline recovery of small volumes (e.g. 100 cc) or production of a few hundred barrels per day in remote locations is not necessarily conclusive. Analyses of open-hole well logs which imply that an interval is productive are not sufficient for attribution of proved reserves. If there is an

indication of economic producibility by either formation test or production, the reserves in the legal and technically justified drainage area around the well projected down to a known fluid contact or the lowest known hydrocarbons, or LKH may be considered to be proved.

In order to attribute proved reserves to legal locations adjacent to such a well (i.e. offsets), there must be conclusive, unambiguous technical data which supports reasonable certainty of production of those volumes and sufficient legal acreage to economically justify the development without going below the shallower of the fluid contact or the LKH. In the absence of a fluid contact, no offsetting reservoir volume below the LKH from a well penetration shall be classified as proved.

Upon obtaining performance history sufficient to reasonably conclude that more reserves will be recovered than those estimated volumetrically down to LKH, positive reserve revisions should be made.

- c. Reserves that can be produced economically through applications of improved recovery techniques (such as fluid injection) are included in the “proved” classification when successful testing by a pilot project, or the operation of an installed program in the reservoir, provides support for the engineering analysis on which the project or program was based.**

If an improved recovery technique which has not been verified by routine commercial use in the area is to be applied, the hydrocarbon volumes estimated to be recoverable cannot be classified as proved reserves unless the technique has been demonstrated to be technically and economically successful by a pilot project or installed program in that specific rock volume. That demonstration should validate the feasibility study leading to the project.

- d. Estimates of proved reserves do not include the following:**
- oil that may become available from known reservoirs but is classified separately as “indicated additional reserves”;**
 - crude oil, natural gas, and natural gas liquids, the recovery of which is subject to reasonable doubt because of uncertainty as to geology, reservoir characteristics, or economic factors;**

- **crude oil, natural gas, and natural gas liquids, that may occur in undrilled prospects;**
- **crude oil, natural gas, and natural gas liquids, that may be recovered from oil shales, coal, gilsonite and other sources.**

Geologic and reservoir characteristic uncertainties such as those relating to permeability, reservoir continuity, sealing nature of faults, structure and other unknown characteristics may prevent reserves from being classified as proved. Economic uncertainties such as the lack of a market (e.g. stranded hydrocarbons), uneconomic prices and marginal reserves that do not show a positive cash flow can also prevent reserves from being classified as proved. Hydrocarbons “manufactured” through extensive treatment of gilsonite, coal and oil shales are mining activities reportable under Industry Guide 7. They cannot be called proved oil and gas reserves. However, coal bed methane gas can be classified as proved reserves if their recovery is shown to be economically feasible.

In developing frontier areas, the existence of wells with a formation test or limited production may not be enough to classify those estimated hydrocarbon volumes as proved reserves. Issuers must demonstrate that there is reasonable certainty that a market exists for the hydrocarbons and that an economic method of extracting, treating and transporting them to market exists or is feasible and is likely to exist in the near future. A commitment by the company to develop the necessary production, treatment and transportation infrastructure is essential to the attribution of proved undeveloped reserves. Significant lack of progress on the development of those reserves may be evidence of a lack of such a commitment. Affirmation of this commitment may take the form of signed sales contracts for the products; request for proposals to build facilities; signed acceptance of bid proposals; memos of understanding between the appropriate organizations and governments; firm plans and timetables established; approved authorization for expenditures to build facilities; approved loan documents to finance the required infrastructure; initiation of construction of facilities; approved environmental permits etc. Reasonable certainty of procurement of project financing by the company is a requirement for the attribution of proved reserves. An inordinately long delay in the schedule of development may introduce doubt sufficient to preclude the attribution of proved reserves.

The history of issuance and continued recognition of permits, concessions and commerciality agreements by regulatory bodies and governments should be considered when determining whether hydrocarbon accumulations can be classified as proved reserves. Automatic renewal of those agreements cannot be expected if the regulatory body has the authority to end the agreement unless there is a long and clear track record which supports the conclusion that those approvals and renewal are a matter of course.

- e. **Proved developed oil and gas reserves are reserves that can be expected to be recovered through existing wells with existing equipment and operating methods. Additional oil and gas expected to be obtained through the application of fluid injection or other improved recovery techniques for supplementing the natural forces and mechanisms of primary recovery should be included as “proved developed reserves” only after testing by a pilot project or after the operation of an installed program has confirmed through production response that increased recovery will be achieved.**

Currently producing wells and wells awaiting minor sales connection expenditure, recompletion, additional perforations or bore hole stimulation treatment would be examples of properties with proved developed reserves since the majority of the expenditures to develop the reserves has already been spent.

Proved developed reserves from **improved recovery techniques** can be assigned after either the operation of an installed pilot program shows a positive production response to the technique or the project is fully installed and operational and has shown the production response anticipated by earlier feasibility studies. In the case with a pilot, proved developed reserves can be assigned only to that volume attributable to the pilot's influence. In the case of the fully installed project, response must be seen from the full project before all the proved developed reserves estimated can be assigned. If a project is not following original forecasts, proved developed reserves can only be assigned to the extent actually supported by the current performance. An important point here is that attribution of incremental proved developed reserves from the application of improved recovery techniques requires the installation of facilities and a production increase.

- f. **Proved undeveloped oil and gas reserves are reserves that are expected to be recovered from new wells on undrilled acreage, or from existing wells where a relatively major expenditure is required for recompletion. Reserves on undrilled acreage shall be limited to those drilling units offsetting productive units that are reasonably certain of production when drilled. Proved reserves for other undrilled units can be claimed only where it can be demonstrated with certainty that there is continuity of production from the existing productive formation. Under no circumstances should estimates of proved undeveloped reserves be attributable to any acreage for which an application of fluid injection or other**

improved recovery technique is contemplated, unless those techniques have been proved effective by actual tests in the area and in the same reservoir. (Emphasis added)

The SEC staff points out that this definition contains no mitigating modifier for the word *certainty*. Also, *continuity of production* requires more than the technical indication of favorable structure alone (e.g. seismic data) to meet the test for proved undeveloped reserves. Generally, proved undeveloped reserves can be claimed only for legal and technically justified drainage areas offsetting an existing productive well (but structurally no lower than LKH). If there are at least two wells in the same reservoir which are separated by more than one legal location and which show communication (reservoir continuity), proved undeveloped reserves could be claimed between the two wells, even though the location in question might be more than an offset well location away from any of the wells. In this illustration, seismic data could be used to help support this claim by showing reservoir continuity between the wells, but the required data would be the conclusive evidence of communication from production or pressure tests. The SEC staff emphasizes that proved reserves cannot be claimed more than one offset location away from a productive well if there are no other wells in the reservoir, even though seismic data may exist. The use of high-quality, well calibrated seismic data can improve reservoir description for performing volumetrics (e.g. fluid contacts). However, seismic data is not an indicator of continuity of production and, therefore, can not be the sole indicator of additional proved reserves beyond the legal and technically justified drainage areas of wells that were drilled. Continuity of production would have to be demonstrated by something other than seismic data.

In a new reservoir with only a few wells, reservoir simulation or application of generalized hydrocarbon recovery correlations would not be considered a reliable method to show increased proved undeveloped reserves. With only a few wells as data points from which to build a geologic model and little performance history to validate the results with an acceptable history match, the results of a simulation or material balance model would be speculative in nature. The results of such a simulation or material balance model would not be considered to be reasonably certain to occur in the field to the extent that additional proved undeveloped reserves could be recognized. The application of recovery correlations which are not specific to the field under consideration is not reliable enough to be the sole source for proved reserve calculations.

Reserves cannot be classified as proved undeveloped reserves based on improved recovery techniques until they have been proved effective in that reservoir or an analogous reservoir in the same geologic formation in the immediate area. An analogous reservoir is one having at least the same values or better for porosity, permeability, permeability distribution, thickness, continuity and hydrocarbon saturations.

g. Topic 12 of Accounting Series Release No. 257 of the Staff Accounting Bulletins states:

In certain instances, proved reserves may be assigned to reservoirs on the basis of a combination of electrical and other type logs and core analyses which indicate the reservoirs are analogous to similar reservoirs in the same field which are producing or have demonstrated the ability to produce on a formation test.

If the combination of data from open-hole logs and core analyses is overwhelmingly in support of economic producibility and the indicated reservoir properties are analogous to similar reservoirs in the same field which have produced or demonstrated the ability to produce on a conclusive formation test, the reserves may be classified as proved. This would probably be a rare event especially in an exploratory situation. The essence of the SEC definition is that in most cases there must at least be a conclusive formation test in a new reservoir before any reserves can be considered to be proved.

h. Statement of Financial Accounting Standards 69, paragraph 30.a. requires the following disclosure:

Future cash inflows. These shall be computed by applying year-end prices of oil and gas relating to the enterprise's proved reserves to the year-end quantities of those reserves.
(Emphasis added)

This requires the use of physical pricing determined by the market on the last day of the (fiscal) year. For instance, a west Texas oil producer should determine the posted price of crude (hub spot price for gas) on the last day of the year, apply historical adjustments (transportation, gravity, BS&W, purchaser bonuses, etc.) and use this oil or gas price on an individual property basis for proved reserve estimation and future cash flow calculation (this price is also used in the application of the full cost ceiling test). A monthly average is not the price on the last day of the year, even though that may be the price received for production on the last day of the year.

Paragraph 30b) states that future production costs are to be based on year-end figures with the assumption of the continuation of existing economic conditions.

i. Position on Probabilistic Methods of Reserve Estimating

Probabilistic methods of reserve estimating have become more useful due to improved computing and more important because of its acceptance by professional organizations such as the SPE. The SEC staff feels that it would be premature to issue any confidence criteria at this time. The SPE has specified a 90% confidence level for the determination of proved reserves by probabilistic methods. Yet, many

instances of past and current practice in deterministic methodology utilize a median or best estimate for proved reserves. Since the likelihood of a subsequent increase or positive revision to proved reserve estimates should be much greater than the likelihood of a decrease, we see an inconsistency that should be resolved. If probabilistic methods are used, the limiting criteria in the SEC definitions, such as LKH, are still in effect and shall be honored. Probabilistic aggregation of proved reserves can result in larger reserve estimates (due to the decrease in uncertainty of recovery) than simple addition would yield. We require a straight forward reconciliation of this for financial reporting purposes.

j. Use of Cautionary Note in Connection with Disclosure Language

We have seen in press releases and web sites disclosure language by oil and gas companies which would not be allowed in a document filed with the SEC. We will request that these disclosures be accompanied by the following cautionary language:

Cautionary Note to U.S. Investors – The United States Securities and Exchange Commission permits oil and gas companies, in their filings with the SEC, to disclose only proved reserves that a company has demonstrated by actual production or conclusive formation tests to be economically and legally producible under existing economic and operating conditions. We use certain terms {in this press release/on this web site}, such as [identify the terms], that the SEC's guidelines strictly prohibit us from including in filings with the SEC. U.S. Investors are urged to consider closely the disclosure in our Form XX, File No. X-XXXX, available from us at [registrant address at which investors can request the filing]. You can also obtain this form from the SEC by calling 1-800-SEC-0330.

Examples of these disclosures would be statements regarding “probable,” “possible,” or “recoverable” reserves among others.

k. Consent of Experts and Potential Civil Liability

The SEC staff reminds professionals engaged in the practice of reserve estimating and evaluation that the Securities Act of 1933 subjects to potential civil liability every expert who, with his or her consent, has been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation used in connection with the registration statement. These experts include accountants, attorneys, engineers or appraisers.

17. Shelf Registration Deal Information under Rule 412

On several occasions, Form 8-K was used to file information identified as relating to a particular takedown of securities from a delayed shelf registration statement. By operation of the shelf registration system, the Form 8-K was incorporated by reference into the prospectus of the relevant effective S-3 registration

statement. The Form 8-K included information that, if not made a part of the Section 10(b) prospectus, may have violated Section 5(b)(1) if used in the offering as contemplated.

In each case, following the closing of the transaction, the registrant filed another Form 8-K for the sole purpose of asserting that the information contained in the earlier Form 8-K and incorporated by reference into the registration statement was expunged. In these cases, we were advised by the registrants that they relied on Securities Act Rule 412 for this removal of information. Under Rule 412, statements in documents incorporated by reference in a Securities Act registration statement are deemed to be modified or superseded by new information contained in a prospectus or a document later incorporated by reference.

While the staff generally has no objection to the use of Form 8-K to include information in a prospectus that is part of a delayed shelf registration statement, Rule 412 does not permit an issuer to file a statement later to remove or “expunge” the information in the earlier Form 8-K. Registrants are advised to refrain from attempting to do so. The staff is of the view that any attempt to remove information under Rule 412 would be null and void. If this practice comes to the attention of the staff in the future, the registrant will be asked to file an amended Form 8-K to correct the attempted removal. Registrants are also advised that they may include deal-specific information as part of the prospectus in a shelf registration statement by filing that information under Securities Act Rule 424 before its use as part of the Section 10(b) prospectus.

18. Recent Enforcement Action – CGI Capital, Inc.

On September 29, 2000, CGI Capital, Inc. consented to the entry of an Order by the Commission censuring CGI Capital for its conduct in connection with two unregistered offerings and directing CGI Capital to cease and desist from committing or causing violations of Section 5 of the Securities Act. CGI Capital also agreed to pay a \$25,000 civil penalty.

From August 1999 through December 1999, CGI Capital, a broker-dealer registered with the Commission, solicited thousands of individuals to invest in two unregistered offerings available through its web site. Specifically, CGI Capital disseminated e-mail messages to prospective investors that contained:

- preliminary information regarding the offerings;
- a link to CGI Capital's web site; and
- a password that allowed these investors to access a password-protected area of CGI Capital's web site that contained brief sales presentations and subscription forms for each offering.

Some recipients of the e-mails did not have a pre-existing substantive relationship with CGI Capital, and CGI Capital failed to determine adequately whether the prospective investors were either accredited or sophisticated. The Commission found that these

e-mails constituted general solicitation, and therefore, there was no exemption available for the unregistered offerings.

The Commission also found that CGI Capital engaged in a general solicitation by failing to take adequate steps to restrict access to the offerings on its web site. [Cf. No-Action Letter of Divisions of Corporation Finance and Market Regulation to IPONET (July 26, 1996); Interpretive Release on Use of Electronic Media, Securities Act Rel. No. 33-7856 (April 28, 2000).] In particular, CGI Capital:

- sent its e-mail solicitations to several thousand potential investors and included in each e-mail a password to the password-protected page of its web site containing the offering materials;
- allowed these potential investors to access the offering materials on its web site before CGI Capital had made a determination that any particular potential investor was accredited or sophisticated;
- failed to gather information from certain potential investors in order to form a reasonable basis for believing these investors to be accredited or sophisticated; and
- allowed these potential investors to purchase securities in offerings that had been posted on the password-protected page of its web site before CGI Capital had made a determination that these potential investors were accredited or sophisticated.

As a result, the Commission found that CGI's activities violated Section 5 of the Securities Act.

B. Industry-Specific Issues

1. Real Estate

a. Review of Filings

The Division has issued three releases regarding real estate disclosure. On June 17, 1991, the Commission issued an interpretive release relating to partnership offerings and reorganizations (Securities Act Release No. 6900); on October 30, 1991, final rules concerning disclosure of roll-up transactions were issued (Securities Act Release No. 6922). On December 1, 1994, the Commission adopted amendments to its roll-up rules (Securities Act Release No. 7113). The staff considers the disclosure guidelines of each of these releases in connection with its reviews of registration statements and proxy statements filed by limited partnerships and real estate investment trusts.

Current real estate filings relate primarily to real estate investment trusts (REITs) and, to a lesser extent, limited partnerships and limited liability companies. Frequently, REIT filings contain an UPREIT structure which includes an Umbrella Operating Partnership formed by the sponsor and affiliated partnerships to contribute

properties or partnership interests to the REIT. In connection with REIT initial public offerings, the staff considers the availability of any claimed exemption from Securities Act registration for the pre-formation roll-up transactions undertaken to form the operating partnership.

Primary offerings by Operating Partnerships must comply with appropriate form requirements. Operating Partnerships may use Form S-3 if the applicable requirements are met, specifically, Instruction I.C., but since the Operating Partnership is unlikely to be able to meet the requirements of Staff Accounting Bulletin 53, separate financial statements and related disclosure must be provided either in the registration statement or through incorporation by reference of a voluntary Form 10. Following the offering, applicable reports must be filed by the Operating Partnership.

Reviews of limited partnership offerings and proxy solicitation materials continue to focus on prior performance and on claims made by sponsors concerning investment obligations and future performance. These reviews also focus on changes to partnership objectives and structure. Finally, the staff continues to examine the practices and disclosure associated with the solicitation of proxies and registration statements related to roll-ups, pursuant to the revised rules. See also Section II.C.1 for a discussion of the disclosure required in tender offers for limited partnership units.

b. Sales Literature Used in Connection with the Offering of Limited Partnerships

Item 19 of Industry Guide 5 requires that sales literature used in the offering of limited partnership units, including material marked for "Broker Dealer Use Only," be submitted for staff review. These materials should provide a balanced presentation of the risks and rewards involved in the offering. All information must be consistent with the information and representations contained in the prospectus and the sales literature should not be presented in a manner which obscures the prospectus cover page. Registrants should contact the staff before using submitted sales materials.

c. Low Income Housing, Rehabilitation, and Historic Tax Credit Real Estate Limited Partnerships

Certain real estate limited partnership offerings indicate the sponsor's intention to invest in low income housing or other programs eligible for federal or state income tax credits. Most of these offerings highlight the percentage returns to the investor of the tax credits on a simple annualized basis. Since the tax credits are available for only 10 years and the enabling statutes require a 15-year holding period for the property, the rate of return disclosure should include the effects of the time value of money. Further, since it is possible that the property may have no or little residual value at the end of the 15-year holding period, the disclosure of the rate of return should assume a zero resale value of the property.

Further, prior performance disclosure of the results of earlier tax credit offerings by the sponsor should be included. Disclosure of the total amount of tax credits generated for each year should be included as should the amount of tax credits per \$1000 invested.

2. Exemption from Registration for Bank and Thrift Holding Company Formations

Section 3(a)(12) of the Securities Act provides an exemption from registration for securities issued in connection with the formation of a bank or savings association holding company where shareholders maintain the same proportional interest in the holding company as they had in the bank or savings association; the rights and interests of the shareholders are substantially the same after the transaction as before it; and the holding company has substantially the same assets and liabilities, on a consolidated basis, as the bank or savings association had before the transaction. The staff has informally taken the position that the exemption would not be available if the new holding company's corporate charter contained antitakeover provisions that were not in the governing documents of the predecessor bank or thrift.

3. Structured Financings

In fall 1992, the Commission extended the benefits of Rule 415 "shelf" registration through the expansion of the availability of Form S-3 to investment grade asset-backed securities offerings (Securities Act Release No. 6964 (October 22, 1992)(the "Shelf Release")). Shortly thereafter, the Commission adopted Rule 3a-7 under the Investment Company Act of 1940 excluding from the definition of "investment company" structured financings that meet the rule's conditions (Investment Company Act Release No. 19105 (November 19, 1992)). These changes appear to have precipitated, or at least coincided with, a movement in the structured finance market toward securitization of assets in the public markets that previously were offered in the private markets. Significant disclosure and eligibility issues continue to come up as a result of market developments.

a. Asset Concentration

The Shelf Release expressly does not adopt a specific asset concentration test. Instead, asset concentration questions have been addressed through existing disclosure rules. While an asset concentration test was not included, the release indicates that the definition of asset-backed security does not encompass securities issued in structured financings for one obligor or group of related obligors.

i. Multiple Core Prospectuses

Another issue involving asset concentration arises in the context of pooling several different types of underlying assets. The staff permits issuers to register on a single shelf registration statement asset-backed securities supported by more than one category of underlying assets without specifying the amount of each type to be offered. The registration statement must specifically identify the various asset

categories and include a separate core prospectus for each such category. In considering whether a separate core prospectus is required, the staff will consider whether the assets described are intended to be pooled together or securitized separately. If the latter, separate core prospectuses ordinarily would be required.

ii. Commercial Mortgages

For securitization of commercial mortgages and leases, where the mortgage loan is a non-recourse obligation of the mortgagor, disclosure related to the operating property(ies) will be required where concentration exists. The staff applies the standards described in Staff Accounting Bulletin 71/71A ("SAB 71/71A"). SAB 71/71A generally employs a 20% asset concentration test to determine whether audited property financial statements are required. At concentration levels between 10-20%, financial and other information regarding the underlying properties is required. In determining whether these concentration thresholds are crossed, loans to the same obligor, group of related obligors, or loans on related properties may be aggregated.

In addition, where a mortgage loan or loans of a single obligor, or group of related obligors, accounts for more than 45% of the pool assets, one or more co-issuers may exist. See *FBC Conduit Trust I, First Boston Mortgage Securities Corporation* (October 6, 1987).

b. Securitizing Outstanding Securities

i. Corporate Debt Securities

The pooling and securitization of outstanding corporate debt securities of other issuers may be registered on Form S-3 if the requirements of the Form for asset-backed securities offerings are met, provided that the depositor would be free to publicly resell the securities without registration. Thus, a depositor generally cannot include restricted securities (*i.e.*, privately-placed securities where the Rule 144(k) two-year holding period has not run) nor can it include registered securities if the securitization is part of the original distribution. To provide certainty in deciding what is part of the original distribution in resecuritizations by affiliates of underwriters involved in the original offering, the staff has used a bright line test (*i.e.*, securities purchased in the secondary market and at least three months after the depositor had sold out any unsold allotment are not viewed as part of the original dispatch).

Where 20% or more of the pool consists of the securities of a single issuer, the staff requires audited financial statements of such issuer to be included in the prospectus. However, if the underlying issuer is eligible to use Form S-3 for a primary common stock offering, and the depositor's transaction in the securities is purely secondary (*e.g.*, there is no tie to the issuer or the issuer's distribution), the staff would accept a reference in the prospectus to the issuer's periodic reports on file with the Commission. Of course, the prospectus must include a description of the material terms of the pooled securities.

In connection with Exchange Act reporting, reference to the S-3 eligible underlying issuer's periodic reports on file with the Commission will be accepted in lieu of direct disclosure of this information. In addition, the staff generally requires the depositor to undertake to provide financial and other information relating to such underlying issuer directly in its reports in the event such underlying issuer terminates reporting after the pooling transaction.

ii. Asset-Backed Securities

Securitization of outstanding asset-backed securities is treated similarly if the underlying trust has outstanding securities held by non-affiliates in excess of \$75 million and files periodic reports with the Commission. The securities of government-sponsored enterprises ("GSE") which have a comparable market float and which make information publicly available comparable to that of Exchange Act reporting entities are treated similarly.

iii. Municipal Securities

The offering of asset-backed securities supported by pools of municipal bonds where asset concentration exists, in general, requires that financial statements and other information relating to the underlying municipal issuer be provided. This information must be included directly in the prospectus, must be current, and must otherwise satisfy fully the disclosure requirements under the federal securities regulations.

While there may be instances where financial statements of the municipal issuer are not material to the investor in the asset-backed security, such instances would appear to be rare and the staff will require appropriate legal opinions and other documentation necessary to support the conclusion that financial and other information relating to the municipal issuer is not material to investors.

c. Structuring the Offering

Often the payment terms of asset-backed securities are tailored to meet the particular investment needs of the investor. Prior to effectiveness of the registration statement, investors often ask the underwriter for various computational materials so as to analyze prepayment and other assumptions affecting yield. These computational materials are not permissible prospectuses under the Securities Act and the Commission's rules and regulations. However, recognizing the realities of the asset-backed market, the staff has issued three no-action letters that recognize the industry's practice of providing written information (other than the statutory prospectus) to prospective purchasers of asset-backed securities when negotiating and structuring the securities to meet purchasers' investment criteria. These letters generally permit the provision of limited information outside the preliminary prospectus to purchasers, provided that the final information is filed as part of the registration statement.

4. Credit Linked Securities of Bank Subsidiaries

Recently, a number of banks proposed the following transaction structure:

- the bank forms a limited purpose finance subsidiary;
- the bank transfers mortgages or asset-backed securities to the subsidiary;
- the bank owns all of the subsidiary's common stock; and
- the subsidiary registers the sale of its preferred stock to the public.

The source of funds for dividend payments on the preferred stock would be limited to the income generated by the finance subsidiary's assets. The banks proposed this structure because the preferred securities of the subsidiary may, under relevant risk based capital guidelines, qualify as capital of the bank.

Under bank regulations, if a financial regulatory event occurs, banks must retrieve, or "claw back," the assets of these subsidiaries. Because the assets of these subsidiaries are subject to this claw back, this structure raises significant registration and disclosure issues.

Under one structure, the preferred securities of the subsidiary automatically convert into securities of the bank. Therefore:

- the bank and the subsidiary must be co-registrants on the registration statement for the initial sale of the preferred stock since the bank is also offering preferred stock;
- the full audited financial statements of the bank must be included in this registration statement; and
- if the bank's financial statements are not in US GAAP, they must be reconciled to US GAAP.

If the bank regulators can require the bank to claw back the subsidiary's assets, the financial condition of the bank is material to the subsidiary preferred stockholder at all times. Therefore:

- the full audited financial statements of the bank must be in the registration statement and in the subsequent periodic reports of the subsidiary; and
- if the bank's financial statements are not in US GAAP, they must be reconciled to US GAAP.

IX. ACCOUNTING ISSUES

Please also see "Current Accounting and Disclosure Issues in the Division of Corporation Finance," dated January 21, 2000, available on our web site at www.sec.gov/rules/othrindx.htm.

A. Initiative to Address Improper Earnings Management

Many in the financial community have expressed concern that market pressures are driving more public companies to use improper earnings management tricks. In remarks made to the NYC Center for Law and Business in September 1998, Chairman Levitt identified several areas where accounting rules have been abused by some companies to manage earnings: "big bath" restructuring charges, "creative" acquisition accounting, miscellaneous "cookie jar" reserves, intentional "immaterial" errors, and manipulative revenue recognition. The Chairman outlined a plan to address the threat to the integrity of financial reporting posed by improper earnings management. The Chairman's speech can be found at www.sec.gov/news/spchindx.htm.

The Division of Corporation Finance established an Earnings Management Task Force that focused staff resources on the review of filings where potential improper earnings management issues could be present. A primary objective of the reviews has been to elicit improved disclosure in financial statements and MD&A about charges involving asset impairments, restructuring charges, purchased in-process research and development, and similar items. Disclosure sought by the staff has included explanation of the types and amounts of restructuring liabilities and valuation reserves, the timing and amount of increases and decreases in these accounts, and the nature and amount of any changes in estimates. The Task Force also examined filings for indicia of earnings management and other accounting abuses involving revenue recognition, unreasonable valuations of purchased in-process research and development, and manipulation of loss allowances and estimated liabilities. Also, as part of its proactive disclosure program, the Division of Corporation Finance sent letters alerting companies, before their filing 1998 annual reports, of disclosures that are often needed to give transparency to significant charges. Samples of those letters are available at the SEC web site.

In further response to the Chairman's earnings management initiative, the AICPA published *Issues in Revenue Recognition*, available at www.aicpa.org, to help auditors evaluate assertions about revenue. The Office of the Chief Accountant is working closely with the FASB to establish clearer standards concerning liability recognition. The Public Oversight Board has established a distinguished committee to review the way audits are performed today and assess the impact of recent trends in business and the accounting profession on the effectiveness of the audit. Other actions taken in connection with the Chairman's earnings management initiative include issuance of staff interpretive guidance and rulemaking proposals discussed elsewhere in this outline.

B. New Rules for Audit Committees and Reviews of Interim Financial Statements

On December 15, 1999, the Commission adopted new rules to improve public disclosure about the functioning of corporate audit committees and to enhance the reliability and credibility of financial statements of public companies. Exchange Act Release No. 42266 (December 22, 1999). The new rules became effective on January 31, 2000. The Commission's actions are part of a broader effort by the securities exchanges and the accounting profession to improve the oversight of financial reporting by corporate boards. Proposals for action by each of the different groups were set forth in the Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees. The Blue Ribbon Committee is a prestigious group of business, accounting, and securities professionals led by John Whitehead and Ira Millstein. The committee's report is available at www.nasdaq.com. The Commission's new rules coincide with rule changes by the New York Stock Exchange, the American Stock Exchange, and the National Association of Securities Dealers.

In brief, the rules require that:

- companies' interim financial statements must be reviewed by independent auditors before they are filed on Forms 10-Q or 10-QSB with the Commission;
- companies, other than small business issuers filing on small business forms, must supplement their annual financial information with disclosures of selected quarterly financial data under Item 302(a) of Regulation S-K;
- companies must disclose in their proxy statements whether the audit committee reviewed and discussed certain matters specified in the ASB's Statements of Auditing Standards No. 61 (concerning the accounting methods used in the financial statements) and the Independence Standard Board's Standard No. 1 (concerning matters that may affect the auditor's independence) with management and the auditors, and whether it recommended to the Board that the audited financial statements be included in the Annual Report on Form 10-K or 10-KSB for filings with the Commission;
- companies disclose in their proxy statements whether the audit committee has a written charter, and file a copy of their charter every three years; and
- companies whose securities are listed on the NYSE or AMEX or are quoted on Nasdaq disclose certain information in their proxy statements about any audit committee member who is not "independent." All companies must disclose, if they have an audit committee, whether the members are "independent." Independence is defined in the listing standards of the NYSE, AMEX and NASD.

Under the new rules, interim auditor reviews must begin with the first fiscal quarter ended after March 15, 2000, and compliance with the other new requirements begin after December 15, 2000. Foreign private issuers are exempt from

requirements of the new rules. The new rules include a "safe harbor" for the disclosures.

The Commission's new rules build upon rule changes proposed by the NYSE and the AMEX and the NASD and approved by the Commission on December 15, 1999, which were also part of the recommendations of the Blue Ribbon Committee. Those rules:

- define "independence" more rigorously for audit committee members;
- require audit committees to include at least three members and be comprised solely of "independent" directors who are financially literate;
- require companies to adopt written charters for their audit committees;
- give the audit committee the right to hire and terminate the auditors; and
- require at least one member of the audit committee to have accounting or financial management expertise.

In December 1999, the AICPA's Auditing Standards Board issued the Statement of Auditing Standard No. 90 which requires independent auditors to discuss with the audit committee the auditor's judgment about the quality, and not just the acceptability under generally accepted accounting principles, of the company's accounting principles as applied in its financial reporting.

C. Materiality in the Preparation or Audit of Financial Statements (SAB 99)

On August 12, 1999, the staff published Staff Accounting Bulletin No. 99. That SAB expressed the staff's view that exclusive reliance on certain quantitative benchmarks to assess materiality in preparing or auditing financial statements is inappropriate. The SAB states that the staff has no objection to the use of a percentage threshold as an initial assessment of materiality, but exclusive use of such thresholds has no basis in law or in the accounting literature. The staff stresses that evaluations of materiality require registrants and auditors to consider *all* of the relevant circumstances, and that there are numerous circumstances in which misstatements below that percentage threshold could be material. Some of the circumstances listed in the SAB that should be considered are:

- whether the misstatement masks a change in earnings or other trends,
- whether the misstatement hides a failure to meet analysts' consensus expectations for the enterprise,
- whether a misstatement changes a loss into income or vice versa,

- whether the misstatement concerns a segment of the registrant's business that plays a significant role in the registrant's present or future operations or profitability,
- whether the misstatement affects compliance with loan covenants or other contractual requirements,
- whether the misstatement has the effect of increasing management's compensation.

The SAB observes that managers should not direct or acquiesce to immaterial misstatements in the financial statements for the purpose of managing earnings. The SAB indicates that investors generally would consider significant an ongoing practice to over- or understate earnings up to an amount just short of some percentage threshold in order to manage earnings.

The SAB also notes that even though a misstatement of an individual amount may not cause the financial statements to be materially misstated, it may, when aggregated with other misstatements, render the financial statements taken as a whole to be materially misleading. The SAB, therefore, provides guidance on when and how to aggregate and net misstatements to see if they materially misstate the financial statements.

The SAB advises that, even if management and auditors find that a misstatement is immaterial, they must consider whether the misstatement results in a violation of the books and records provisions in Section 13(b) of the Exchange Act. Section 13(b) requires that public companies make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect transactions and the disposition of assets of the registrant, and that they maintain internal accounting controls that are sufficient to provide reasonable assurances that financial statements are prepared in conformity with GAAP. In this context, what constitutes "reasonable assurance" and "reasonable detail" are not based on a "materiality" standard but on the level of detail and degree of assurance that would satisfy prudent officials in the conduct of their own affairs.

The SAB sets forth various factors, in addition to those used to evaluate materiality, that a company may consider in deciding whether a misstatement violates its obligation to keep books and records that are accurate "in reasonable detail." Some of these factors are:

- the significance of the misstatement,
- how the misstatement arose,
- the cost of correcting the misstatement, and
- the clarity of the authoritative accounting guidance with respect to the misstatement.

Finally, the SAB reminds auditors of their obligations under Section 10A of the Exchange Act and auditing standards to inform management and, in some cases, audit committees of illegal acts, such as violations of the books and records provisions of the Exchange Act, coming to the auditor's attention during the course of an audit.

D. Restructuring Charges, Impairments and Related Issues (SAB 100)

On November 24, 1999, the staff published Staff Accounting Bulletin No. 100, which provides guidance on the accounting for and disclosure of certain expenses and liabilities commonly reported in connection with restructuring activities and business combinations, and the recognition and disclosure of asset impairment charges.

The Emerging Issues Task Force addressed Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring) in Issue No. 94-3. Generally, that consensus limits costs that may be recognized solely pursuant to management's plan to incur them to those costs which result directly from an exit activity, are not associated with and do not benefit continuing activities, and for which there is appropriate authorization, specification, and commitment to execute. SAB 100 discusses the EITF criteria and related disclosure requirements in particular circumstances encountered by the staff in its review of filings by public companies. The SAB expresses the staff's view that a company's exit plan should be at least comparable in its level of detail and precision of estimation to the company's other operating and capital budgets, and should be accompanied by controls and procedures to detect and explain variances and adjust accounting accruals. The SAB discusses disclosures in financial statements and MD&A that are often necessary to make the effects of restructuring activities on reported results sufficiently transparent to investors.

SAB 100 also addresses issues that arise in the application of FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of. The SAB reminds registrants that the operational requirement to continue to use an asset disallows accounting for the asset as held for sale. If the asset is held for use, its carrying value must be systematically amortized to its salvage value over its remaining economic life. If management contemplates the removal or replacement of assets more quickly than implied by their depreciation rates, the useful lives of the assets and rates of depreciation must be re-evaluated. The SAB also provides the staff's views regarding the assessment and measurement of any impairment of enterprise level goodwill, and it specifies the accounting policy disclosures that should be provided.

The SAB also highlights the staff's concerns when a registrant records liabilities assumed in a business combination at amounts materially greater than historically reported by the acquired company. That circumstance could indicate that costs incurred before or after the merger were not properly recognized in the reported results of one or the other combining company. The SAB reminds registrants that, if

the acquired company's historical accounting for a liability is based on reasonable estimates of undiscounted future cash flows, the estimated undiscounted cash flows underlying the liability recorded by the acquiring company would not be expected to differ materially from those estimates unless the acquirer intends to settle the liability in a manner demonstrably different from that contemplated by the acquired company.

E. Interpretive Guidance on Revenue Recognition (SAB 101, SAB 101A and SAB 101B)

On December 3, 1999, the staff published Staff Accounting Bulletin 101 to provide guidance on the recognition, presentation and disclosure of revenue in financial statements (www.sec.gov/rules/acctreps/sab101.htm). The SAB draws on the existing accounting rules and explains how the staff applies those rules, by analogy, to transactions that the accounting literature does not otherwise address specifically. On October 12, 2000 the staff published Frequently Asked Questions and Answers which responds to inquiries received from auditors, preparers and analysts about how the accounting literature and guidance in SAB 101 should be applied (www.sec.gov/offices/account/sab101fq.htm).

SAB 101 identifies basic criteria that must be met before registrants can record revenue:

- persuasive evidence of an arrangement exists;
- delivery has occurred or services have been rendered;
- the seller's price to the buyer is fixed or determinable; and
- collectibility is reasonably assured.

In the absence of authoritative literature addressing a specific arrangement or a specific industry, the staff believes preparers and auditors should assure that the company's revenue recognition policy satisfies all of these criteria.

Specific fact patterns discussed in the SAB include bill-and-hold transactions, long-term service transactions, refundable membership fees, contingent rental income, and up-front fees when the seller has significant continuing involvement. The SAB also addresses whether revenue should be presented at the full transaction amount or on a fee or commission basis when the seller is acting as a sales agent or in a similar capacity. Finally, the SAB provides guidance on the disclosures registrants should make about their revenue recognition policies and the impact of events and trends on revenue.

The Q&A provides additional interpretive guidance about the significance of title transfer, the meaning of substantial performance and customer acceptance, the effect of undelivered elements on nonrefundable payments, the conditions for recognition of refundable service revenue, and various SAB 101 implementation questions.

Registrants may need to change their accounting policies to comply with the SAB. Provisions of the SAB addressing the period in which the new policies should be adopted were amended by Staff Accounting Bulletin 101B, which was issued June 26, 2000. Provided the registrant's former policy was not an improper application of GAAP, registrants may adopt a change in accounting principle to comply with the SAB no later than the last fiscal quarter of the fiscal year beginning after December 15, 1999.

F. Mandatorily Redeemable Securities of Subsidiaries Holding Debt of Registrant

Registrants should consider the adequacy of disclosures about mandatorily redeemable securities issued by a finance subsidiary of a parent company when the financial subsidiary holds only debt instruments issued by the parent, particularly if the outstanding security of the finance subsidiary is guaranteed by the parent and mirrors the cash flows of the debt of the parent held by the finance subsidiary. The staff believes that disclosures in these situations often must be expanded to provide investors with a fair and balanced picture of the registrant's effective capitalization and leverage. Inclusion of the outstanding public security in minority interest with minimal disclosure of its characteristics is not adequate, particularly when Section 12(h) reporting relief is requested by registrants for the finance subsidiary. In those situations, the parent should disclose the subsidiary's outstanding securities as a separate line item in the parent's balance sheet captioned "Company-obligated mandatorily redeemable security of subsidiary holding solely parent debentures," "Guaranteed preferred beneficial interests in Company's debentures," or similar descriptive wording. Notes to the financial statements should describe fully the terms of the securities and explain that those terms parallel the terms of the company's debentures which comprise substantially all of the assets of the consolidated trust or subsidiary.

G. Accountant's Refusals to Re-issue Audit Reports

Some accounting firms have adopted risk management policies that lead them to refuse to re-issue their reports on the audits of financial statements that have been included previously in Commission filings. In some cases, accountants whose reports on acquired businesses were included in a registrant's Form 8-K have declined to permit that report to be included in a registrant's subsequent registration statement. In other cases, accountants have declined to reissue their reports on the registrant's financial statements after the registrant engaged a different auditor for subsequent periods. The Commission's staff is not in a position to evaluate the reasons for an accountant's refusal to re-issue its report and will not intervene in disputes between registrants and their auditors. Moreover, the staff will not waive the requirements for the audit report or the accountant's consent to be named as an expert in filings. If a registrant is unable to re-use the previously issued audit report in a current filing, the registrant must engage another accountant to re-audit those financial statements. A registrant that is unable to obtain either re-issuance of an audit report or a new audit by a different firm may be precluded from raising capital in a public offering.

When registrants engage an accountant to perform audit services, they should consider the need for the accountant to re-issue its audit report in future periods. It may be appropriate to address in the audit services contract the registrant's expectations regarding the use of the audit report in filings that it or its successors may make under either the Exchange Act or the Securities Act and the circumstances under which the accountant may decline to permit its re-use.

H. Market Risk Disclosures

On January 28, 1997, the Commission adopted amendments to Regulation S-K, Regulation S-X, and various forms (Securities Act Release No. 7386) to clarify and expand existing requirements for disclosures about derivatives and market risks inherent in derivatives and other financial instruments. Derivative financial instruments are defined in FASB Statement No. 119 to include futures, forwards, swaps, and options. Derivative commodity instruments are defined in the Release to be commodity contracts that are permitted by contract or business custom to be settled in cash or with another financial instrument (e.g., commodity futures, commodity forwards, commodity swaps, and commodity options). Other financial instruments are defined in FASB Statement No. 107 to include, for example, investments, including structured notes, loan receivables, debt obligations, and deposit liabilities. The requirements for quantitative and qualitative information about market risk apply to all registrants except registered investment companies and small business issuers.

In general, the release:

- requires enhanced descriptions of accounting policies for derivatives in the footnotes to the financial statements;
- requires quantitative and qualitative disclosures about market risk inherent in derivatives and other financial instruments outside the financial statements; and
- provides a reminder to registrants to supplement existing disclosures about financial instruments, commodity positions, firm commitments, and other anticipated transactions with related disclosures about derivatives.

On July 31, 1997, the staff released Questions and Answers about the New "Market Risk" Disclosure Rules. The interpretive answers were prepared by the staffs of the Office of the Chief Accountant and the Division of Corporation Finance. This publication is posted at the Commission's Internet site;
[http:// www.sec.gov](http://www.sec.gov).

Based on the Division's reviews of filings by some registrants required to provide the disclosures about derivatives and market risks inherent in derivatives and other financial instruments, we have the following suggestions:

1. **Accounting policies for derivatives**

Remember to provide all of the disclosures regarding accounting policies for certain derivative financial instruments and derivative commodity instruments, to the extent material, as required by Rule 4-08(n) of Regulation S-X and SFAS 119. Include clear disclosure of the method used to account for each type of derivative financial instrument and derivative commodity instrument.

2. General

Remember to cite the new Item specifically (e.g., Item 7A for Form 10-K or Item 9A for Form 20-F) in the form. Registrants can include the quantitative and qualitative disclosures under the Item reference, cross-reference from the Item reference to the disclosures elsewhere in the filing, or indicate under the Item reference that the disclosures are not required (See Rule 12b-13).

Registrants may need to discuss a material exposure under the Item even though they do not invest in derivatives. For example, registrants that have investments in debt securities or have issued long-term debt should discuss risk exposure if the impact of reasonably possible changes in interest rates would be material. Likewise, registrants that have invested or borrowed amounts in a currency different from their functional currency should discuss risk exposure if the impact of reasonably possible changes in exchange rates would be material.

The market risk disclosures can refer to the financial statements but disclosures required by the new rules should be furnished outside the financial statements. The “safe harbor” established under the new rules does not extend to information presented in the financial statements.

3. Quantitative disclosures

a. Tabular presentation

Include all relevant terms of the related market sensitive instruments. In addition, disclose the method and assumptions used to determine estimated fair value, cash flows and future variable rates. In addition, segregate instruments by common characteristics and by risk classification.

b. Sensitivity analysis and Value at Risk (VAR)

Disclose the types of instruments (e.g., derivative financial instruments, other financial instruments, derivative commodity instruments) included in the sensitivity analysis and VAR analysis and provide an adequate description of the model and the significant assumptions used, such as the magnitude and timing of selected hypothetical changes in market prices, method for determining discount rates, or key prepayment or reinvestment assumptions. Indicate whether other instruments are included voluntarily, such as certain commodity instruments and positions outside the required scope of the rule, cash flows from anticipated transactions, etc.

4. Qualitative disclosures

Explain clearly how the company manages its primary market risk exposures, including the objectives, general strategies and instruments, if any, used to manage those exposures. Explain clearly the changes in how the company manages its exposures during the year in comparison to the prior year and any known or expected changes in the future.

I. Financial Statements in Hostile Exchange Offers

In registration statements that require financial statements of a company other than the registrant (such as when the registrant acquires or will acquire another entity), the audit report of the target's independent accountants must be included in the registration statement. The consent of the target's auditor to the inclusion of its report in the registration statement is required pursuant to Rule 436 of Regulation C.

A registrant offering its own securities in a hostile exchange offer for the target's stock may seek and not be able to obtain the target's cooperation in providing either its audited financial statements or the target auditor's consent to the use of its report in the required registration statement. In this situation, the registrant should follow the guidance in SAB Topic 1A. If the target is a public company, SAB Topic 1A requires that any publicly filed financial information of the target, including its financial statements, be included in the registrant's filing or incorporated by reference into, and therefore made a part of, that filing.

The acquirer/registrant should use its best efforts to obtain the target's permission and cooperation for the filing or incorporation by reference of the target's financial statements, and the target auditor's consent to including its report on the financial statements. At a minimum, a registrant is expected to write to the target requesting these items and to allow a reasonable amount of time for a response prior to effectiveness of the filing. The target may, however, fail to cooperate with the registrant.

Under Rule 437 of Regulation C, a registrant may request a waiver of the target auditor's consent by filing an affidavit that states the reasons why obtaining a consent is impracticable. The affidavit should document the specific actions taken by the registrant to obtain the cooperation of the target for the filing of its financial statements as well as the efforts made to obtain the target auditor's consent. As stated in SAB Topic 1A, the staff will request copies of correspondence between the registrant and the target evidencing the request for and the refusal to furnish financial statements.

If the registrant uses its best efforts but is still unsuccessful in obtaining the target's permission and cooperation on a timely basis, the staff will generally agree to waive the requirement to include or incorporate by reference the target auditor's audit report, but not the target's financial statements. If target financial statements are incorporated by reference into the acquirer's registration statement from the target's public filings, disclosure should be made that, although an audit report was issued on the target's financial statements and is included in the target's filings, the auditor has not permitted use of its report in the registrant's registration statement. The auditor should not be named. Any legal or practical implication for shareholders of either the registrant or the target of the inability to obtain the cooperation of the target or consent of the target's auditor should be explained. No disclosure in the registration statement should expressly or implicitly purport to disclaim the registrant's liability for the target's financial statements. In the event that circumstances change, for example, if the deal turns friendly, the registration

statement should be amended to include the audited financial statements and the auditor's consent required by the form.

J. Proposed Rule for Disclosure about Valuation and Loss Accruals and Long-Lived Assets

On January 21, 2000, the Commission proposed rule amendments to reposition certain schedule information about valuation and loss accruals that is currently required in exhibits to certain periodic reports and registration statements (Securities Act Release No. 33-7793). Under the proposed rule, this information would be required by new Item 302(c) of Regulation S-K and be included within the main body of reports and registration statements. Also, a proposed new Item 302(d) of Regulation S-K would require certain information concerning tangible and intangible long-lived assets and related accumulated depreciation, depletion, and amortization. Amendment of Form 20-F also is proposed to include a new Item 8C soliciting identical information in filings by foreign private issuers. The rule proposals are intended to provide investors with (1) more transparent, better detailed disclosures concerning changes in valuation and loss accrual accounts and in the underlying accounting assumptions, and (2) more detailed information to assess the effects of useful lives assigned to long-lived assets.

Under the proposed rule, registrants would be required to provide beginning and ending balances and additions to and deductions from accounts established for each major class of valuation or loss accrual. Examples of accounts for which the disclosure would be required include allowances for doubtful trading accounts or notes receivable; allowances for sales returns, discounts and contractual allowances; unamortized discount or premium; excess of estimated costs over revenues on contracts (losses accrued under SFAS 5); liabilities for costs of discontinued operations; liabilities for exit and employee termination relating to a restructuring or business combination; contingent tax liabilities recorded under SFAS 5; product warranty liabilities, and probable losses from pending litigation. Disclosures provided in response to this item would not be audited, and would not be duplicated if they are presented in the financial statements.

Similarly, the proposed rule would require provision of unaudited information depicting beginning and ending balances and additions to and deductions from accounts established for each major long-lived asset classification and its corresponding accumulated depreciation, depletion and amortization account. Major long-lived asset classifications are those for which separate presentation is made on the balance sheet and include land, buildings, equipment, leaseholds, brand names, non-compete agreements, customer lists, and goodwill.

K. Recent Enforcement Action – America Online, Inc.

On May 15, 2000, America Online, Inc. consented to the entry of an Order by the Commission making findings about the company's accounting for certain advertising costs, and directing AOL to cease and desist from causing any violations of Sections 13(a) and 13(b)(2)(A) of the Exchange Act and rules thereunder.

(Accounting and Auditing Enforcement Release No. 1257). In addition, AOL agreed to pay a \$3.5 million civil penalty.

During the two fiscal years ending June 30, 1996, AOL capitalized certain direct response advertising costs -- primarily the costs associated with sending disks to potential customers. AOL reported those costs as an asset which was amortized over 12 months until July 1, 1995, when the amortization period was increased to 24 months. On a quarterly basis, the effect of capitalizing those costs was that AOL reported profits for six of the eight quarters in the two years ended June 30, 1996, rather than losses that it would have reported had the costs been expensed as incurred.

The AICPA's Statement of Position 93-7, *Reporting on Advertising Costs*, permits the capitalization and amortization of direct response advertising costs only when persuasive historical evidence exists that allows the entity to reliably predict future net revenues that will be obtained as a result of the advertising. Further, that rule specified that the realizability of the amounts reported as assets must be evaluated at each balance-sheet date on a cost-pool-by-cost-pool basis. Paragraph 70 of the SOP observes that the conditions under which direct response advertising may be capitalized "are narrow because it is generally difficult to determine the probable future benefits of advertising with the degree of reliability sufficient to report the results of the advertising as assets."

AOL based its capitalization of the advertising costs on a model which assumed stability of customer retention rates over an extended period, as well as the maintenance of the company's gross profit margin percentage. The Commission found that AOL did not meet the essential requirements of SOP 93-7 because its unstable business environment precluded reliable forecasts of future net revenues. Moreover, AOL did not assess recoverability of the capitalized cost on a cost-pool-by-cost-pool basis.

L. Segment Disclosure

SFAS 131 defines an operating segment, in part, as a component of an enterprise whose operating results are regularly reviewed by the chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance. Segments may be aggregated in the disclosure only to the limited extent permitted by the standard. If segments are aggregated, that fact must be disclosed. Under SFAS 131, the chief operating decision maker is not necessarily a single person, but is a function that may be performed by several persons.

If the chief operating decision maker receives reports of a component's operating results on a quarterly or more frequent basis, the staff may challenge a registrant's determination that the component is not a segment for purposes of SFAS 131 unless reports of other overlapping sets of components are more clearly representative of the way the business is managed. On a few occasions, the staff has requested copies of all reports furnished to the chief operating decision maker if the reported segments did not appear realistic for management's assessment of a

company's performance or conflicted with that officer's public statements describing the company. The staff also has reviewed analysts' reports, interviews by management with the press, and other public information to evaluate consistency with segment disclosures in the financial statements. Where that information revealed different or additional segments, amendment of the registrant's filings to comply with SFAS 131 was required.

X. SIGNIFICANT NO-ACTION AND INTERPRETIVE LETTERS THROUGH OCTOBER 2000

A. Section 2(a)(1) of the Securities Act

Minnesota Mutual Companies, Inc. - November 24, 1999

The Division stated that it will not recommend enforcement action to the Commission if, following the adoption of a plan to provide benefits to Company members, Minnesota Mutual, a mutual insurance holding company, continues to issue membership interests without registration under the Securities Act or the Exchange Act. In reaching this position, the Division noted particularly counsel's representation that the regulation of Minnesota Mutual and its subsidiaries by the Minnesota Commissioner of Commerce remains as described in Minnesota Mutual's prior no-action request dated May 19, 1998.

American Stock Exchange - NASD - July 10, 1998

The Division expressed the view that the American Stock Exchange (the "Exchange") memberships, or "seats," described in the letter are not securities within the meaning of Section 2(a)(1) under the Securities Act. The Division also expressed the view that the described transaction, in which substantially all of the assets and liabilities of the Exchange would be transferred to a limited liability company in exchange for i) an interest in the limited liability company and ii) contractual obligations of the NASD under the agreement governing the transaction, would not involve a distribution of the securities issued by the limited liability company under Securities Act Rule 145(a)(3).

B. Sections 2(a)(3) and 5 of the Securities Act

American Bar Association – July 25, 2000

The Division expressed the view that the automatic enrollment, as described below, of employees in a Section 423 employee stock purchase plan before the company's initial public offering would not involve the offer or sale of a security before effectiveness of the plan's Form S-8 registration statement.

The plan's initial offering period would begin upon effectiveness of this Form S-8, which would be filed following effectiveness of the company's initial public offering registration statement. Employee enrollment would take place earlier on an involuntary, automatic basis. This enrollment would provide for the maximum level of

participation set by the plan and lump sum cash payment by the end of the offering period.

No offers would be made to employees, nor would any employee take any action regarding the plan, before the company files the Form S-8. After the plan's Form S-8 becomes effective, an employee would be able to elect participation at a lower percentage of compensation or switch to payroll deductions as the form of payment. The Division expressed the view that company solicitation or payroll deduction elections after effectiveness of the plan's Form S-8 would not violate Section 5.

First Mutual Savings Bank - October 8, 1999

The Division stated that it no longer responds to requests for no-action advice under Sections 2(a)(3) and 5 for holding company formations structured to occur without a vote of shareholders.

Vanderkam & Sanders - January 27, 1999 Simplystocks.com - February 4, 1999

In each of these letters, the Division expressed the view that the issuance of securities in consideration of a person's registration or visit to an issuer's internet site would be an event of sale within the meaning of Section 2(a)(3), and would violate Section 5 of the Securities Act unless it were the subject of a registration statement or a valid exemption from registration.

C. Section 2(a)(10) of the Securities Act

Since 1997, the Division has issued a series of no-action letters enabling third-party providers to contract with underwriting firms for the recording and electronic transmission of roadshows to a limited audience selected by the managing or lead underwriter in connection with registered non-shelf offerings. In each request, counsel provided a legal opinion that the transmissions would not be "prospectuses" within the meaning of Section 2(a)(10) of the Securities Act. The Division responded that, without necessarily agreeing with that analysis, it would not recommend enforcement action if the parties proceeded as described in their letters. See *Private Financial Network* (March 12, 1997); *Net Roadshow, Inc.* (July 30, 1997); *Bloomberg L.P.* (October 27, 1997); *Thomson Financial Services, Inc.* (September 4, 1998); *Activate.net Corporation* (September 21, 1999). Conditions common to these letters include:

- (1) an entire "live" roadshow, including any questions and answers from the audience, would be recorded after the filing of the registration statement for transmission on a real-time or subsequent basis; there would be no editing, except for "housekeeping"-type changes to eliminate dead airtime and to correct mistakes;

- (2) the electronic roadshow would not be made widely available, but instead, access would be restricted by password to a limited audience of persons customarily invited by the underwriter to attend a "live" roadshow;
- (3) any investor given password-restricted access to an electronic roadshow would only be able to view the presentation twice in connection with a particular offering (e.g., *Private Financial Network*), or an unlimited number of times within a single 24-hour period (e.g., *Bloomberg L.P.*). In either case, a registration statement first would be filed;
- (4) a copy of the prospectus in the registration statement would be delivered, either in paper or electronic format, to each viewer before or contemporaneously with obtaining access to the roadshow; viewers would be able to download and print any electronically delivered prospectus;
- (5) viewers would agree not to copy, download or further distribute the roadshow transmission, and a visual statement or "crawl" would be included in each transmission to emphasize this prohibition;
- (6) material developments occurring after the taping of the original, or "live," roadshow would be presented pursuant to a periodic textual crawl; and
- (7) information provided in the electronic roadshow would not be inconsistent with the filed prospectus.

In 1998, the staff also issued a letter to Net Roadshow addressing the internet-based transmission of roadshows in Rule 144A deals. See *Net Roadshow, Inc.* (January 30, 1998), located in Section X.F. of this outline.

Most recently, in letters dated November 15, 1999, and February 9, 2000, the Division allowed Charles Schwab & Co., Inc., a broker-dealer firm, to make electronic roadshows transmitted in connection with firm-commitment, underwritten IPOs available to a segment of its retail customer base (as well as certain "independent" investment advisers), where Schwab is a member of the underwriting syndicate or selling group. Under the Schwab letters, however, the Division has clarified that: (1) there can only be one version of the "live" roadshow captured for electronic transmission to eligible investors; (2) the electronically transmitted roadshow cannot exclude any material information, such as earnings projections, intended to be included in any other presentation of the roadshow; and (3) the content of the electronic roadshow must be consistent with the content of the statutory prospectus relating to a particular IPO.

Given the increasing use of electronic roadshows evidenced by the letters described above, as well as the more general use of the Internet in securities offerings, the Commission has indicated that it wishes to consider rulemaking in these areas. Because of this, the staff has determined to cease issuance of no-action or interpretive letters focusing on electronic roadshows pending Commission action.

W.R. Hambrecht + Co. July 12, 2000
Wit Capital Corporation July 20, 2000
Bear, Stearns & Co., Inc. July 20, 2000

These interpretive letters address “live” online auctions in offerings registered under the Securities Act. The letters are discussed in detail in Section VIII.A.6.

D. Section 3(a)(10) of the Securities Act

Food Lion, Inc. - January 13, 1999

The Division stated that it would not object if , based on counsel’s opinion that the exemption from registration provided by Section 3(a)(10) is available, the described exchange of securities traded on the Nasdaq National Market were conducted as proposed.

In reaching its position, the Division noted the recent enactment of the Securities Litigation Uniform Standards Act of 1998 (105 P.L. 353, 112 Stat. 3227), which amended Section 18(b)(4)(C) of the Securities Act to include a reference to Section 3(a)(10). Section 18 of the Securities Act creates an exemption from state securities law registration requirements for “covered securities”, and defines “covered security” to include any security listed on the Nasdaq National Market System. As amended, Section 18(b)(4)(C) removes securities that are otherwise covered securities from the definition if they are offered and sold in reliance on certain federal exemptions, including Section 3(a)(10). The Division expressed the view that, as a result of the amendment, state securities law provisions authorizing the approval of certain exchanges of securities may be used to perfect an exemptive claim under Section 3(a)(10) where the security is otherwise a “covered security”. The Division stated that, because of this Congressional action, statements to the contrary in Staff Legal Bulletin No. 3, as published on July 25, 1997, are no longer valid.

The Division also addressed other questions raised with respect to the proposed exchange.

Maverick Networks - January 25, 1999

The Division expressed the view that an exemptive claim under Section 3(a)(10) for securities listed on the New York Stock Exchange, the American Stock Exchange, or the Nasdaq Market System in a transaction reviewed under Section 25142 of the California Corporations Code would not be impaired by Section 18(b) of the Securities Act. The Division noted that through the recent amendment to Section 18(b)(4)(C) of the Securities Act, such securities, which otherwise would be “covered securities” exempted by Section 18 from state securities law regulatory requirements, are removed from the definition of covered securities if they are offered and sold in reliance on Section 3(a)(10). As a result, the Division stated, state securities law provisions (such as the California provision at issue) authorizing the approval of certain exchanges of securities may again be used to perfect exemptive claims under Section 3(a)(10) with respect to securities that otherwise would be covered securities.

E. Section 5 of the Securities Act

NASD Regulation, Inc. - January 21, 2000

In a letter to NASD Regulation, Inc., dated January 21, 2000, the staff advised that persons who hold securities in blank check companies are probably underwriters of those securities. While the facts and circumstances are critical, Section 4(1) of the Securities Act may not be available for resales of these securities by promoters, affiliates, and their transferees, regardless of the length of time they may have held the securities. The design of the blank check companies is intended to allow these persons to introduce large quantities of securities into the public markets at the time of a business combination with an operating company. These sales are distributive in character, not the ordinary trading transactions Section 4(1) exempts. In addition, the staff expresses the view that resale transactions of these securities, where the initial distribution was not accomplished through registration and conformance with Rule 419 under the Securities Act, cannot be done under Rule 144 because a scheme to evade registration is involved making the provision unavailable. The staff also cautioned about the applicability of Rules 101 and 102 of Regulation M in these situations. As a final matter, the staff noted that Rule 701 would generally not be available to blank check companies.

Metropolitan Life Insurance Company - November 17, 1999

In a letter issued jointly with the Division of Market Regulation and the Division of Investment Management, the Division responded to several questions regarding the Company's proposed demutualization transaction, the Reorganization. In the Reorganization, Metropolitan Life would become a subsidiary of a newly-formed Holding Company. Policyholders' membership interests in Metropolitan Life would be extinguished, and Policyholders would receive cash, policy credits or be allocated Metropolitan Life common stock in exchange for their membership interests. The Metropolitan Life common stock would in turn be exchanged for an equal number of shares of Holding Company stock to be held through a Trust. Policyholders' allocated stock would be allocated beneficial Interests in the Trust equal to the number of shares of Holding Company common stock allocated to them. After one year, Policyholders may withdraw all their allocated shares of Holding Company common stock held in the Trust.

In its response, the Division stated, among other things, that:

1. it would not recommend enforcement action to the Commission if Metropolitan Life were to conduct the Reorganization without Securities Act registration, in reliance on the exemption provided by Section 3(a)(10);
2. it would not object if, after a registered initial public offering of Holding Company common stock, the Trust registers the Trust Interests on Exchange Act Form 8-A, including descriptions of the Interests, the common stock and the rights issued under the stockholder rights plan adopted by the Holding Company, and incorporating certain information from the Holding Company's Form 8-A for the common stock and rights;

3. it would not object if the Trust complies with Exchange Act Section 13(a) by filing financial statements of the Trust only, at the time of mailing dividends and other distributions to persons holding Trust beneficial interests. The financial statements will show distributions the Trust received and paid during the period ending on the financial statement date, and the Trust Shares and other assets held by the Trust on that date. The financial statements will be audited, and will be filed under cover of Form 10-K, in connection with the annual distribution of cash dividends. Filings made in connection with distributions will be on Form 8-K, and will include unaudited financial statements. The Trust will also file reports on Form 8-K if there is an event relating to the Trust that the Form requires;
4. it would not object if, only with respect to Trust Shares, and not with respect to any common stock acquired in open market purchases,
 - neither the Trust, the Trustee, the Custodian of the Trust nor the Holding Company disseminates any proxy soliciting materials, annual and quarterly reports or information statements of the Holding Company to a Trust beneficiary in connection with a vote or consent of stockholders of the Holding Company, except in connection with a Beneficiary Consent Matter or upon request of any Trust beneficiary;
 - the Trust, the Trustee, the Custodian of the Trust and the Holding Company follow the procedures described in the letter for the distribution of proxy soliciting materials, annual reports or information statements in connection with a Beneficiary Consent Matter (including the procedures that require mailing and other expenses to be reimbursed by a stockholder in certain circumstances, instead of following the reimbursement procedures outlined in Rule 14a-7 under the Exchange Act) (in reaching its position regarding compliance with Rule 14a-7 with respect to any solicitation of Trust beneficiaries, the Division particularly noted the Holding Company's representation that it will always elect to mail, rather than to provide a shareholder list, with respect to a Beneficiary Consent Matter);
 - none of the Holding Company, the Trust, the Trustee or Custodian of the Trust inquires as to the beneficial ownership of the Trust Shares, pursuant to Rules 14a-13, 14b-2 and 14b-1 under the Exchange Act, respectively, in connection with such votes or consents of stockholders of the Holding Company, or provides information in connection with those inquiries, except in connection with a Beneficiary Consent Matter;
5. it will not object if Holding Company Board members provide Schedule 13D and Section 16(a) information as described in the request; and

6. it agrees that a withdrawal of Trust Shares from the Trust by a person holding Trust beneficial interests, after expiration of the one-year period, is not an event that requires Securities Act registration.

PetroSell.com, LLC - September 22, 1999

The Division agreed that it would not recommend enforcement action under Section 5 of the Securities Act for Internet auctions offering and selling whole interests in oil or gas properties exclusively to persons actively engaged in oil or gas exploration or production. Counsel opined that the auctions would not involve sales of securities within the meaning of Section 2(a)(1) of the statute.

Wit Capital- July 14, 1999

The Division, without concurring in counsel's analysis, agreed not to recommend enforcement action to the Commission under Section 5(a) or 5(b) against Wit Capital for its conduct of initial public offerings using the procedures described in Wit's request.

Under the procedures, Wit circulates an e-mail notice conforming to Rule 134 after posting a preliminary prospectus in a segregated area within Wit's web site. The segregated area in Wit's web site, the "cul de sac," separates information concerning the IPO from other information on Wit's web site. A person entering the cul de sac cannot link to other sites on the Internet, such as the issuer's web site. The cul de sac includes only a notice conforming to Rule 134, the preliminary prospectus, and information on Wit's general account and subscription procedures.

A person visiting the cul de sac who does not hold accounts with Wit must open the account before submitting an offer to buy shares in the IPO. A minimum of \$2,000 must be deposited to open the account. The amount deposited is independent of the amount that may be required to purchase shares and remains in the control of the investor. Persons holding accounts who wish to participate in the offering may make offers to buy through the subscription documents included in the cul de sac. Offers to buy may specify the price the investor is willing to pay. Offers to buy that do not specify a price are treated as limit orders at the maximum estimated public offering price disclosed in the prospectus.

Approximately 48 hours before the anticipated effectiveness of the registration statement, Wit sends an e-mail notice requesting reaffirmation of the offers to buy. Persons who do not confirm their earlier offers will not receive allocations. The confirmation will be valid for a maximum of seven business days from this e-mail notice. A further reconfirmation will be required at any time the public offering price deviates from the estimate and at any time the preliminary prospectus is recirculated.

After the registration statement is effective and shortly before the IPO is priced using Rule 430A procedures, Wit will send an e-mail notice to each bidder stating that the offering is about to price and that unless the bidder withdraws the offer to buy within a brief period (the minimum is an hour), Wit may accept the offer.

Notices of acceptance are sent to persons who have received allocations. The notice will be followed by a confirmation that satisfies Exchange Act Rule 10b-10 and the final prospectus required by Section 5(b)(2).

IPONET - July 26, 1996

With respect to public offerings, the Division addressed the application of Securities Act Rule 134 to an electronic coupon or card. The Division stated that the reference in Rule 134(d) to "an enclosed or attached coupon or card, or in some other manner" would be equally applicable to the acceptance of indications of interest via electronic coupon or card as well as paper coupon or card. In this regard, the Division noted the representation that Rule 134(d)'s other requirements will be satisfied in connection with the acceptance of such indications of interest.

The Division also addressed, in the electronic context, the definitions of "general solicitation" and "general advertising" under Securities Act Regulation D Rule 502(c). The Division took the position that the initial qualification of accredited or sophisticated investors by means of a generic questionnaire, followed by the subsequent posting of a notice of a private offering in a password-protected page of IPONET accessible only to IPONET members who previously qualified as accredited investors, would not involve any form of "general solicitation" or "general advertising" within the meaning of Rule 502(c).

In reaching this conclusion, the Division noted that (i) both the invitation to complete the questionnaire used to determine whether an investor is accredited or sophisticated and the questionnaire itself will be generic in nature and will not reference any specific transactions posted or to be posted on the password-protected page of IPONET; (ii) the password-protected page of IPONET will be available to a particular investor only after the supervisor of IPONET has made the determination that the particular potential investor is accredited or sophisticated; and (iii) a potential investor could purchase securities only in transactions that are posted on the password-protected page of IPONET after that investor's qualification with IPONET. In this regard, the Division stated that it took no position as to whether the information obtained by the supervisor is sufficient to form a reasonable basis for believing an investor to be accredited or sophisticated.

Real Goods Trading Corporation - June 24, 1996

The Division (as well as the Divisions of Investment Management and Market Regulation) addressed the Company's proposed trading system that would provide information about prospective buyers and sellers of Real Goods Trading's common stock. The Division took the position that the Real Goods Trading's activities in connection with the establishment and maintenance of the trading system would not require that offers or sales made through the trading system be registered under the Securities Act. The Division of Investment Management took the position that Real Goods Trading may engage in the activities specified without registering under the Investment Advisers Act. The Division of Market Regulation took the position that it would not recommend enforcement action under Exchange Act Section 5, 6 or 15 if Real Goods Trading operates the trading system in the manner specified without

registration as a national securities exchange under Section 6 or as a broker-dealer under Section 15 of the Exchange Act.

In reaching these positions, the Divisions noted that (i) Real Goods Trading will provide specified notices regarding operation of and participation on the trading system that will be set forth or contained on the screens and/or hard copy by which trading system information is provided; (ii) Real Goods Trading is an Exchange Act Section 12 registrant and will retain that status or, if it should cease to be a Section 12 registrant, otherwise undertake to make publicly available the information required by Exchange Act Section 13(a) in the same manner that buyers and sellers of Real Goods Trading's common stock will obtain access to the trading system (e.g., electronic mail, facsimile, mail, the Company's World-Wide Web site, etc.); (iii) Real Goods Trading will keep records of all quotes entered into the trading system and make those records available to the Commission and the Pacific Stock Exchange (or any other regulated market on which Real Goods Trading's securities are listed) upon reasonable request; (iv) Real Goods Trading's advertising will comply with specified representations; (v) neither Real Goods Trading nor any of its affiliates will use the trading system, directly or indirectly, to offer to buy or sell securities, except in compliance with the securities laws, including any applicable registration requirements (absent an available exemption therefrom); and (vi) neither Real Goods Trading nor any of its affiliates will (a) receive any compensation for creating or maintaining the trading system; (b) receive any compensation for the use of the trading system; (c) be involved in any purchase or sale negotiations arising from the trading system; (d) provide information regarding the advisability of buying or selling Real Goods Trading's common stock or any other securities; or (e) receive, transfer or hold funds or securities as an incident of operating the trading system.

F. Rules 144, 145, and 144A

Goldman Sachs- December 20, 1999

The Division agreed to the use of restricted or control securities under pre-paid forward contracts. In the arrangement, a holder of restricted or control securities currently eligible for sale under Rule 144 would lend the securities to its counterparty. The lender would file a notice on Form 144. The borrowing counterparty would then sell the maximum number of shares of the same class into the public market in a manner satisfying the brokerage transaction condition required by Rule 144(f) and defined in Rule 144(g). The Division agreed that the borrowed securities may then be treated as though they were not restricted or control securities. Securities delivered to the lender to close the contract would not be restricted securities within the meaning of Rule 144(a)(3).

bamboo.com - December 20, 1999

The Division stated that it would not recommend enforcement action to the Commission if the Company exchanges its common shares for its preferred shares paired with preferred shares of its wholly-owned Canadian subsidiary without Securities Act registration, in reliance on Section 3(a)(9). The Division also expressed the view that the holding period under Rule 144(d)(4)(ii) for the common

shares exchanged may be the date the preferred shares of parent and subsidiary were acquired. In reaching both positions, the Division noted especially that the preferred shares of the subsidiary, which were inseparable from the parent's preferred shares, represented no right except the right to receive the common shares of its parent. The Division also noted that the exchange did not add to the number of equity owners of the parent.

Harmony Trading Corp.- November 22, 1999

After disagreeing with some of counsel's conclusions under Rule 144(d) and (k) and declining to express views on others, the Division expressed its concern over circumstances where, after a company is formed without either substantial capital or the prompt commencement of business, but in proximity to the company's efforts to have its securities traded in a public market, its closely-held securities are transferred to significant numbers of persons. In these circumstances, the Division suggested, resales of the transferred securities in claimed reliance on Rule 144 may involve evasive schemes to avoid registration under the Securities Act.

Juno Online Services, Inc. - November 17, 1999

A limited partnership agreement confers on the general partner the right to reconstitute the business of the partnership as a corporation. When the general partner exercises this authority, the limited partners who had given up the right to vote on the transaction recasting the business into a different organizational form may date their holding period under Rule 144(d) for the common stock of the successor corporation to the date of purchase and full payment for their limited partnership interests. The general partner who made the investment decision must date its holding period for the shares in the corporation to the date of the succession.

EarthWeb Inc. - August 20, 1999

Portfolio restricted securities held by a closely-held limited liability company are transferred in kind to its members ratably in accordance with the equity represented by their membership interests. As is the case with similar transfers by closely-held partnerships and corporations, the holding period under Rule 144(d) for the securities transferred to the members of the LLC will be the date of purchase and full payment by the LLC from the issuer.

Jevic Transportation, Inc.- April 20, 1999

Common equity securities of a single issuer that carry different voting rights are not "securities of the same class" for purposes of Rule 144(e), the rule's volume limitation.

**Mandatorily Exchangeable Issuer Securities –
October 25, 1999**

The Division addressed the eligibility of a security for resale under Rule 144A, where that security, itself eligible to be resold in reliance on Rule 144A(d)(3), is exchangeable at the issuer's election for securities of unrelated issuers. The securities of the unrelated person could be resold by the issuer of the overlying security in reliance on Section 4(1), either because they were not restricted securities within the meaning of Rule 144(a)(3) or because they could be sold in reliance on Rule 144(k). The Division expressed the view that, under the circumstances described, the overlying security would be eligible for resale under Rule 144A. The Division expressed no view on the application of the conversion premium test of Rule 144A(d)(3) to securities of this description.

Net Roadshow, Inc. - January 30, 1998

The Division stated that it would not recommend enforcement action if Net Roadshow transmits roadshows over its Internet web site solely to "qualified institutional buyers" ("QIBS") within the meaning of Securities Act Rule 144A(a)(1) on behalf of a QIB (or person acting on its behalf) that purchases securities from an issuer for resale to other QIBS under Rule 144A ("Seller").

The Division noted counsel's opinion that the activities described would be consistent with Rule 144A(d)(1) and conditioned its position on Net Roadshow's compliance with the following conditions in connection with each roadshow.

- (1) Net Roadshow will deny access to its web site for viewing a particular roadshow (including any notice of the roadshow posted on Net Roadshow's web site) to all but:
 - (A) New Roadshow's or the Seller's employees or authorized agents for that roadshow; and
 - (B) the institutions for which the Seller has confirmed its reasonable belief regarding their QIB status.
- (2) The confidential password assigned to QIBS for a particular roadshow will be unique to that roadshow, and will expire no later than the date the related offering terminates.
- (3) Each Seller's confirmation to Net Roadshow will include the following:
 - (A) a representation that the Seller is a QIB;
 - (B) an adequate basis for the Seller's representation of its "reasonable belief" that:
 - (i) each entity to which the Seller has assigned a confidential password is a QIB; and

- (ii) the offering to which the particular roadshow relates is not subject to Securities Act registration.
- (4) Net Roadshow otherwise has no actual knowledge or reason to believe, that:
 - (A) the Seller is not a QIB;
 - (B) any of the entities to which the Seller has assigned a confidential password is not a QIB; or
 - (C) the securities offering to which a particular roadshow relates is subject to Securities Act registration.
- (5) Net Roadshow is not an affiliate of any Seller or issuer of a security that is the subject of a particular roadshow.

Finally, the Division stated that the Commission or staff may reevaluate this no-action position in the future because regulatory responses to legal issues raised by technological developments may evolve.

Verio Inc. - May 25, 1999

The Division expressed the view that, once Verio has fully and unconditionally guaranteed a debt security of its wholly owned subsidiary, holders of warrants to purchase Verio common stock who pay the warrant exercise price by surrendering the guaranteed debt instrument may use their holding periods on the warrants and debt securities to calculate their holding periods for the common stock received on exercise. In reaching its position, the Division particularly noted that the addition of the Verio guarantee would allow Verio and its wholly owned subsidiary to be considered the same issuer for purposes of Rule 144(d)(3)(ii). The Division noted that warrant holders paying the exercise price with any consideration other than the guaranteed debt securities or other Verio securities would use the date of exercise of the warrant and payment of its exercise price as the beginning of the holding period for the Verio common stock received upon exercise. The Division stated that *Amdahl Corp.* (February 27, 1999) and *American Telephone and Telegraph Company* (May 1, 1999) no longer represent the Division's view on this issue.

CommScan, LLC - February 3, 1999

The Division expressed the view that sellers may rely on the Company's qualified institutional buyers list ("QIB List"), which would be published on an Internet web site accessible only by registered broker/dealers, as a method for establishing a reasonable belief that a prospective purchaser is a "qualified institutional buyer" within the meaning of Rule 144A(a)(1) under the Securities Act. Information underlying inclusion of an entity in the QIB List must be as of a date within 16 months before the date of sale of securities in the case of a United States purchaser, and within 18 months before such date of sale for a foreign purchaser.

The Petersen Companies, Inc. - July 16, 1998

The Division expressed the view that the Rule 144(d) holding period for shares of Company common stock exchanged for limited liability company interests in Petersen Holdings, L.L.C. ("Petersen") began on October 1, 1997, the date of the exchange. The Division stated that the holding period could not "tack" to an earlier date because the agreement Petersen interest holders signed when Petersen was formed, granting the Company (in its capacity as Petersen's manager) the right to control all aspects of any initial public offering, did not expressly contemplate conversion from a limited liability company to corporate form in advance of a public offering of securities, with holders of Petersen units retaining no veto or other voting power with respect to the conversion. The Division referred specifically to *Peapod, Inc.* (Nov. 10, 1997).

Peapod, Inc. - November 10, 1997

The Division took the position that limited partners of a partnership and the shareholders of its corporate general partner could "tack," under Securities Act Rule 144(d), their holding periods for their limited partnership interests and shares, respectively, onto their holding periods for the shares of Peapod received in a conversion (and, in the case of the general partner's shareholders, the general partner's subsequent liquidation).

In the conversion,

- all the equity interests in the partnership were exchanged for Peapod shares;
- the partnership was dissolved; and
- all of the partnership's assets and liabilities were transferred to Peapod.

In reaching this conclusion, the Division noted in particular specified agreements and their contemplation of the partnership's conversion to corporate form in advance of, and to facilitate, the new corporation's public offering.

Rite Aid Corporation - October 20, 1997

The Division expressed the view that, where securities originally issued in a Securities Act Rule 145(a) transaction are transferred as gifts to third parties by a person Rule 145(c) deems an underwriter, the donees in the transfers who are not the issuer's affiliates may make unregistered public resales of the securities in the same manner and to the same extent as the donor.

Nextel Communications, Inc. - August 19, 1997

The Division stated that, where securities originally issued in a Securities Act Rule 145(a) transaction are privately sold by a person deemed an underwriter by Rule 145(c) (other than an affiliate of the issuer), an unaffiliated purchaser of the

securities may make unregistered public resales of the securities to the same extent and in the same manner as the private seller.

First Bank System, Inc. - July 30, 1997

The Division stated that when an affiliate pledgor defaults on a loan that is collateralized by securities that are not "restricted" in the hands of the pledgor, and the pledgee bank forecloses on the pledge, the pledgee bank may sell those securities without regard to the holding period requirement of Securities Act Rule 144.

G. Rule 701

Morgan, Lewis & Bockius - November 3, 1999

The Division provided further guidance for issuers when transitioning from former Rule 701 to the new version. The Division expressed these views concerning the treatment of options:

- an issuer could rely on the grant date method for options granted in the 12 months before effectiveness of the revised rule up to the ceiling permitted under the old rule. Excess options - option grants over the ceiling in the old rule - could be considered against the available ceiling under the revised rule either when the excess options become exercisable or when they are actually exercised, whichever is most advantageous;
- the disclosure required by the revised rule where the \$5 million ceiling is exceeded must be provided to investors a reasonable time before the exercise of options, even if those options were granted long before the rule revision; and
- the "clean slate" method is appropriate only if the available ceiling under the revised rule is not exceeded when offers and sales under the former rule are combined with sales under the revised rule.

Occidental Petroleum Corporation - August 3, 1999

The Division expressed the view that a private subsidiary of Occidental, a publicly reporting company, may use Rule 701 to offer or sell its securities to its employees.

American Bar Association - August 3, 1999

The Division stated that, subject to preliminary note 5 to Rule 701, a private subsidiary of a publicly reporting company may use Rule 701 to offer or sell its securities, including deferred compensation arrangements whether guaranteed or not guaranteed by the parent, to its employees, officers, directors, partners, trustees, consultants or advisors, or those of its parents or other majority-owned subsidiaries of its parent.

American Bar Association - August 3, 1999

With respect to issues of transition from the former Rule 701 to the new version, the Division expressed the view that the grant date method, the effective date method and the exercisable date method described, each appear to be appropriate ways of handling unexercisable options under the new provision. The Division also concurred with the view that options issued in reliance upon the prior version of Rule 701 regardless of their exercisability would not be subject to the new disclosure requirements at the time of the option grants.

H. Regulation S

Initial Public Offerings of U.S. Companies on EASDAQ – July 27, 1999

The Division took the position that it would not recommend enforcement action if equity securities of non-reporting, U.S. companies are offered and sold in initial public offerings offshore pursuant to Regulation S in connection with a listing on EASDAQ without implementation of the stop-transfer and other provisions set forth under Rule 903(b)(3)(iii)(B), Rule 903(b)(3)(iv) and Rule 904(b)(1)(ii). In reaching its position, the Division relied on counsel's opinion that the alternative restrictions and arrangements described in the request provide reasonable procedures to prevent public distribution of these equity securities in the United States. The Division also noted that U.S. firms are not permitted to participate in the EASDAQ market, either as brokers or market-makers, and that no EASDAQ trading screens will be placed in the United States.

Sales of Convertible Securities Under Regulation S – August 26, 1998

The Division stated that it would not recommend enforcement action if convertible securities of U.S. reporting companies that are eligible for resale under Rule 144A and that are held in global certificated form (as either registered or bearer securities) by a depository for a book-entry clearance facility are offered and resold pursuant to Regulation S without implementation of the stop-transfer provisions or other procedures set forth under Rule 903(b)(3)(iii)(B)(4) of Regulation S, as long as certain procedures are followed during the applicable distribution compliance period. The Division stated that its view was limited to convertible securities offered or resold under Regulation S, and would not affect the applicability of Rule 903(b)(3)(iii)(B)(4) to any equity securities issued upon the conversion of the convertible securities during the distribution compliance period.

The Division also indicated that debt securities convertible into the equity securities of a person other than the issuer ("exchangeable" securities) would be considered convertible securities for Regulation S purposes.

I. Section 18(b)(4)(A) of the Securities Act

David M. Katz, Esq. - April 24, 1997

The Division addressed one of the definitions of "covered security" provided by Securities Act Section 18(b). Section 18(b)(4)(A) states that a security is a "covered security" as to a transaction that is exempt from Securities Act registration under Securities Act Section 4(1) or 4(3), provided that the issuer "files reports" with the Commission under Exchange Act Section 13 or 15(d). The Division stated that an issuer "files reports" for purposes of Section 18(b)(4)(A) if it has completed a registered initial public offering under the Securities Act, but has not yet been required to file any reports under Section 13 or 15(d).

J. Securities Act Forms

D'Ancona Attorneys - March 6, 2000

The Division addressed General Instruction A.1(a)(5) to Form S-8, which makes Form S-8 available for the exercise of employee benefit plan options and the subsequent resale of the underlying securities by an employee's "family member" (as defined in the instruction) who has acquired the options from the employee through a gift or domestic relations order. The instruction defines "family member" to include "a trust in which these persons have more than fifty percent of the beneficial interest." For purposes of determining whether a trust satisfies this test, the Division has said that:

1. The phrase "these persons" includes the employee, as well as the persons who, with respect to the employee, have one of the family relationships otherwise specified in the instruction.
2. A remainder interest in such a trust is not considered a "beneficial interest" unless the person or persons with the remainder interest have the power, directly or indirectly, to exercise or share investment control over the trust.
3. A determination whether a trust meets the "more than fifty percent of the beneficial interest" test must be made at the time of the registered transaction, whether that transaction is an option exercise or the resale of the underlying security.

K. Section 12 of the Exchange Act

Kinkos, Inc. - November 30, 1999

The Division stated that it will not raise any objection if Kinkos does not comply with the registration requirements of Exchange Act Section 12(g) with respect to deferred share awards and stock options to be granted under Kinkos' employee stock incentive plan as proposed in the request. In reaching this position, the Division particularly noted that Kinkos will terminate any such award or option that does not automatically expire upon termination of a holder's employment for any

reason. The position will remain in effect until the earlier of any Trigger Date (as defined in the request) and the date at which Kinkos otherwise becomes subject to the Exchange Act registration and/or reporting requirements with respect to any class of its equity securities.

L. Proxy Rules

IBM - February 16, 2000

The Division declined to permit exclusion from the company's proxy materials, on Rule 14a-8(i)(4) (personal grievance/benefit not shared by other shareholders) and Rule 14a-8(i)(7)(ordinary business) grounds, a proposal focusing on the policy implications of the company's conversion from a traditional, defined-benefit pension plan to a so-called "cash-balance" plan. With respect to the company's Rule 14a-8(i)(7) argument, the staff was persuaded that the widespread public debate on the significant social and corporate policy issues raised by conversion from defined-benefit to cash-balance retirement plans caused the subject-matter of this particular proposal to fall outside the realm of "ordinary business" matters subject to exclusion under Rule 14a-8(i)(7).

IBM - March 2, 2000

A different proponent requested that IBM's board establish a committee of outside directors to prepare a report on the potential impact on the company of pension-related proposals now under consideration by national policymakers, "including legislative proposals affecting cash balance pension plan conversions." In granting the company's request for no-action relief under Rule 14a-8(i)(7), the staff noted that the proposal appears directed at involving IBM in the political or legislative process relating to an aspect of IBM's operations (i.e., lobbying activities)."

The Coca-Cola Company - February 7, 2000

The Division was unable to concur in the company's arguments regarding the excludability, on Rule 14a-8(i)(7) and other grounds, of a proposal requesting that "the board adopt a policy of removing genetically engineered crops, organisms, or products thereof from all products sold or manufactured by Coca-Cola, where feasible, until long-term testing has shown that they are not harmful to humans, animals, and the environment, with the interim step of labeling and identifying these products, and report to the shareholders by August 2000." In the staff's view, the proposal raised significant policy issues transcending the company's ordinary business operations.

Johnson Controls, Inc. - October 26, 1999

The Division addressed whether a proposal recommending certain disclosure in the financial statements included in Johnson's Commission-prescribed documents could be omitted from Johnson's proxy material under Rule 14a-8(i)(7), as relating to Johnson's ordinary business operations. In expressing its view that the proposal could be omitted, the Division stated that it has determined that proposals requesting

additional disclosures in Commission-prescribed documents should not be omitted under the “ordinary business” exclusion solely because they relate to the preparation and content of documents filed with or submitted to the Commission. This interpretive approach reverses the Division’s prior approach to such proposals. Beginning with *Johnson Controls*, when evaluating such proposals the Division will consider whether the subject matter of the additional disclosure sought in a particular proposal involves a matter of ordinary business. Where it does, the Division believes the proposal may be excluded under Rule 14a-8(i)(7).

Chevron Corporation - March 4, 1999

The Division took the position that it would not recommend enforcement action if Chevron omitted a shareholder proposal requesting the board of directors to review and report on Chevron’s code of business conduct under Rule 14a-8(i)(12)(ii). The Division noted that the current proposal, when viewed together with the proposals submitted in 1996 and 1997, all appear to focus on Chevron’s operations in Nigeria. Furthermore, changing circumstances are not a consideration under Rule 14a-8(i)(12). On this basis, the Division continued to follow the precedent established by a prior staff no-action letter issued to Florida Progress Corporation on January 8, 1997.

General DataComm Industries, Inc. - December 9, 1998

The Division stated that it did not believe that General DataComm could rely on Rule 14a-8(i)(7) as a basis to exclude a shareholder proposal mandating a bylaw amendment on stock option repricing from its proxy materials. The Division noted that in view of the widespread public debate concerning option repricing and the increasing recognition that this issue raises significant policy issues, its view is that proposals relating to option repricing no longer can be considered matters relating to a registrant’s ordinary business. This letter reverses a prior staff no-action letter issued to Shiva Corporation on March 10, 1998.

M. Section 16 Rules

General Motors Corporation – May 19, 2000

The Division addressed the application of Exchange Act Rule 16b-3 to transactions occurring in the context of issuer exchange offers. In such an exchange offer, the disposition to the issuer of shares of one class of issuer stock would be eligible for exemption under Rule 16b-3(e). The acquisition from the issuer of shares of a different class of issuer stock would be eligible for exemption under Rule 16b-3(d).

In either case, the approval conditions of Rule 16b-3 may be satisfied at any time before the company’s acceptance of the tendered shares and the issuance of shares of the other class, which may be after the date on which the exchange offer expires. Approval will satisfy the rule’s specificity requirements if the issuer’s board of directors or committee of non-employee directors adopts resolutions that:

- name each tendering officer or director,
- approve the disposition based on the specific number of shares tendered by each named person,
- approve the acquisition of shares of the other class based on the exchange ratio set forth in the exchange document, and
- state that the dispositions and acquisitions are subject to reduction by applying proration methodology to be applied uniformly to all participants (except odd lot holders) if the offer is oversubscribed, describing that methodology.

Baker Botts LLP – July 13, 2000

The expiration of a put option more than six months following the date on which it was written would be the exempt closing of a derivative security position for the writer if no value is given in exchange for the expiration. The expiration would not be considered a sale by the writer, resulting from the decrease in a call equivalent position under Rule 16b-6(a), that could be matched under Rule 16b-6(c)(2) with another transaction by the writer. (The Division took the same position regarding expiration of call options in Sullivan & Cromwell (June 24, 1993).)

American Bar Association - October 15, 1999

The staff addressed the application of Rule 16b-3(c) to open market stock purchase plans that, under the standards of Securities Act Release No. 4790, are not required to be registered under Section 5 of the Securities Act. The Division said that the acquisition of issuer stock pursuant to accumulated payroll deductions under such a plan is a transaction with “an employee benefit plan sponsored by the issuer” for purposes of Rule 16b-3(a) where:

- the issuer deducts funds from compensation;
- deducted funds accumulate for a regular, specified interval no shorter than a pay period;
- accumulated funds are invested in issuer stock; and
- the open market plan restricts participation to employees of the issuer and its parents or subsidiaries who would be eligible to purchase securities of the issuer under a registration statement on Form S-8.

Such an acquisition is exempt under Rule 16b-3(c) if the open market plan meets the conditions of Rule 16b-3(b)(5), the definition of a Stock Purchase Plan. Because subsequent sales or transfers of the securities so acquired would be outside the plan, these transactions would not be exempt under Rule 16b-3. Acquisitions pursuant to additional voluntary contributions, although not exempt under Rule 16b-3,

would not make the exemption unavailable for acquisitions pursuant to payroll deductions.

Select Sector SPDR Trust - May 6, 1999

In a joint letter with the Division of Investment Management, the Division addressed the application of Section 16(a) to shares issued by the Trust, a registered open-end management investment company, in its nine separate investment portfolios (the "Funds"). The Divisions stated that, having expressed in this letter and in *PDR Services Corporation* (December 14, 1998) their views as to whether insiders and five percent beneficial owners of exchange-traded products, such as the shares issued by the Funds, must file ownership reports under Sections 16(a) and 13(d), respectively, the Divisions will no longer respond to requests for no-action relief in this area unless the request presents a novel or unusual issue.

American Bar Association - February 10, 1999

The Division addressed the application of Exchange Act Rule 16b-3 to transactions occurring in the following contexts:

- A transaction in issuer securities by the issuer's officer or director with the issuer's majority-owned subsidiary (or an employee benefit plan sponsored by a majority-owned subsidiary) will be considered a transaction with the issuer for purposes of Rule 16b-3(a). However, the approval requirements of Rule 16b-3(d) and 16b-3(e) must be satisfied at the issuer--rather than the subsidiary--level.
- The following salary limitations implement "benefit or contribution limitations set forth in the Internal Revenue Code" for purposes of Rule 16b-3(b)(2): (a) the annual compensation limit in Internal Revenue Code Section 401(a)(17); and (b) the Internal Revenue Code Section 415 exclusion from taxable compensation of salary that has been deferred into a non-qualified plan. A supplemental plan that permits employer contributions that otherwise would have been made to the related qualified plan but for either of these limitations will be an Excess Benefit Plan.
- The following plans are not Excess Benefit Plans because the amount of issuer securities acquired will be determined based on the amount of salary the officer or director chooses to defer:
 - a non-qualified deferred contribution plan; and
 - a supplemental plan that provides an employer matching contribution based on the employee's deferral of salary into a non-qualified plan.
- Periodic acquisitions of phantom stock under a non-qualified deferred compensation plan or a supplemental plan that is not an Excess Benefit

Plan that are exempted by Rule 16b-3(d) may be reported on an aggregate basis on Form 5.

- Rule 16b-3 is available to exempt an officer's or director's indirect interest in transactions, reportable by the officer or director, between the issuer and the following entities if the approving entity for purposes of Rules 16b-3(d) and 16b-3(e) knows (and the document evidencing approval specifies) the existence and extent of the officer's or director's indirect interest and that the approval is granted for purposes of Rule 16b-3:
- a partnership or corporation;
- a member of the officer's or director's immediate family; and
- a trust.

**Skadden, Arps, Slate, Meagher & Flom LLP –
January 12, 1999**

The Division addressed the application of Exchange Act Rule 16b-3 to transactions occurring in the context of corporate mergers.

Where the conversion or cancellation is simultaneous with or immediately before the related merger, each of the following transactions constitutes a disposition to the issuer of target equity securities eligible for exemption under Rule 16b-3(e), even if the acquiror pays the merger consideration directly to target equity security holders:

- the conversion of target nonderivative equity securities into acquiror equity securities, debt, cash or a combination of different forms of merger consideration; and
- the conversion of target derivative securities into acquiror derivative securities or acquiror nonderivative equity securities, or the cancellation of target derivative securities for cash.

The approval conditions of Rule 16b-3(e) may be satisfied only by the target.

The acquisition of acquiror equity securities (including acquiror derivative securities) by officers and directors of the acquiror through the conversion of target equity securities in connection with a merger constitutes an acquisition from the acquiror eligible for exemption under Rule 16b-3(d). This position applies equally to employees and directors of the target who become officers and/or directors of the acquiror before, or at the time of, the merger ("New Acquiror Insiders"). The approval conditions of Rule 16b-3(d) may be satisfied only by the acquiror.

In the case of both dispositions and acquisitions, the approval conditions of Rule 16b-3 may be satisfied at the same time as, or following, approval of the merger agreement by the respective issuer's board of directors, as long as they are satisfied

before consummation of the merger. Guidance is provided as to the specificity required if approval is granted by the full board or a committee of two or more Non-Employee Directors. Approval of an acquisition may be granted before a New Acquiror Insider becomes an officer or director of the acquiror.

N. Regulation D

Mobile Biopsy, LLC- August 11, 1999

An issuer's communication to all physicians in North Carolina made with a view to sales of the issuer's securities would be a general solicitation within the meaning of Rule 502(c) under Securities Act Regulation D.

O. Trust Indenture Act of 1939

San Jacinto Holdings Inc.- April 14, 1999

Qualification of an indenture may not be made under the Trust Indenture Act of 1939 after the effective date of an application for qualification under Section 307 of the statute. The act generally does not admit post-effective qualification procedures.