Duties under the Federal Securities Laws

Federal and state laws regulate the disclosure practices and securities transactions of public companies and their directors, officers and employees. The federal securities laws are administered by the SEC and affect many aspects of the day-to-day operation of public companies. Violation of these laws can result in significant criminal and civil penalties, imposed not only on the corporation but also on directors individually. Directors need to be particularly attentive to their own, as well as the corporation’s, compliance with these laws. Review of programs and policies designed to maintain compliance with the federal securities laws, absent a legal compliance committee, is often delegated to the audit committee.

A. SEC Reporting Requirements

Federal law requires public companies to file periodic reports with the SEC, including an annual report on Form 10-K and quarterly reports on Form 10-Q. Reports on Form 8-K are also required for disclosure of quarterly earnings releases and a broad spectrum of other specified events and may also be used for voluntary disclosure of information. The SEC’s proxy rules require that the annual meeting proxy statement be accompanied or preceded by an annual report to shareholders. Many of these reports are required to include specified financial and other information.

The corporation’s annual report on Form 10-K, which contains the last fiscal year’s audited financial statements and mandated manage-
ment comments on recent financial performance and important trends and uncertainties, is the most detailed of the required reports filed with the SEC and must be signed by a majority of the corporation’s directors. Separate and apart from the audit committee’s involvement, all directors should review and be satisfied with the corporate processes used to prepare the Form 10-K and understand the significant disclosures in that report; to that end, they should have an opportunity to comment on and ask questions about it before it is filed.

Directors are not expected to verify independently the accuracy of underlying facts contained in earnings releases or reports filed with the SEC. However, the audit committee and the board should be satisfied that there are disclosure controls and procedures in place reasonably designed to achieve the timeliness, accuracy and completeness of annual and quarterly reports as well as all other reports and public releases. In addition, the chief executive officer and chief financial officer of public companies are required by the Sarbanes-Oxley Act to review and, based on their knowledge, certify the material accuracy and completeness of quarterly and annual reports. Quarterly assessments of disclosure controls and procedures and annual assessments of internal control over financial reporting are also required. Audit committee members of public companies should be familiar with these certifications and assessments and the procedures undertaken to support them; and the audit committee should always be attentive to reports of control deficiencies.

B. Fair Disclosure

The SEC’s Regulation FD (for fair disclosure) provides that material information about a public company may not be disclosed on a selective basis by the corporation or its agents to marketplace participants, such as analysts, brokers, investment advisors and shareholders who may act
on the information. Rather, the corporation must take steps to disseminate such information in a manner that makes it broadly available to all members of the public at the same time. Violations of this regulation have resulted in SEC enforcement actions and fines against public companies and corporate officers. Regulation FD has caused public companies to adopt more restrictive policies regarding the persons who are authorized to communicate with securities analysts and others. Directors should be careful not to disclose non-public information about the corporation and its business.

C. Compliance Programs

Many public companies have established specific policies and procedures dealing with insider trading and communications. These programs are designed to ensure that the corporation makes complete, accurate and timely disclosure of material information, complies with disclosure requirements and satisfies other securities law obligations. These programs also help directors and other insiders to comply with insider trading and other applicable laws and the corporation to meet its obligations under Regulation FD to avoid improper selective disclosure of material information. The audit committee (or the legal compliance committee, if there is one) generally should monitor the establishment and operation of such compliance programs.

D. Insider Trading

The federal securities laws prohibit corporate insiders, including directors, and the corporation itself from purchasing or selling securities, either in the open market or in private transactions, when they possess undisclosed material information about the corporation. The corporation or an insider in possession of such information may not trade until the information is publicly disseminated. The federal securities laws also prohibit insiders from revealing material, non-public information concerning the corporation, or giving a recommendation to buy or sell based upon such information, to others who trade on the basis of such infor-
information. As a general rule, the federal securities laws also prohibit the recipient of a tip from acting on material, non-public information obtained from a corporate source. Under the SEC’s Rule 10b5–1, directors (and officers) can mitigate the risk of insider trading liability by adopting plans in advance for scheduled sales and purchases of the corporation’s securities.

Information is material if there is a substantial likelihood that a reasonable investor would consider it important in deciding whether to buy, sell or hold a security. Some believe that information may be considered material if, upon disclosure, it would likely affect the stock price. If there is any doubt whether undisclosed information is material, legal guidance should be sought or, as a practical alternative, the information should be treated as material.

Violation of these insider trading laws triggers strict sanctions. The SEC has an aggressive program of discovering and proceeding against insider trading violations. The violator is liable for any profit made or loss avoided. In addition, a court can assess a penalty against the trader, the tipper or the tippee of treble damages—three times the profits made or losses avoided—and criminal sanctions are also available. The Sarbanes-Oxley Act gives the SEC the power to prohibit any individual from serving as an officer or director of any public company if the individual has violated the antifraud or insider trading laws and demonstrates unfitness to serve as an officer or director. The SEC also has the authority to award informants who report a violation up to ten percent of the amount of the penalty recovered.

Many public companies have developed procedures requiring senior executives and directors to contact corporate counsel, the corporate secretary or another designated person before trading in the corporation’s securities so that any proposed transaction can be reviewed in the light of the current state of public information. The growing
corporate practice is to require that all trades by senior officers and directors be cleared in advance by the corporate general counsel or another designated person. Many public companies have established corporate policies prohibiting insiders and their affiliates from trading in the corporation’s securities during specified “blackout” periods. The board of directors (directly or through its audit or legal compliance committee) should periodically review corporate information and insider trading policies and procedures in view of Regulation FD and insider trading prohibitions.

E. Short-Swing Profits

Directors, executive officers and large shareholders of public companies must report to the SEC all of their holdings of, and transactions in, the corporation’s equity securities and must disgorge to the corporation any profits realized from buying and selling, or selling and buying, such securities within any six-month period. When a person first becomes an insider (a director, executive officer or more-than-ten-percent shareholder), a report of beneficial ownership of the corporation’s equity securities must be filed on Form 3. Thereafter, whenever there is a change in that beneficial ownership, a report on Form 4 must be filed electronically within two business days. Annual reports on Form 5 are also required in some cases. These reports must be electronically filed on a timely basis with the SEC. Any delinquency in making such filings must be disclosed in the corporation’s annual meeting proxy statement, and civil monetary fines can be imposed for filing delinquencies. An insider is normally deemed to be the owner of securities that are owned by a spouse or child living at home, and may also be deemed to be the owner of securities held in a trust of which the insider is a trustee, settlor or
beneficiary or of securities owned by a corporation controlled by the insider.

Profit disgorgement is required if an insider purchased the corporation’s securities within six months before selling its securities and vice versa (i.e., sales within six months before buying). Any “profit”—measured as the difference between the prices of any two “matchable” transactions during the six-month period (i.e., the highest-priced sale and the lowest-priced purchase)—must be paid over to the corporation. The requirement is intentionally arbitrary and, subject to tightly defined regulatory exemptions, applies to all transactions within any six-month period regardless of whether the individual had inside information or, in fact, made a profit on an overall basis. This provision is aggressively enforced by the plaintiffs’ bar, which monitors SEC filings.

Some transactions, such as the grant and exercise of stock options and the acquisition of securities under employee benefit plans, may be exempt from the purchase and sale triggers of the short-swing profit rules if procedural requirements established by SEC regulations have been satisfied. Absent an exemption, the receipt of an option, the acquisition of securities through a benefit plan or the acquisition of a derivative security related to the value of the corporation’s common stock normally will be considered to be a purchase of the underlying security and could give rise to accountability. In addition, other indirect changes in ownership, such as reclassifications, intracompany transactions, pledges and mergers, may also be considered a purchase or sale transaction for purposes of the short-swing profit rules.

A retiring director may be subject to profit recovery based on transactions occurring even after the director departs. Thus, if a director purchases shares of the corporation, resigns and sells shares within six months after the purchase, liability may be imposed for any short-swing profit even though the individual is no longer a director at the time of the sale. In short, unexpected liability may result from the application of the short-swing profit rules.

Directors, officers and more-than-ten-percent shareholders also are prohibited from selling the corporation’s shares short; as a means of enforcement of this restriction, they must deliver shares against a sale within twenty days.

This regulatory regime is highly technical. Legal counsel should be consulted before committing to a transaction in the corporation’s securities or in options or other derivatives geared to its securities.
F. Sales by Controlling Persons

Unless an exemption is available, the federal securities laws generally require registration with the SEC of the corporation’s securities by controlling persons before they may be offered or sold to the public. (Who is a controlling person is a sophisticated question of law and fact as to which legal guidance is advisable; directors are often included.) The most common exemption is provided by the SEC’s Rule 144, which permits the sale of limited amounts of securities without registration if conditions set out in the rule are satisfied. For example, if the securities to be sold were acquired from the issuer (or an affiliate of the issuer) in a transaction not involving a public offering, they must be held for at least one year to be eligible for sale pursuant to Rule 144 and thereafter may be sold only in limited quantities after notification to the SEC.

G. Registration Statements

Directors should take diligent steps to assure the accuracy of their corporation’s registration statements filed with the SEC in connection with any offering (including in a merger or acquisition) of the corporation’s securities to the public. Whether or not a director signs the registration statement, the director is liable for any material inaccuracy or omission in the registration statement, including information incorporated by reference from other filed documents, unless the director establishes that, after diligent steps, the director was not aware of the inaccuracy or omission.

The director’s primary defense to registration statement liability is due diligence. To establish this defense, the director must show that, after reasonable investigation, the director had reasonable grounds to believe, and did believe, that the registration statement did not contain any materially false or misleading statements or any material omissions that made the registration statement misleading. Actions required by the director to satisfy the due diligence standard will vary with the circumstances. During the registration process, directors are well advised to satisfy themselves that the corporation has developed and utilizes appropriate corporate disclosure controls and procedures reason-
ably calculated to ensure the registration statement’s accuracy and completeness. Although all registration statements should be prepared with appropriate care, certain registered offerings may have a higher potential for liability, such as an initial public offering, a follow-on equity offering or a financing or reorganization of a public company that has experienced problems. Accordingly, the filing of registration statements for such offerings should ordinarily be preceded by a board meeting or meetings with counsel, accountants and management present at which there is discussion of the disclosures in the registration statement. Each director also should personally review the document for accuracy, with particular attention to those statements and disclosures in the registration statement that are within the director’s knowledge and competence.

H. Proxy Statements

Federal law requires that public companies soliciting proxies for shareholder votes on the election of directors or other matters furnish each shareholder with a proxy statement. Where actions other than election of directors or other routine business are to be taken, a draft must be filed with, and typically will be reviewed and cleared by, the SEC. In other cases, only the final proxy statement, as mailed, is filed with the SEC. Directors should be attentive to the procedures followed in preparing the corporation’s proxy statements. It is good practice for every director to review a reasonably close-to-final draft of a proxy statement before it is mailed or filed with the SEC, particularly those sections that deal with matters about which the director has personal knowledge or contain a report of a committee on which the director serves.
I. Directors of Foreign Corporations with Securities Traded in the United States

A large number of non-U.S. corporations from almost sixty countries file reports with the SEC because their securities are traded on U.S. securities markets. Traditionally, the federal securities laws have required these “foreign private issuers” to file annual reports and other material information distributed to their shareholders with the SEC, but have not otherwise sought to regulate their corporate governance and other internal practices.

The Sarbanes-Oxley Act’s reporting and corporate governance requirements generally apply to non-U.S. corporations that have securities registered with the SEC. The SEC, in adopting rules under the Sarbanes-Oxley Act, has considered the concerns of foreign private issuers and made some rules inapplicable to them or included special provisions addressing their concerns. Directors of foreign private issuers should be aware of the general categories of substantive U.S. corporate governance requirements that may apply to their corporations.