Dechert LLP

Private Equity

JANUARY 2003 / ISSUE 3

update

Sarbanes-Oxley and High-Yield Debt Issuers

Does the Sarbanes-Oxley Act of 2002 apply to private companies with registered debt?

Yes. Sarbanes-Oxley has two kinds of provisions, those with general implications for the capital market (e.g., the creation of the Public Company Accounting Oversight Board) and those directly addressed toward companies. The latter cover any "issuer," which is a term specifically defined in the Act. A company that places debt securities in a registered offering—whether in an original issuance or in an exchange offer following a Rule 144A offering—is an "issuer," and thus governed by Sarbanes-Oxley, from the time of filing of the registration statement, even if its equity is held privately.

When does the application of Sarbanes-Oxley end?

A company ceases to be an "issuer" when the registration statement is withdrawn before it becomes effective, or, if the registration statement has become effective, when the company is no longer required to file periodic reports (10-K, 10-Q, etc.) under the Securities Exchange Act of 1934.

It was initially unclear whether Sarbanes-Oxley would apply to debt issuers that are no longer required by the Exchange Act to file periodic reports with the SEC, but are required to do so by the reporting covenants in their indentures. The Division of Corporation Finance of the SEC recently clarified that the definition of "issuer" in Sarbanes-Oxley does not include these voluntary filing companies.

How do I know whether a company that files SEC reports is an "issuer" or a voluntary filing company?

Section 15(d) of the Exchange Act provides an automatic suspension of the reporting obligation as to any fiscal year (except for the fiscal year in which the registration statement became effective) if the company has fewer than 300 holders of the registered security at the beginning of such fiscal year. Under Rule 15d-6, a Form 15 should be filed to notify the SEC of the suspension, but the suspension is granted by statute and is not contingent on filing the Form 15. Thus, a company with registered high-yield debt but fewer than 300 bondholders at the beginning of any fiscal year (except for the fiscal year in which the registration statement became effective) is not an "issuer" within the Sarbanes-Oxley definition.

If a company initially places registered debt with fewer than 300 investors, is it ever an "issuer" under Sarbanes-Oxley?

Yes, from the time of filing of the registration statement until the end of the fiscal year in which the registration statement became effective.

Should a company with fewer than 300 bondholders file a Form 15?

We believe that it can only be advantageous for the company to go on record that it is not an "issuer" under Sarbanes-Oxley. Companies should decide on a case-by-case basis the appropriate format for going on record. The clearest form is the filing of a Form 15. If the company is concerned that the filing may be misunderstood by its bondholders, the company should consider stating its position in the context of an Exchange Act report (10-K or 10-Q).

What provisions of Sarbanes-Oxley are relevant for those companies that are "issuers?"

See the following summary of those provisions that may be relevant to public companies. Provisions that apply to debt issuers that are "issuers" under the Sarbanes-Oxley definition are checked under the column "Applicable to High-Yield Debt Issuers Required To File SEC Reports."

Are there any provisions that apply to voluntary filing companies even though they are not "issuers" under the Sarbanes-Oxley definition?

Yes. These are provisions that mandate certain certifications or disclosures in the reports filed with the SEC. They are checked under the column "Applicable to High-Yield Debt Issuers Filing SEC Reports Voluntarily."

Some of these disclosure provisions use the term "issuer" and on their face do not seem to apply to voluntary filing companies. They relate to off-balance sheet transactions (Section 401(a)(j)), the code of ethics (Section 406), the audit committee financial expert (Section 407), and financial statement certifications (Section 906). However, we believe that it is not the intention of Sarbanes-Oxley to create two different standards for Exchange Act reports and recommend that voluntary filing companies comply with these disclosure requirements.

What is the current status of rule-making by the SEC?

The following summary reflects the status as of January 21, 2003. The SEC is currently in the middle of a rule-making initiative. Some rules required by the January 26, 2003, deadline have been adopted but not yet been published, and others are expected to be adopted shortly. We will update this summary after all the rules required by the January 26th deadline have been adopted and published.

Robert Seber
robert.seber@dechert.com

Bradley Luria
bradley.luria@dechert.com

Sarbanes-Oxley Act of 2002 — Provisions Applicable to Companies

Provision	Effective Date	Applicable to High Yield Debt Issuers Required To File SEC Reports	Applicable to High Yield Debt Issuers Filing SEC Reports Voluntarily
Limitations on Non-audit Services and Pre-approval of Auditing and Non-auditing Services (Sections 201 and 202) Limits the nature of non-auditing services that can be provided to an issuer by its auditor. All auditing services (which may entail providing comfort letters) and, subject to *de minimus* exceptions, all permitted non-auditing services must be pre-approved by audit committee. Approval of non-auditing services must be disclosed in periodic SEC reports.	The SEC has published proposed rules (Rel. 33-8154), and final rules are due no later than January 26, 2003.	☑	☐
Conflicts of Interest (Section 206) A public accounting firm may not act as the auditor for an issuer if the CEO, CFO, controller or chief accounting officer was employed by that firm and participated in that issuer's audit during the one-year period prior to the initiation of the audit.	The SEC has published proposed rules (Rel. 33-8154), and final rules are due no later than January 26, 2003.	☑	☐
Independent Audit Committee (Section 301) Requires national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with the Act's audit committee standards, including the requirement that every member of the audit committee be "independent."	The SEC has published proposed rules (Rel. 34-47137), and final rules are due no later than April 26, 2003.	☐	☐

Provision	Effective Date	Applicable to High Yield Debt Issuers Required To File SEC Reports	Applicable to High Yield Debt Issuers Filing SEC Reports Voluntarily
Officer Certifications (Section 302) CEOs and CFOs must certify as to the accuracy of their company's annual and quarterly reports and make certain statements regarding disclosure controls and procedures and internal controls. The statute applies to "each company filing periodic reports under section 13(a) or 15(d) of the Securities Exchange Act of 1934." Under the SEC's final rules, Forms 10-Q and 10-K include the required certification and Regulation S-K includes relevant disclosure requirements.	The SEC adopted final rules (Rel. No. 33-8124), which became effective August 29, 2002 (with some provisions that become applicable only for fiscal periods ending after that date).	☑	☑
Improper Influence on Conduct of Audits (Section 303) No officer or director of an issuer shall take any action to fraudulently influence, coerce, manipulate or mislead an auditor for the purpose of rendering the financial statements materially misleading.	The SEC has published proposed rules (Rel. No. 34-46685), and final rules are due no later than April 26, 2003.	☑	☐
Forfeiture of Bonuses and Profits (Section 304) If earnings are restated due to material noncompliance with the financial reporting requirements under the securities laws as a result of misconduct, CEOs and CFOs must disgorge to the issuer any bonus or other incentive-based compensation and profits from trading in company securities received during the 12-month period following the earlier of the first public issuance or SEC filing of the financial information required to be restated.	July 30, 2002	☑	☐

Provision	Effective Date	Applicable to High Yield Debt Issuers Required To File SEC Reports	Applicable to High Yield Debt Issuers Filing SEC Reports Voluntarily
No Insider Trades During Individual Account Plan Blackout Periods (Section 306) Directors and executive officers of an issuer of any equity security (other than an exempted security) are prohibited from directly or indirectly purchasing, selling or otherwise acquiring or transferring equity securities of the issuer during certain "blackout periods" set by their companies' individual account plans (e.g. 401(k) plan).	The SEC, in consultation with the Secretary of Labor, adopted final Regulation Blackout Trading Restriction (BTR), which take effect on January 26, 2003.	☐	☐
Disclosure of Material Correcting Adjustments (Section 401) Each financial report that contains financial statements and that is required to be prepared in accordance with (or reconciled to) GAAP shall reflect all material correcting adjustments that have been identified by the registered public accounting firm in accordance with GAAP and SEC rules and regulations.	July 30, 2002	☑	☑
Disclosure of Off-Balance Sheet Transactions and Pro Forma Financial Information (Section 401) Each annual and quarterly financial report required to be filed with the SEC must disclose all material off-balance sheet transactions and other relationships of the issuer with unconsolidated entities. Pro forma financial information in a report or press release must be presented in a manner that is not materially misleading and reconciles the pro forma financial information to the GAAP financial statements.	SEC has issued proposed rules (Rel. Nos. 33-8144) with respect to off-balance sheet transactions, and final rules are due no later than January 26, 2003. The SEC adopted final Regulation G with respect to pro forma financial information, which will be published shortly.	☑	☑

Provision	Effective Date	Applicable to High Yield Debt Issuers Required To File SEC Reports	Applicable to High Yield Debt Issuers Filing SEC Reports Voluntarily
Company Loans to Directors or Executive Officers (Section 402) An issuer may not, directly or indirectly, including through any subsidiary, extend or maintain credit, or arrange for an extension of credit, or renew an extension of credit, in the form of a personal loan, to its directors and executive officers, other than the continuation of credit maintained on July 30, 2002 (but no material modifications or renewals thereof are permitted), and certain bank loans and consumer-type loans made by issuers in that business and on terms generally available to the public.	July 30, 2002	☑	☐
Accelerated Disclosure of Transactions by Insiders (Section 403) All Section 16 filers must disclose changes in beneficial ownership within two business days of the change. Section 16 reports must be filed electronically, and the issuer must provide the filing on its web site (if it has one) within one business day of the filing.	The SEC adopted final rules (Rel. No. 34-46421), which became effective on August 29, 2002, implementing the two-business day filing requirement. Electronic filing is required by July 30, 2003.	☐	☐
Management Assessment of Internal Controls (Section 404) Each annual report required by the Exchange Act must contain an internal control report stating management's responsibilities for establishing and maintaining adequate internal controls and procedures for financial reporting, its assessment of the effectiveness of the internal control structure and procedures for financial reporting of the company. The auditor shall attest to, and report on, the assessment made by management in the report.	The SEC has issued proposed rules (Rel. No. 33-8138), but no deadline was imposed in the Act for final rules.	☑	☑

Provision	Effective Date	Applicable to High Yield Debt Issuers Required To File SEC Reports	Applicable to High Yield Debt Issuers Filing SEC Reports Voluntarily
Disclosure of Code of Ethics (Section 406) Each issuer must disclose in its periodic reports whether or not (and if not, the reason therefor) such issuer has adopted a code of ethics for principal executive officers and senior financial officers, and on Form 8-K any change in or waiver of its code of ethics.	The SEC adopted final rules. Companies will be required to provide the new disclosures in annual reports for fiscal years ending on or after July 15, 2003.	☑	☑
Disclosure of Audit Committee Financial Expert (Section 407) Requires each issuer to disclose with periodic SEC reports whether or not (and if not, the reasons therefor) the audit committee is comprised of at least one member who is a financial expert.	The SEC adopted final rules, which also require disclosure whether the financial expert is independent. Companies will be required to provide the new disclosures in annual reports for fiscal years ending on or after July 15, 2003.	☑	☑
Plain English Rapid Disclosure of Material Changes (Section 409) Each issuer filing SEC reports must report to the public on a "rapid and current basis" any material changes to their financial condition or operations in "plain English."	The SEC must issue rules implementing this requirement, but no deadline was imposed in the Act.	☑	☐
Officer Certifications (Section 906) CEOs and CFOs must certify that each periodic report containing financial statements filed by an issuer with the SEC complies with the requirements thereof and that the financial statements contained in the report fairly present, in all material respects, the financial condition and results of operations of the issuer.	July 30, 2002	☑	☑

Private Equity Group

If you have questions regarding the information in this update, please contact the Dechert partner with whom you regularly work, or any of the attorneys listed below. Visit us on the web at www.dechert.com/privateequity.

Practice group contacts . . .

Adrienne M. Baker	+1.617.728.7151	adrienne.baker@dechert.com
Carl A. de Brito	+1.212.698.3543	carl.debrito@dechert.com
David S. Denious	+1.215.994.2177	david.denious@dechert.com
Jonathan L. Drake	+1.215.994.2794	jonathan.drake@dechert.com
Sarah B. Gelb	+1.215.994.2763	sarah.gelb@dechert.com
Paul Gluck	+1.212.698.3533	paul.gluck@dechert.com
Craig L. Godshall	+1.215.994.2491	craig.godshall@dechert.com
Gary L. Green	+1.215.994.2656	gary.green@dechert.com
Ronald R. Jewell	+1.212.698.3589	ronald.jewell@dechert.com
Gerhard Kaiser	+49 69 971 68 245	gerhard.kaiser@dechert.com
John D. LaRocca	+1.215.994.2778	john.larocca@dechert.com
Glyndwr P. Lobo	+1.212.698.3567	glyndwr.lobo@dechert.com
Roger Mulvihill	+1.212.698.3508	roger.mulvihill@dechert.com
G. Daniel O'Donnell	+1.215.994.2762	daniel.odonnell@dechert.com
Sang H. Park	+1.212.698.3561	sang.park@dechert.com
Carmen J. Romano	+1.215.994.2971	carmen.romano@dechert.com
David E. Schulman	+44 20 7775 7437	david.schulman@eu.dechert.com
Robert Seber	+1.212.698.3560	robert.seber@dechert.com
Geraldine A. Sinatra	+1.215.994.2824	geraldine.sinatra@dechert.com
Joseph J. Smallhoover	+33 1 53 65 05 17	joseph.smallhoover@dechert.com
David Wallis	+44 20 7775 7595	david.wallis@eu.dechert.com
Richard P. Wild	+1.215.994.2670	richard.wild@dechert.com
Barton J. Winokur	+1.215.994.2505	barton.winokur@dechert.com
Bruce B. Wood	+1.212.698.3531	bruce.wood@dechert.com
Kathleen Ziga	+1.215.994.2674	kathleen.ziga@dechert.com