JONES WALKER

E*ZINES
May 2003 Vol. 28

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SEC ISSUES FINAL MD&A DISCLOSURE RULES REGARDING OFF-BALANCE SHEET ARRANGEMENTS AND CONTRACTUAL OBLIGATIONS

By Curtis R. Hearn and Amos J. Oelking, III

Earlier this year, the SEC adopted new rules to implement changes mandated by Section 401(a) of the Sarbanes-Oxley Act of 2002 requiring disclosure of "off-balance sheet" arrangements in a separately-captioned section of MD&A and an overview of certain contractual obligations in tabular format. *(Click here to link to our E*Zine regarding the SEC's proposed MD&A disclosure rules.)*

Companies must comply with the new off-balance sheet disclosure requirements in registration statements, Forms 10-K and 10-Q, and proxy and information statements (that are required to include financial statements) for fiscal years ending on or after June 15, 2003, and must include the table of contractual obligations in such SEC filings for fiscal years ending on or after December 15, 2003. Companies may voluntarily comply with the requirements of the final rules prior to these compliance dates. *(Click here to link to the full text of the SEC's final rules release.)*

Off-Balance Sheet Arrangements

The SEC's final rules require each reporting company to present a comprehensive explanation of its off-balance sheet arrangements under a separately-captioned section of its MD&A. The final rules generally define an "off-balance sheet arrangement" as any transaction, agreement or other contractual arrangement pursuant to which a reporting company has, or in the future may have, with respect to any unconsolidated entity:

- any obligation under a direct or indirect guarantee;
- a retained or contingent interest in assets transferred to the unconsolidated entity or similar arrangement that serves as credit, liquidity or market risk support to such entity;
- risk with respect to certain derivatives, to the extent that the fair value of the derivatives is not fully reflected as a liability or asset in the financial statements; or

- any obligation or liability, including a contingent obligation or liability, to the extent that it is not fully reflected on the face of the financial statements (but excluding contingent liabilities arising out of litigation, arbitration or regulatory actions).

The final rules require disclosure of off-balance sheet arrangements that "either have, or are reasonably likely to have, a current or future effect on the registrant's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors." Specifically, the final rules require companies to disclose:

- the nature and purpose of the off-balance sheet arrangements;

- the importance to the company of the arrangements in terms of liquidity, capital resources, market risk support, credit risk support and other benefits;

- the amounts of revenues, expenses and cash flows arising from the arrangements;

- the nature and amount of any interests retained, securities issued or other indebtedness incurred by the company in connection with the arrangements;

- the nature and amounts of any other obligations or liabilities resulting from the arrangements that are, or are reasonably likely to become, material and the corresponding triggering events that could cause them to arise; and

- any known event, demand, commitment, trend or uncertainty that will, or is reasonably likely to, result in the termination or material reduction in availability of the off-balance sheet arrangements, and the action the company has taken or proposes to take in response.

In addition, companies should include any additional information that it believes is necessary for an understanding of its off-balance sheet arrangements and their effects. These disclosures should cover the company's most recent fiscal year, but also any changes from prior year disclosures necessary to an understanding of the disclosures.

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The instructions to the final rules provide that a company is not required to disclose an off-balance sheet arrangement until a definitive agreement, subject only to customary closing conditions, exists or, in the absence of an agreement, when settlement of the transaction occurs. Moreover, because some of the disclosures required by the final rules are redundant of GAAP disclosure requirements, the final rules permit companies to cross-reference the appropriate disclosures to information in the financial statement footnotes.

Contractual Obligations

The SEC's final rules also require tabular disclosure of the amounts of specified contractual obligations, aggregated by type, for specified time periods as of the latest fiscal year-end balance sheet date. The tabular disclosure should be made in substantially the following form:

Contractual Obligations	Payments due by period				
	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Long-Term Debt					
Capital Lease Obligations					
Operating Leases					
Purchase Obligations					
Other Long-Term Liabilities					
Total					

Companies may break-out the specified categories into categories suitable to their particular business so long as the table covers all of the listed obligations. In addition, the table should be accompanied by footnotes describing contractual provisions and other information necessary to understand the table. Reporting companies may place the table anywhere in their MD&A that they deem "appropriate."

"Safe Harbor" For Disclosures

Because the disclosures required by the SEC's final rules will usually contain forward-looking information, the final rules provide that the statutory safe harbor protections (Section 27A of the Securities Act and Section 21E of the Exchange Act) against private legal actions apply to forward-looking information that is required to be disclosed pursuant to the final rules.

Small Business Issuers

Small business issuers (*i.e.,* filers of Forms 10-KSB and 10-QSB) are required to include the disclosures regarding off-balance sheet arrangements in their SEC filings, but are <u>not</u> required to include the tabular disclosure of contractual obligations.

Foreign Issuers

The SEC's final rules apply to foreign private issuers that file annual reports on Form 20-F or Form 40-F. However, the requirements of the final rules do <u>not</u> apply to Forms 6-K filed by such issuers.

The SEC's January 2002 MD&A Release

In January 2002, the SEC provided guidance regarding MD&A disclosure requirements, including factors reporting companies should consider in disclosing off-balance sheet arrangements. (*Click here to link to our E*Zine regarding the SEC's January 2002 MD&A release.*)

The disclosures regarding off-balance sheet arrangements required by the SEC's final rules supersede the related guidance in the SEC's January 2002 release as of the compliance date for such disclosures (discussed above). Similarly, the guidance in the January 2002 release relating to tabular disclosure of contractual obligations will be superseded by the final rules' requirements regarding tabular disclosure of contractual obligations as of the compliance date for such disclosure (discussed above). All other guidance included in the SEC's January 2002 release will remain in effect. As stated in its final rules release, the SEC assumes that reporting companies will continue to follow the guidance in the January 2002 release prior to these compliance dates.

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NYSE AMENDS PROPOSED CORPORATE GOVERNANCE RULES

By Kenneth J. Najder and Andrew D. Pilant

On April 4, 2003, the New York Stock Exchange filed with the SEC an amended and restated version of its proposed corporate governance rules originally filed in August 2002. The SEC published these revised rules for public comment on April 17, 2003. The revised proposal tightens the rules relating to director independence and amends other of the corporate governance rules originally proposed in August 2002. *(Click here to link to the full text of the NYSE's revised corporate governance rule proposals.)*

Revised Director Independence Rules

Similarities to Original Proposal. Under its revised proposal, the NYSE still proposes to require that a majority of a listed company's board of directors be independent, and that the board affirmatively determine that each "independent director" has no material relationship with the company. The revised rules also continue to disqualify directors from being deemed "independent" if they or their immediate family members are affiliated with the company's current or former auditors or with other companies through interlocking compensation committee relationships.

Key Proposed Changes. The August 2002 proposal permitted boards to adopt categorical standards for determining the independence of directors who are affiliated with another company that has a business relationship with the listed company. The revised proposal retains this concept, but adds a bright-line rule that prohibits a determination of independence for any director that is an executive officer or employee (or who has an immediate family member that is an executive officer) of another company when either

- such other company accounts for the greater of 2% or $1 million of the listed company's consolidated gross revenues; or
- the listed company accounts for the greater of 2% or $1 million of such other company's consolidated gross revenues.

The new proposal further tightens the definition of independence by disqualifying directors from being "independent" if any of their immediate family members receive more than $100,000 of annual direct compensation from the company.

Also in its August 2002 proposal, the NYSE barred former employees from qualifying as independent directors for five years after the employment relationship ended. The NYSE now proposes to replace this five-year *per se* bar to independence with a presumption that *any* director who receives more than $100,000 in annual direct compensation from the company (excluding director fees) is not independent until five years following the last year in which more than $100,000 in compensation was received. The board may override this presumption if all independent directors determine that the compensatory relationship is not material; any such determination must be specifically explained in the company's proxy statement.

The new proposal also retains the original proposal's five-year "look-back" period for any relationship (including the receipt of compensation) that would preclude a director's independence, and adds a five-year transition period during which the look-back will apply only to the time elapsed since the rule's effective date.

If the SEC approves the NYSE's proposed rules, listed companies will have 18 months to comply with the new director independence standards; companies with classified boards of directors will have an additional 12 months under certain circumstances.

Amendments to Other Corporate Governance Provisions

With respect to other corporate governance matters, the NYSE has revised its August 2002 proposal to conform it to subsequent SEC rulemaking and add certain requirements and clarifying language, including the following:

- "General Application" Section. The NYSE has added a "General Application" section to clarify how its proposed corporate governance standards will apply to different types of listed companies. Specifically, certain provisions of the proposed new standards, if approved, will not be applicable to specified classes of listed companies, such as controlled companies, limited partnerships, closed-end funds, trusts, and foreign private entities. This provision is consistent with the NYSE's traditional approach to listing standards compliance.

- Audit Committee Standards. As revised, the text of the NYSE's proposed rules explicitly state that the audit committee must receive appropriate funding from the company to employ outside

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advisors. In its August 2002 proposal, the NYSE had only mentioned this requirement in the commentary section of its proposed audit committee standards. The revised commentary to the NYSE's proposed audit committee standards also clarifies that the independent auditors must report directly to the audit committee, and that the audit committee must be "directly responsible" for oversight of the independent auditors.

- Posting Code of Business Conduct on Company Website. The NYSE's revised proposal further requires that each company's code of ethics and business conduct be posted on its website. Further, each company's annual report must state that the code is available on its website, and that a copy will be provided to any shareholder who requests it.

- Additional CEO Certification. Finally, the NYSE's revised proposal adds a requirement that each listed company CEO promptly notify the NYSE after any executive officer of the company becomes aware of any material non-compliance with any provision of the NYSE's corporate governance rules.

Please remember that these legal principles may change and vary widely in their application to specific factual circumstances. You should consult with counsel about your individual circumstances. For further information regarding these issues you may contact the head of our Corporate and Securities practice group:

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