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In the Twilight Zone: The Unique Status of High Yield-Only Issuers

High yield issuers present a unique analytical challenge under the federal securities laws and Sarbanes-Oxley Act. The nature of the initial private offering followed by a registered exchange, their status as "voluntary filers," the fact that they generally do not have listed equity securities and their status as non-accelerated filers each individually, and particularly when considered in combination, lead to a confusing amalgam of technical and practical regulatory distinctions from the traditional public company.

by Gerald T. Nowak, Andrew J. Terry, and William Chou

Time was that being public was a lot like being pregnant . . . either you were or you weren't. There was no such thing as being "a little bit public." Starting with the advent of the 144A high yield market and continuing with the passage of the Sarbanes-Oxley Act of 2002,[1] the distinction between public and private has blurred as it relates to issuers of high yield debt. High yield-only issuers now exist in a quantum[2] state, in which their status under the federal securities laws is both inherently confusing and changing over time. At one moment, the company is an "issuer,"[3] subject to the provisions of Sarbanes-Oxley, the next moment it is not. The offering memorandum used to initially issue the high yield bonds is virtually identical to a prospectus for a registered public offering, yet the high yield notes are in fact initially sold in a private placement under the Securities Act of 1933 (1933 Act), to persons who functionally act as underwriters, yet are called "initial purchasers." The paradoxes and complexities of their situation and how it changes over time would do Rod Serling or Salvador Dali proud. This article is an attempt to bring these issues into sharper focus.

It should be noted at the outset that the term "high yield-only issuer," as used in this article, refers to those companies that are issuers of only high yield debt (*i.e.*, these companies have not issued other securities that would otherwise subject them to filing requirements under the Securities Exchange Act of 1934 (1934 Act)). There are basically four ways in which a high yield-only issuer differs from a traditional public company under the federal securities laws and the Sarbanes-Oxley Act:

1. A high yield-only issuer issues notes initially under a private placement, and only subsequently effects a 1933 Act registration of those notes through the "A/B exchange" mechanism discussed subsequently.
2. A high yield-only issuer, other than during the fiscal year in which the A/B exchange occurs, is a "voluntary filer" under SEC rules, and therefore is generally not an "issuer" subject to many of the provisions of Sarbanes-Oxley.[4]
3. A high yield-only issuer is a "debt-only" issuer, not subject to the corporate governance rules of Sarbanes-Oxley or New York Stock Exchange (NYSE), Nasdaq Stock Exchange (Nasdaq) and certain equity-only SEC rules.

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4. A high yield-only issuer is necessarily not an "accelerated filer" under applicable SEC rules, and thus not subject to the new tighter deadlines for filing reports under the 1934 Act.

The Initial Offering

The typical high yield offering is structured as a private placement to the investment banks leading the transaction, known as "initial purchasers," under Section 4(2) of the 1933 Act, followed by a resale mostly to qualified institutional buyers,[5] or QIBs, under Rule 144A.[6] The principal advantage of this transactional structure over a registered initial offering is time—the issuer can bring its securities to market significantly faster and therefore obtain funding from investors more quickly because the process does not involve SEC review and its associated delays. However, that transactional structure also makes the notes in the hands of those QIBs "restricted securities"[7] under the 1933 Act (although QIBs can trade those restricted securities amongst themselves under Rule 144A).[8] QIBs want to (or need to, under their investment guidelines) own securities that are not "restricted securities."[9] Historically, this would have presented a problem, as the 1933 Act requires issuers to register *transactions*, not *securities*, and as the initial sale transaction would have already taken place, the only means available to provide the buyers with the ability to sell without restriction would have been to file a resale shelf registration statement and keep that statement effective for a period of years, which is both costly and an administrative burden.

By the early 1990s, however, that all changed. The change began with the SEC's issuance of a no-action letter to Exxon Capital Corporation permitting it to register a transaction whereby it offered to exchange a series of pre-existing securities for an identical series of new securities.[10] The registration of this transaction resulted in the new securities not being "restricted securities." This new technique, combined with the SEC's promulgation of Rule 144A in 1990, resulted in the dramatic expansion of the high yield debt market. A Thomson Financial Securities Data study reported that the total value of high-yield debt offerings in 2003 was approximately $123.2 billion. According to Securities Data Corp., 144A offerings accounted for 86 percent of all high-yield debt issuances (2001 voluntary reporting figures). These data contrast with a Donaldson, Lufkin, and Jenrette study that reported no 144A offerings in 1991, and where the combined value of high yield debt and preferred stock offerings the same year totaled only $12.3 billion.

In the modern era, a feature of virtually every 144A high yield offering is the second step made possible by *Exxon Capital*. Designed to meet the requirements of *Exxon Capital*, this second step enables the issuer to provide existing note holders with unrestricted securities under the 1933 Act by exchanging their original "Series A" notes with a new set of "Series B" notes, known as an "A/B exchange" transaction.[11]

Another ubiquitous feature of the modern 144A transaction is the preparation of an offering memorandum for the initial 4(2) private placement prepared generally using the disclosure standards applicable to a prospectus for a registered public offering. Given the substantial similarity between a private offering memorandum and a public offering prospectus, one might assume that the scope of liability is the same or at least similar for the two offerings. One would be wrong. Under the 1995 *Gustafson v. Alloyd* case,[12] the Supreme Court held that 1933 Act liability can only attach in a registered public offering, leaving buyers in a private placement to rely on Rule 10b-5 under the 1934 Act for their remedies in connection with a private placement.[13] This is not an irrational difference, as the buyers in an initial high yield offering are invariably sophisticated investors, acknowledged under the federal securities laws as generally able to fend for themselves.[14] It is also not a trivial difference, as Rule 10b-5 requires *scienter* (knowledge or reckless disregard) on the part of the seller,[15] as compared to the 1933 Act remedies, which carry strict liability for the issuer and allow a due diligence defense (as opposed to an ignorance defense) for others involved, including directors and officers.[16]

Whether the 10b-5 liability that attaches in the private placement is converted into 1933 Act liability in an A/B exchange is an interesting question, given that the only consideration in the A/B exchange is the private note with its inherent 10b-5 remedy attached.[17] While the policies behind *Gustafson, Exxon Capital,* and Rule 144A itself would each suggest for its own reasons that investors in high yield notes do not have or need the pro-

tection of the securities laws beyond Rule 10b-5, it is difficult to reach the conclusion that completing a registered public offering, *i.e.*, the A/B exchange, registered on a Form S-4, does *nothing* with respect to the issuer's liability, or that as a registered public offering, it is not attended by the remedies available *by statute* to purchasers in a registered public offering.[18] Yet when presented with that precise question, at least one court dismissed a Section 11 claim on the grounds that (1) no damages could be demonstrated because the exchange involved two sets of identical bonds and (2) there was no reliance because the investors' decision to exchange one set of bonds for another did not depend on the veracity of the registration statement.[19]

Looking for Volunteers

High yield-only issuers are generally amused when lawyers inform them that they are actually "voluntary filers" for SEC reporting purposes. How voluntary is it? As a technical matter, under Section 15(d) of the 1934 Act, an issuer of securities becomes subject to the reporting requirements of the 1934 Act on the effectiveness of a registration statement filed under the 1933 Act. That duty to file, however, is *automatically* suspended as of the first day of the first fiscal year after which the 1933 Act registration statement is declared effective if, as of that time, there are less than 300 record holders of the class of securities under which the 1933 Act registration statement was filed.[20] There are invariably less than 300 record holders of a series of high yield notes (in part, because the notes are held in book-entry rather than certificated form).[21] The SEC has been consistent and clear that based on the clear language of the 1934 Act, no further action is required by such an issuer; as of that date, the issuer is no longer required to file 1934 Act reports.[22]

High yield indentures routinely require an issuer to continue filing 1934 Act reports for so long as the SEC will continue to accept them.

This "voluntary filer" concept is nothing new. The high yield market has long recognized this fact, and high yield indentures routinely require an issuer to continue filing 1934 Act reports for so long as the SEC will continue to accept them. If the SEC refuses to accept the filings, a typical indenture requires the issuer to prepare them anyway and deliver them directly to holders of the notes. Thus the knowing chuckles when issuers hear they are "voluntary filers;" in fact, there is nothing voluntary about it.

Now enter the Sarbanes-Oxley Act of 2002, imposing a host of new requirements on public companies. The irony of it all! Here is our poor voluntary filer who is now subject to a whole new set of rules that were not in the picture when he "volunteered" to file those 1934 Act reports. Gladly, in a twist of fate worthy of a Greek comedy, the peculiar drafting of Sarbanes-Oxley *excludes* voluntary filers from its ambit, by generally defining an "issuer" (the baseline requirement for being subject to most Sarbanes-Oxley rules) as a person *required* to file 1934 Act reports.[23] Sweet victory! Our heroic voluntary filer has dodged the bullet.

Not so fast. The manner in which the SEC has implemented a number of the Sarbanes-Oxley provisions has resulted in a "magic bullet" effect, catching our voluntary filer in the cross-fire. While Sarbanes-Oxley generally does not apply to voluntary filers, the SEC embedded most of the disclosure requirements of Sarbanes-Oxley *in the 1934 Act forms themselves*. So, in fulfilling the indenture requirement to file compliant 1934 Act forms, the voluntary filer must also comply with most of the disclosure requirements of Sarbanes-Oxley. Those requirements include:

- The civil certification provisions of Sarbanes-Oxley Section 302 (embedded in Forms 10-K, 10-Q, and Item 601 of Regulation S-K).[24]
- Disclosure surrounding the use of non-GAAP financial measures in filings with the SEC[25] as required by Sarbanes-Oxley Section 401(b) (embedded in Item 10 of Regulation S-K; note that as a purely technical matter, Regulation G, which applies to public statements outside of a filing with the SEC, does not apply to voluntary filers).[26]
- Disclosure of whether an issuer has an "audit committee financial expert" on its audit committee and whether that person is independent, as required by Sarbanes-Oxley Section 407 (embedded in Item 401(h) of Regulation S-K).[27]
- Disclosure of whether an issuer has a code of

ethics, as well as amendments to and waivers of that code, as required by Sarbanes-Oxley Section 406 (embedded in Item 406 of Regulation S-K).[28]
- Disclosure of off-balance sheet arrangements and aggregate contractual obligations, as required by Sarbanes-Oxley Section 401 (embedded in Item 303 of Regulation S-K).[29]
- The auditor's attestation regarding the issuer's internal controls as required by Section 404 of Sarbanes-Oxley (embedded in Item 308(b) of Regulation S-K; note, however, the relief granted to high yield-only issuers and other non-accelerated filers, further described subsequently).
- Auditor independence rules, as required by Sections 201, 202, and 203 of Sarbanes-Oxley (embedded in Rules 2-01 and 2-07 of Regulation S-X).[30]
- Maintenance and evaluation of disclosure controls and procedures, as required by SEC Rule 15d-15 and Item 307 of Regulation S-K.[31]
- Disclosure of material correcting adjustments identified by a registered public accounting firm in reports containing financial statements prepared in accordance with GAAP, as required by Sarbanes-Oxley Section 401.
- Real-time disclosure of additional information concerning certain material events affecting the issuer's financial condition as required by Sarbanes-Oxley Section 409 and amendments to Form 8-K and Item 601 of Regulation S-K.[32]

While many of the provisions of Sarbanes-Oxley do apply to high yield-only issuers notwithstanding their "voluntary filer" status, there are a few important provisions that generally do not apply to voluntary filers. These include:

- The criminal certification provisions of Sarbanes-Oxley Section 906.[33]
- The Sarbanes-Oxley Section 402 prohibition on director and executive loans.[34]
- The Sarbanes-Oxley Section 304 provisions regarding forfeiture of bonuses and profits in the case of an accounting restatement due to misconduct.
- The Sarbanes-Oxley Section 408 provisions that require the SEC to review periodic reports filed by issuers under Section 13(a) of the 1934 Act.

But once again, the SEC giveth, and the SEC taketh away. While the foregoing provisions do not apply once the issuer becomes a voluntary filer, they *do apply* once the high yield-only issuer files an exchange offer registration statement and during the year in which that registration statement is declared effective. Particularly as it relates to target companies in sponsor-led leveraged buy-out transactions, the Sarbanes-Oxley prohibition on director and executive loans creates a problem. For tax reasons, it has been common practice for executives in such companies to purchase equity in their companies in exchange for a promissory note, which is prohibited under Sarbanes-Oxley Section 402.[35] Many recent 144A offerings have been done using a holding company structure, in part to avoid this provision of Sarbanes-Oxley.[36]

No Public Equity

Traditional public companies, *i.e.*, companies that have equity securities traded on the NYSE or the Nasdaq, are subject to the full panoply of SEC rules and regulations, as well as the listing rules of the applicable market and the full scope of the Sarbanes-Oxley Act. Because high yield-only issuers do not have public equity securities, they are not subject to the rules of those markets, and as a result there are a number of SEC rules and Sarbanes-Oxley provisions that do not apply to them. These include:

- the audit committee provisions of Sarbanes-Oxley,
- the insider trading reporting and short swing profit rules of Section 16 under the 1934 Act, and
- the SEC's proxy rules.

As it relates to individual SEC registrants, Sarbanes-Oxley and its progeny can generally be divided into three categories: (1) disclosure requirements, (2) corporate governance requirements, and (3) everything else. As described, the disclosure requirements of Sarbanes-Oxley do end up applying to high yield-only issuers through the magic bullet theory. Not true of the corporate governance requirements. On these topics, between Sarbanes-Oxley, SEC rules and NYSE and Nasdaq rules, there are a number of new corporate governance requirements relating to majority-independent boards, audit committee composition, nominating and compensation committees and the like. By definition, if not by design, these requirements are not applicable to companies that do not have listed securities, and companies typically only list equity

securities (note that there are exchange-traded debt securities, but those are not the norm and in many cases are issued by companies that also have listed equity securities).[37] As a result, high yield-only issuers are not subject to:

- The majority independent board requirement as effected by Section 303A.01 of the NYSE rules and Nasdaq Marketplace Rule 4350(c)(1).
- The independent audit committee requirement of Sarbanes-Oxley Section 301, as effected by Section 303A.07(b) of the NYSE rules and Nasdaq Marketplace Rule 4350(d).[38]
- The nominating/corporate governance and compensation committee requirements as effected by Sections 303A.04 and .05 of the NYSE rules and Nasdaq Marketplace Rules 4350(c)(3) and (4).

In addition to the new Sarbanes-Oxley corporate governance rules, there is a whole body of SEC statutes and rules that apply by their terms solely to companies with public-traded equity securities. Chief among these is Section 16 of the 1934 Act. Section 16 comprises two different, but related sets of rules. Under Section 16(a), corporate insiders (directors, officers and 10 percent stockholders) must publicly disclose their transactions in the company's equity securities. Under prior rules, these disclosures had to be made within 10 days after the end of the month in which they were made, allowing for a possible 41 day delay before disclosure would be required. Under current rules,[39] disclosure is required within two business days of the trade. Under Section 16(b), insiders are required to disgorge to the company any profits made on matching purchase and sale transactions made in company securities within six months of each other.[40] In each case, these are burdens borne by insiders of companies with public equity securities, but not public debt.

There are also other SEC rules that apply solely to public equity issuers, including the beneficial ownership disclosure required by Section 13(d) of the 1934 Act by persons acquiring a 5 percent or greater stake in a public equity issuer. Once again, these rules do not apply to debt-only issuers.[41]

Public equity issuers are also required, as a result of the confluence of SEC rules, exchange listing standards and state corporate law, to have an annual meeting of shareholders and to distribute proxy materials in advance of that meeting. Once again, debt-only issuers are not subject to these requirements. However, this is not quite the free pass that it appears to be. Proxy statements contain a number of disclosures about the company's management, including significant disclosure about their compensation and related party transactions.[42] While debt-only issuers are not required to file proxy statements, they are nonetheless required to include that information in their annual report on Form 10-K.

Accelerated Filers

One of the SEC's mantras in the post-Sarbanes-Oxley world is clearly "sooner is better than later," at least as it relates to disclosure. Along with imposing a slew of new disclosure requirements and potential liabilities on public companies, the SEC adopted rules accelerating the filing deadlines for most large public companies.[43] These rules generally apply to companies that have a public float of $75 million or more. Public float is defined as the market value of the company's equity securities held by non-affiliates as of the last day of the last second fiscal quarter.[44] By definition, therefore, a company with no traded equity securities cannot be an accelerated filer, which will eventually give high yield-only issuers a 30 day advantage over accelerated filers when filing their Annual Reports on Form 10-K and a 10 day advantage when filing their Quarterly Reports on Form 10-Q.

Another significant benefit to not being an accelerated filer relates to the transition rules for the auditor's attestation regarding internal controls required by Section 404 of Sarbanes-Oxley. The SEC has extended the compliance date for this rather burdensome requirement by one year for non-accelerated filers.[45] While accelerated filers must meet this burden for their fiscal years ending on or after November 14, 2004, non-accelerated filers have been given relief until their first fiscal year ending on or after July 15, 2005.

Conclusion

It should be noted in closing that while the differences between high yield-only issuers and traditional public companies are real and at least some of them have practical implications for a high yield-only issuer, there is still fundamentally no such thing as being a

"little bit public." High yield-only issuers are still subject to the lion's share of the reporting requirements of being a public company. It is up to counsel to advise such issuers precisely how those requirements apply to them while in this twilight zone stage of their corporate evolution.

NOTES

1. Sarbanes-Oxley is also known as the Public Company Accounting Reform and Investor Protection Act, Pub.L. 107-204, July 30, 2002, 116 Stat. 745.
2. The reference to quantum mechanics, the physical laws governing extremely small things, is both arcane and entirely intentional. With apologies to Werner Heisenberg, this article is an attempt to reduce uncertainty by shining a light on the subject matter, a seeming contradiction of the principle that bears his name. *See* Brian R. Greene, The Fabric of the Cosmos: Space, Time, and the Texture of Reality (2004).
3. *See* Mark Stegemoeller & Michael Treska, "The Status of High Yield Bond Issuers and Other "Voluntary Filers" under the Sarbanes-Oxley Act," *Insights* April, 2003 at 9.
4. Specifically, from the time of the initial offering to the time of the A/B exchange, the high yield-only issuer is not required to file reports with the SEC, but is typically required to provide them to bondholders pursuant to the terms of the indenture. As a technical matter, when the A/B exchange registration statement is filed, the high yield-only issuer becomes an "issuer" under Sarbanes-Oxley but is not yet required to file 1934 Act reports. From the time the registration statement is declared effective and for that fiscal year, the high yield-only issuer is required to file reports with the SEC pursuant to Section 15(d) of the 1934 Act. Beginning on the first day of the following fiscal year, the high yield-only issuer returns to being a voluntary filer as its obligation to file 1934 Act reports under Section 15(d) terminates automatically as of that date, and, as a result, it ceases to be an "issuer" under Sarbanes-Oxley.
5. QIBs include insurance companies, investment companies and investment advisers that in the aggregate invest at least $100 million on a discretionary basis in unaffiliated securities. QIBs also include: (1) banks and savings and loans that invest on a discretionary basis at least $100 million in unaffiliated securities and have a net worth of at least $25 million, and (2) registered broker-dealers that invest on a discretionary basis at least $10 million in unaffiliated securities. Rule 144A(a)(i) and (ii).
6. Rule 144A was promulgated under the 1933 Act as an exemption from registration for sales made by and between large investors, *i.e.*, QIBs. Rule 144A is not available as an exemption from registration for the issuer, explaining the designation of the initial sale to the investment banks as a private placement under Section 4(2). In addition to Rule 144A, a resale of high yield securities can be done under the so-called "Section 4(1-1/2)"exemption, permitting, among other things, the resale of restricted securities to Institutional Accredited Investors (IAIs) (generally, banks and business trusts with total assets over $5,000,000). *See* Release No. 33-6188 (February 1, 1980), n.178. Finally, the resale of high yield securities can also be done outside the United States under Regulation S, which was promulgated under the 1933 Act.
7. Rule 144A, Preliminary Note 6.
8. Specifically, 144A(b) states that any person who fulfills the sales conditions set forth by 144A(d) is deemed not to be a participant in a distribution of securities, and can thus find a registration exemption under Section 4(1) of the 1933 Act (exempts transactions by any person other than an issuer, underwriter or dealer). Similarly, 144A(c) provides that any dealer who fulfills the requirements of 144A(d) is deemed not to be an underwriter, and therefore the transaction qualifies for the dealer exemption under Section 4(3) of the 1933 Act.
9. Generally, restricted securities are those securities acquired from the issuer or an affiliate of the issuer in a transaction not involving a public offering, and must be held for a minimum of a year before they can be resold to the public. Unrestricted securities generally offer greater liquidity, as they can be resold to a wider group of investors than merely QIBs, Reg S purchasers and IAIs. In addition, some investors face an additional impediment with respect to owning restricted securities under the Investment Company Act of 1940. Generally, mutual funds must hold no more than 15 percent of their net assets in "illiquid" securities. In Release No. IC-17452 (April 23, 1990), the SEC stated that the question of whether 144A restricted securities are "illiquid" involves a determination of fact based on a variety of considerations, including, *inter alia*: (1) the frequency of trades and quotes; (2) the number of dealers willing to purchase or sell the security and the number of other potential purchasers; and (3) the time needed to dispose of the security.
10. Exxon Capital Holdings Corporation (publicly available May 13, 1988). Subsequent no-action letters, including Morgan Stanley (publicly available June 5, 1991), Shearman & Sterling (publicly available July 2, 1993) and Brown & Wood (publicly available February 7, 1997) have limited the scope of the A/B exchange.
11. The A/B exchange presents several advantages over its alternative, a resale shelf registration. First, the issuer takes on a greater risk of 1933 Act liability when using a resale shelf because of the applicability of Sections 11 and 12(a)(2) in a resale (see the text surrounding ns. 17–19 for a discussion of whether 1933 Act liability attaches in an A/B exchange). Second, a resale shelf makes the issuer a constant seller of securities, which in turn requires it to regularly update its registration statement (a high-yield only issuer cannot incorporate by reference to its 1934 Act reports) during the resale period. Third, a resale shelf generally entails a greater administrative burden than an exchange offer (*e.g.*, trying to locate security holders of record).
12. *Gustafson v. Alloyd*, 513 U.S. 561 (1995).
13. Whereas the scope of liability under Section 11 is limited by its language to only registered offerings, Section 12(a)(2) liability does not hinge on whether a transaction is registered or not, but "whether a prospectus is a document soliciting the public to purchase securities from the issuer." *Id.*, at 579.
14. The language of the 1933 Act itself does not provide clear guidelines as far as what constitutes a public or a private offering, *e.g.*, whether it depends on the number of investors or their knowledge and sophistication. In *SEC v. Ralston-Purina,* 346 U.S. 119, 126 (1953), the Supreme Court looked to the underlying policies of the 1933 Act and concluded that a private offering by its nature should involve investors who are knowledgeable and/or sophisticated, and who thus do not require the protection of the securities laws. This concept has been embodied not only in Rule 144A, but also in other SEC regulations, such as Rules 505 and 506 (which allow issuers to offer their securities to an unlimited number of "accredited investors"). Additionally, private placement investors also presumably do not need the protection of the securities laws because they can, at least in theory, negotiate over terms and conditions, avoiding the collective action problems that occur when there are many dispersed potential investors.
15. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).
16. Sections 11(b)(3) and 12(a)(2) of the 1933 Act. Section 11 imposes strict liability on an issuer for a materially misleading registration statement, while providing others with a due diligence defense. Section 12(a)(2), on the other hand, imposes liability for a materially misleading prospectus but provides all parties with a due diligence defense.
17. Section 11 provides for the remedy of "rescission," which generally means that the investors get their consideration back.
18. The plain language of Section 11 of the 1933 Act provides for liability if "any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading . . ."
19. *In re Safety-Kleen Corp. Bondholders Litig.*, C/A No. 3:00-1145-17 (D.S.C. Mar. 27, 2002). With regard to Section 12(a)(2), the *Safety-Kleen* court solicited advice from the SEC on the question of whether that section

applies to the registered exchange of the securities. The SEC, in response, expressed its view that *Gustafson* likely precluded 1933 Act liability for material misstatements in an offering memorandum. However, it also noted that it was sympathetic to the contrary position, as it had understood prior to *Gustafson* that Section 12(a)(2) applied to "all offers and sales of securities, whether in a public or private transaction." *See also In re Hayes Lemmerz Int'l, Inc. Equity Securities Litig.*, 271 F. Supp. 2d 1007, 1028 (E.D. Mich 2003) (citing in the *Safety Kleen* case the letter from SEC General Counsel David M. Becker to Judge Joseph Anderson, dated June 20, 2001).

20. Section 15(d) of the 1934 Act. During the period between the effective date of the registration statement and the termination of the duty to report by virtue of having less than 300 security holders of record, the issuer is still subject to all the requirements set forth under Section 15(d), and it is still an "issuer" for purposes of the Sarbanes-Oxley Act. *See* Question 1, SEC, Division of Corporation Finance, Sarbanes-Oxley Act of 2002, Frequently Asked Questions, at *http://www.sec.gov/divisions/corpfin/faqs/soxact 2002.htm*.

21. Rule 12g5-1(a)(3) under the 1934 Act uses a special counting method for securities held in a custodial capacity for a single account. In such a case, each account is a distinct holder of record for purposes of Sections 12(g) and 15(d) of the 1934 Act. Therefore, depository corporations are not single holders of record for purposes of Section 15(d). Instead, each of the depository's accounts for which the securities are held is considered a single record holder. SEC, Manual of Publicly Available Telephone Interpretations, Chapter M, Question 30 (July 1997).

22. Section 15(d) automatically suspends the duty to report as to any fiscal year if the issuer has fewer than 300 security holders of record *at the beginning* of such fiscal year (except for the fiscal year in which the registration statement is declared effective). Although an issuer should file a Form 15 to notify the SEC of such suspension, the suspension is granted by statute and is not contingent on filing the Form 15. SEC, Manual of Publicly Available Telephone Interpretations, Chapter M, Question 38 (July 1997). *See also* Rule 15d-6 under the 1934 Act.

23. Sarbanes-Oxley Section 2(a)(7). Sarbanes-Oxley also defines "issuer" as a person who has a filed a registration statement that has yet to be declared effective, but has not been withdrawn.

24. Specifically, the SEC has expressed its view that all voluntary filers must still comply with SEC Rule 15d-14, which requires the issuer's CEO and CFO to certify 1934 Act reports. *See* Question 9, SEC, Division of Corporation Finance, Sarbanes-Oxley Act of 2002, Frequently Asked Questions, at *http://www.sec.gov/divisions/corpfin/faqs/soxact2002.htm*.

25. The SEC has a long history of disfavoring non-GAAP financial measures. *See* Release No. 33-8176. Beyond the simple disclosure of which measures are non-conforming to GAAP, Sarbanes-Oxley 401(b)(2) and Regulation G further require that these measures be reconciled to a GAAP measure so as to provide the reader with a basis of comparison.

26. Notwithstanding the fact that Regulation G does not technically apply to voluntary filers, market practice and common sense have led many such filers to voluntarily comply with Regulation G in all of their public statements. In addition, the SEC has expressed its view that because the voluntary filing of 1934 Act reports gives the appearance of the filer being a public company that is subject to Regulation G, voluntary filers making statements that are not in compliance with Regulation G can raise "significant issues" with respect to the anti-fraud provisions of the 1934 Act (Rule 10b-5). Question 33, SEC, Division of Corporate Finance, Frequently Asked Questions Regarding the Use of Non-GAAP Financial Measures, at *http://www.sec.gov /divisions/corpfin/faqs/nongaapfaq.htm*.

27. Sarbanes-Oxley Section 407 defines an "audit committee financial expert" as someone who has: (1) an understanding of generally accepted accounting principles and financial statements; (2) experience in—(A) the preparation or auditing of financial statements of generally comparable issuers; and (B) the application of such principles in connection with the accounting for estimates, accruals and reserves; (3) experience with internal accounting controls; and (4) an understanding of audit committee functions. *See also* Release No. 33-8177.

28. If the issuer has not adopted a code of ethics, it must also explain why it has not done so. S*ee* Release 33-8177.

29. *See* Release No. 33-8182.

30. Although technically these auditor independence rules do not apply to voluntary filers, a critical element of an issuer's reporting obligations is the need to provide independently audited financial statements. Therefore, as a practical matter voluntary filers must comply with Sarbanes-Oxley's provisions on auditor independence once the notes are issued. Sarbanes-Oxley Section 201 prohibits a registered public accounting firm from performing any non-audit activities for an issuer unless approval is given in advance by the issuer's audit committee. Section 202 requires that any non-audit services performed by a public accounting firm for an issuer must be disclosed in periodic reports. Section 203 requires audit partners of public accounting firms to rotate clients every five years. *See* Release No. 33-8183.

31. *See* Question 9, SEC, Division of Corporation Finance, Sarbanes-Oxley Act of 2002, Frequently Asked Questions, at *http://www.sec.gov/divisions/ corpfin/faqs/soxact2002.htm*. The SEC stated that all voluntary filers must still comply with Rule 15d-15 and Item 307 of Regulation S-K.

32. The amendments to Form 8-K and Item 601 of Regulation S-K are effective August 23, 2004. *See* Release Nos. 33-8400.

33. The applicability of Section 906 is limited to "issuers." As previously discussed, the SEC has expressed its view that voluntary filers are not "issuers" under Sarbanes-Oxley. Therefore, by its own terms, Section 906 does not apply to voluntary filers.

34. Section 402 adds new Section 13(k) to the 1934 Act, which applies only to those companies that fit within the Sarbanes-Oxley definition of an "issuer" (*i.e.*, one who is required to file 1934 Act reports or has filed a registration statement that is not yet effective but has not been withdrawn). It should be noted that Sarbanes-Oxley has a grandfathering provision for those director or executive loans outstanding as of July 30, 2002 (when Section 402 was enacted), provided that they have not been later materially modified or renewed. However, there is no grandfathering for loans made after this date by "issuers," even if the company was not an "issuer" under Sarbanes-Oxley at the time the loan was made. Therefore, companies must extinguish outstanding loans made after July 30, 2002, before filing a registration statement.

35. Often, executives choose to buy common stock rather than (or in addition to) receiving options because, if structured properly, the profit from that common stock can receive capital gains, rather than ordinary income, federal income tax treatment. This is often done at least partially using a note, which would be prohibited under Sarbanes-Oxley Section 402 when the note is owed to a Sarbanes-Oxley "issuer." *See* Levin, J., Structuring Venture Capital, Private Equity, and Entrepreneurial Transactions ¶¶ 202.1-2. (2004).

36. The language of Sarbanes-Oxley Section 402 only proscribes loans made by an issuer, or its subsidiary, to an executive or director of the issuer. A holding company is a parent of the issuer and does not appear to be covered by the text of this provision. However, there has been no SEC or other official guidance specifically declaring this practice as compliant with Section 402.

37. High yield securities *are* typically traded on the PORTAL market, a subsidiary of the Nasdaq Stock Market, but that market is a purely private market not subject to the Sarbanes-Oxley-driven rules that we are discussing.

38. Sarbanes-Oxley Section 202 requires an audit committee to preapprove all services provided by an auditor. However, Sarbanes-Oxley defines "audit committee" not only as a separate committee to oversee accounting and financial reporting, but also as the entire board of directors if a separate committee is not established.

39. The accelerated time period was technically required by Sarbanes-Oxley Section 403, although the SEC had been considering accelerating the time period prior to Sarbanes-Oxley.

40. To further illustrate the harshness of Section 16(b), no state of mind needs to be shown on the part of the insider, nor does any misuse of insider

information need to be proven in order to require the insider to disgorge his profits. *See Smolowe v. Delendo Corp.*, 136 F.2d 231, 236 (2d Cir. 1943). Moreover, purchases and sales may be matched off in order to maximize the total amount that has to be disgorged (*i.e.*, lowest price bought, highest price sold within the six month period). *Id.* at 239.

41. Section 13(d) was enacted by the Williams Act amendments of 1968. This legislation was enacted in response to a wave of tender offers and was designed to give managers and shareholders of, and other potential bidders for, a company advance notice of the filer's creeping ownership and intentions. In light of its purpose, it makes sense that the Williams Act is not applicable to debt-only issuers.

42. *See* Items 401, 402, and 404 of Regulation S-K, which are required disclosure items under Schedule 14A.

43. *See* Release No. 33-8128.

44. *Id.* at n.27.

45. Release No. 33-8392.

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