

A Biweekly  
Newsletter of  
Federal Securities,  
Corporate &  
Banking Law  
Developments

## Merger Deals Could be Treated as Tax Shelters

New IRS regulations that became effective in February have the potential of inadvertently causing merger transactions to be treated as tax shelters. If this happens, the participants in the transaction must file special reports with the IRS, and the acquiror would need to register as a tax shelter. (<http://frwebgate4.access.gpo.gov/cgi-bin/waisgate.cgi?WAIISdocID=24552826474+1+0+0&WAIISaction=retrieve>)

This is because the IRS regulations treat transactions as tax shelters if the transactions do not permit participants to disclose the merger's tax structure or consequences, or have the effect of preventing this disclosure. Most merger transactions involve confidentiality agreements and have confidentiality provisions in the actual merger agreements, either of which could trigger these tax shelter rules.

To avoid this treatment, companies should include language suggested by the IRS that gives participants the right to disclose this tax information without limitation, except where prohibited by federal or state securities laws. This would permit disclosure once the merger is publicly announced.

**Even though confidentiality agreements and merger agreements normally do not require confidential treatment of tax consequences, companies should consider using the "safe harbor" language suggested by the IRS.**

### ■ CEOs MUST TEST INTERNAL CONTROLS EACH YEAR

The SEC finalized rules on May 27, 2003 that will require executives of public companies to annually assess and disclose the ability of their internal controls to detect accounting fraud and mistakes. (<http://www.sec.gov/news/press/2003-66.htm>) These rules are required by Section 404 of the Sarbanes-Oxley Act. Under the rules, a company's annual report on Form 10-K must contain:

- (i) management's statement of responsibility for internal controls;
- (ii) a description of how management will evaluate its internal controls; and
- (iii) management's assessment of internal control effectiveness for the year.

In addition, the company's independent auditors must annually attest to this process, using standards that the new Public Company Accounting Oversight Board hopes to issue by the end of the year. Finally, quarterly rather than annual evaluations must be made of any significant changes in internal controls during the year. These rules are generally effective beginning with the fiscal years ending after June 15, 2004.

Companies should be careful to avoid any conflicts of interest which could result from the use of an auditor to both create and test a system of internal control. **We urge companies to use the phase-in period to design the internal control testing procedures and to discuss these procedures with their auditors.**

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## ■ OCC PROPOSES THAT SARBANES-OXLEY RULES APPLY TO PUBLIC AND NON-PUBLIC BANKS

The Office of the Comptroller of the Currency is proposing to revise its regulations to require publicly-held national banks, and some non-public banks, to follow the SEC's rules issued under the Sarbanes-Oxley Act. (Treasury Reg. 1.6011-4, 26 C.F.R. Sec. 1.6011-4) Although the OCC already has jurisdiction to enforce federal securities laws as they apply to national banks, the proposed rules would also cover non-public banks that (i) have offered stock to the public in the past and (ii) have 300 or more but less than 500 stockholders. Those non-public banks are already required to file SEC-type quarterly and annual reports with the OCC.

The SEC rules covered by the OCC proposal relate to (i) maintaining the independence of audit committees; (ii) filing annual and quarterly report CEO and CFO certifications; (iii) prohibiting improper influence of auditors; (iv) prohibiting trading of an issuer's securities by directors and officers during "blackout periods;" (v) testing and reporting on internal controls; and (vi) disclosing whether an audit committee has a financial expert. The OCC has requested comments by June 20, 2003.

**This OCC proposal highlights once again the potential for bank regulators to impose Sarbanes-Oxley type rules on non-public banks and thrifts.**

## ■ SEC ADOPTS FINAL RULES PROHIBITING IMPROPER INFLUENCE OF AUDITS

The SEC finalized regulations on May 20, 2003 prohibiting officers and directors (as well as others acting "under the direction" of management) of a company from improperly influencing the company's independent auditors. (<http://www.sec.gov/rules/final/34-47890.htm>) This rule also covers third parties, such as customers, legal advisors,

securities professionals and even partners at the audit firm, who put pressure on an auditor to, among other things, limit the scope of an audit or not object to inappropriate accounting treatment. Types of conduct that constitute improper influence include bribing and providing other financial incentives, providing inaccurate or misleading legal analysis, threatening to cancel engagements if the auditor objects to the company's accounting, blackmailing and making physical threats.

This new regulation is required by Section 303 of the Sarbanes-Oxley Act and is intended to compel management to make full and open disclosures to the auditor of their financial statements. **Companies should be aware that this new rule becomes effective on June 20, 2003 and that the SEC has indicated it intends to apply the rule broadly.**

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