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Accelerated and Expanded Section 16(a) Filings Final Rules Adopted

Overview

Among its many governance-related provisions, the Sarbanes-Oxley Act of 2002 amends Section 16(a) of the Securities Exchange Act of 1934 by accelerating filing deadlines and requiring electronic filing of Section 16 reports. Text of the legislation can be found at http://financialservices.house.gov/media/pdf/H3763CR_HSE.pdf. The amendments to Section 16(a) became effective on August 29, 2002.

On August 27, 2002, the SEC adopted final rules addressing the Sarbanes-Oxley Act's amendments to Section 16. An online copy of the final rules may be obtained at <http://www.sec.gov/rules/final/34-46421.htm>.

Accelerated and Expanded Filing Requirements

Legislative Requirements

Section 403 of the Sarbanes-Oxley Act amends Section 16(a) to accelerate the filing date for reports of all changes in ownership of securities held by directors, executive officers and greater-than-10% beneficial


owners to the **second business day** following a transaction that effects such changes in ownership.

Before this amendment, Section 16(a) required insiders to report changes in beneficial ownership on a Form 4 filed by the tenth day of the month following the month in which the transaction occurred. The SEC had excluded from these requirements gifts and most benefit plan transactions.

Benefit Plan Transactions

Amended Rule 16a-3(f) requires insiders to report benefit plan-related transactions — which are currently exempted from Section 16(b) short-swing profit recovery by Rule 16b-3 — on a Form 4 filed within two business days after the execution of the transaction. Generally, the execution date is the trade date, or the date upon which the insider becomes irrevocably committed to the transaction.

Previously, insiders could report these transactions on a Form 5 filed within 45 days after the issuer's fiscal year-end. Pursuant to the amended rules, insiders must report virtually all transactions in the issuer's securities or derivative securities,



including all stock option grants and restricted stock issuances, option exercises, repricings and cancellations and transactions in deferred compensation plans, on Form 4 within the two-day accelerated time frame.

The new rules create an extended Form 4 filing date for two kinds of transactions by insiders:

- a transaction pursuant to a plan that satisfies the affirmative defense conditions of Rule 10b5-1(c), to the extent the insider does not choose the execution date of the transaction; and
- a Discretionary Transaction pursuant to an employee benefit plan, to the extent the insider does not choose the execution date of the transaction. (A Discretionary Transaction is a voluntary transaction (not made in connection with death, disability, retirement or termination or pursuant to an Internal Revenue Code requirement) that results in an intra-plan transfer involving an issuer stock fund or a cash withdrawal from an issuer stock fund.)

The extended Form 4 filing date for either of these kinds of transactions is the second business day following notice to the insider of the execution of the transaction, so long as such notification is not later than the third business day following the trade date.

Unaffected Transactions

The amended rules do not affect gifts or transactions in issuer stock funds

under qualified stock plans (such as 401(k) plans) other than Discretionary Transactions. Insiders may continue to report gifts on Form 5 within 45 days after the issuer's fiscal year end. Insiders need not file any reports under Section 16 with respect to transactions under qualified stock purchase plans other than Discretionary Transactions. Insiders should report their holdings in stock funds in such plans on Section 16 forms that they are otherwise required to file.

Cashless Option Exercises

Some commentators have speculated that a cashless option exercise facilitated by a broker who sells the stock underlying the option to finance the exercise price may constitute a loan prohibited by Section 402 of the Sarbanes-Oxley Act. They have speculated further that even a loan from a broker to the insider to pay the exercise price at the time of exercise may constitute a prohibited arrangement of a loan if the company facilitates the arrangement with the broker. Charles Schumer, the senator from New York who drafted the loan prohibition in the Sarbanes-Oxley Act, has stated that in his view cashless exercises are subject to the prohibition. Many companies have suspended cashless option exercises entirely until further clarification is available. If a company wishes to continue to permit cashless exercises, they should require delivery of the full option exercise price upon exercise of the option and they should require insiders to obtain any necessary financing of the exercise


price from a broker or otherwise without any involvement by the company. The SEC has indicated informally that it will not be providing any guidance on this matter in the immediate future.

Transition Rules

The amended Section 16 rules apply to transactions on or after August 29, 2002. Insiders may report transactions occurring before August 29, 2002 in accordance with the Section 16 rules in effect before that date. The SEC staff has published a new Form 4, which may be obtained at <http://www.sec.gov/divisions/corpfin/forms/form4.htm>, and will publish a new Form 5 to reflect the amendments.

EDGAR Filing

As of a date no later than July 30, 2003, insiders must file their Section 16 reports electronically on the EDGAR system. Furthermore, the SEC will be required to make these filings available on the Internet one business day following the filing and the companies must post the filings on their Web sites (if they maintain one). The SEC has indicated informally that the staff will propose regulations on electronic filings as soon as possible, but that they will accept such filings now even though EDGAR does not accommodate the boxes and columns currently on the forms. Using EDGAR to file Section 16 forms now requires obtaining the necessary EDGAR codes for each insider. The SEC will accept group applications for such codes submitted by an issuer on behalf of its



insiders. Please note that each individual should have one EDGAR code for use with respect to all issuers of which the individual is an insider.

Recommendations

The accelerated and expanded filing requirements are effective for transactions that occur on or after August 29, 2002. It is critically important, therefore, that companies immediately adopt new procedures to ensure compliance with the new requirements. Such compliance procedures will help prevent inadvertent violations of the federal securities laws, will help avoid the appearance of insider trading and will prevent potentially embarrassing proxy disclosures.

We recommend the following:

- Each company should adopt and implement **pre-clearance procedures**, pursuant to which all directors and executive officers pre-clear with the General Counsel or another designated officer any planned transactions in the company's securities, including open market transactions, benefit plan transactions, option exercises, gifts and trust transactions.¹ Such pre-clearance requirements have become standard practice among many large public companies.

¹ Companies should confirm that they have correctly identified the executive officers subject to Section 16 and have not been over-inclusive in their designation of such persons.

Attached as Exhibit A is an example of a memorandum to directors and executive officers outlining new procedures. It is based on a form designed by The Corporate Counsel. If you would like to review the original, you can find it at thecorporatecounsel.net.

- Each company should consider assuming **initial responsibility for preparing** all Section 16 filings for its directors and executive officers and should require that each director and executive officer give the company a **power of attorney** to file such Section 16 forms on the individual's behalf. If a director or executive officer is reluctant to grant such a power, the company could undertake to use the power only upon specific instruction by the individual. Nevertheless, the company needs the flexibility to meet the accelerated filing deadlines if the individual is unavailable for signature. We have attached a form power of attorney to this memorandum as Exhibit B.
- Each company should **obtain a signed certificate** from each director and executive officer that he or she is aware of, and intends to follow, the new rules and the new internal procedures. By obtaining this certification, companies will be able to document their efforts to implement the new rules. We have attached a form of certification to this memorandum as Exhibit C.

- Each company should plan to **send periodic reminders** to its directors and officers regarding the procedures. It is important to note that an insider could be filing multiple Forms 4 each month rather than a single form for the whole month.
- Each company should **suspend cashless exercises** or require insiders to **deliver the full exercise price** for each option exercised at the time of exercise.

Commentators Peter Romeo and Jesse Brill are recommending that each company designate the brokers with whom their directors and executive officers may engage in transactions, including cashless option exercises. Romeo and Brill also recommend that companies agree upon compliance procedures with the identified brokers that include a requirement that, before executing a trade, the brokers confirm that the affected insider has pre-cleared the trade with the company. We do not believe these actions are required by the new legislation and regulations, and suggest that each company consider whether this procedure is necessary and appropriate for its situation, particularly in light of the discussions regarding cashless exercises.



Related SEC Initiatives

The SEC has noted that, in light of the amendments to Section 16, it will no longer consider its previously proposed amendments that would have required issuers to report directors' and executive officers' transactions in the issuer's securities on a Current Report on Form 8-K. The SEC stated that it will continue to consider the other amendments proposed in its prior release on amendments to Form 8-K that would, among other things, require companies to disclose information about: (1) directors' and executive officers' arrangements intended to satisfy the affirmative defense conditions of Rule 10b5-1(c); and (2) company loans and loan guarantees to directors and executive officers that are not prohibited by the Sarbanes-Oxley Act.



EXHIBIT A

TO: Directors and Executive Officers [All Section 16 Reporting Persons]
FROM: [CEO]
RE: The Two-Day Form 4 Filing Requirement Becomes Effective August 29

Our New Procedures

The new Sarbanes-Oxley Accounting/Corporate Responsibility legislation contains a two-day Form 4 filing requirement that is effective for transactions occurring on or after August 29, 2002.

Covered Persons

The new filing requirement applies to all Section 16 reporting persons (including family members and others in your household), the same people who are now subject to Section 16.

Covered Transactions

In addition to purchases and sales, the two-day requirement in the new law applies to stock and option grants, and transactions under deferred compensation plans.

Sanctions

As you know, we must report any late or delinquent Form 4 filings in our proxy statement in a separate captioned section, naming names. Congress has granted the SEC broad authority to seek “any equitable relief that may be appropriate or necessary for the benefit of investors” for violations of any provisions of the securities laws.

Our Compliance Procedures

To ensure compliance with the new accelerated reporting requirements, help prevent in advance any inadvertent violations of the federal securities laws, and avoid even the appearance of trading on inside information, we are implementing the following:

1. Our Mandatory Pre-clearance Procedure

Directors and executive officers of the Company, together with their family members, may not engage in any transaction involving the Company's securities (including a stock plan transaction such as an option exercise, a gift, a loan or pledge or hedge, a contribution to a trust or any other transfer) without first obtaining pre-clearance of the transaction from the [General Counsel]. A request for pre-clearance should be submitted to the [General Counsel] at least [three business days] in advance of the proposed transaction. The [General Counsel] will then determine whether the transaction may proceed and, if so, assist in complying with the new reporting requirements.



2. *Power of Attorney*

In order to enable the Company to help you prepare and file the Forms 4 on a timely basis, it is important that you sign and return immediately the enclosed power of attorney.

3. *Certifications*

I am requesting that all directors, officers and other employees subject to the procedures set forth in this memorandum certify their understanding of, and intent to comply with, the procedures set forth in this memorandum. Please return the enclosed certification immediately.

4. *Company Assistance*

Any person who has a question about this memorandum or its application to any proposed transaction may obtain additional guidance from the [General Counsel].

5. *Periodic Preventive E-mail Alerts/Reminders*

Because the risk of inadvertent Form 4 filing violations is so high and because public scrutiny has been heightened, we will be sending you periodic preventive Reminders and Alerts during the course of the year.



EXHIBIT B

POWER OF ATTORNEY

Know all by these presents, that the undersigned hereby constitutes and appoints each of _____ and _____, signing singly, the undersigned's true and lawful attorney-in-fact to:

- (1) execute for and on behalf of the undersigned, in the undersigned's capacity as an officer and/or director of _____ (the "Company"), Forms 3, 4 and 5 in accordance with Section 16(a) of the Securities Exchange Act of 1934 and the rules thereunder;
- (2) do and perform any and all acts for and on behalf of the undersigned that may be necessary or desirable to complete and execute any such Form 3, 4 or 5, complete and execute any amendment or amendments thereto, and timely file such form with the United States Securities and Exchange Commission and any stock exchange or similar authority; and
- (3) take any other action of any type whatsoever in connection with the foregoing that, in the opinion of such attorney-in-fact, may be of benefit to, in the best interest of, or legally required by, the undersigned, it being understood that the documents executed by such attorney-in-fact on behalf of the undersigned pursuant to this Power of Attorney shall be in such form and shall contain such terms and conditions as such attorney-in-fact may approve in such attorney-in-fact's discretion.

The undersigned hereby grants to each such attorney-in-fact full power and authority to do and perform any and every act and thing whatsoever requisite, necessary or proper to be done in the exercise of any of the rights and powers herein granted, as fully to all intents and purposes as the undersigned might or could do if personally present, with full power of substitution or revocation, hereby ratifying and confirming all that such attorney-in-fact, or such attorney-in-fact's substitute or substitutes, shall lawfully do or cause to be done by virtue of this power of attorney and the rights and powers herein granted. The undersigned acknowledges that the foregoing attorneys-in-fact, in serving in such capacity at the request of the undersigned, are not assuming, nor is the Company assuming, any of the undersigned's responsibilities to comply with Section 16 of the Securities Exchange Act of 1934.

This Power of Attorney shall remain in full force and effect until the undersigned is no longer required to file Forms 3, 4 or 5 with respect to the undersigned's holdings of and transactions in securities issued by the Company, unless earlier revoked by the undersigned in a signed writing delivered to the foregoing attorneys-in-fact.

IN WITNESS WHEREOF, the undersigned has caused this Power of Attorney to be executed as of this ____ day of _____, 200__.

Signature

Print Name



EXHIBIT C

CERTIFICATION

I certify that:

1. I have read and understand the Company's compliance procedures regarding pre-clearance of all trading in Company securities by me and members of my family. I understand that the [General Counsel] is available to answer any questions I have regarding the new procedures.

2. I will continue to comply with these procedures for as long as I am subject to the Section 16 insider reporting requirements.

Signature: _____

Date: _____

Print Name: _____