209 Annual SEC Update Part 1: New Leadership, New Directions

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Faculty Biographies

Alan L. Beller

Alan L. Beller is the director of the Division of Corporate Finance with the U.S. Securities and Exchange Commission and is senior counselor to the Commission.

Prior to joining the SEC, Mr. Beller was a partner at Cleary, Gottlieb, Steen & Hamilton, where his practice involved a variety of domestic and international corporate, securities, and derivatives issues.

Mr. Beller received his BA from Yale University and his JD from the University of Pennsylvania Law School.

Michael D. Cahn

Michael D. Cahn is senior associate general counsel‹securities at Textron Inc. in Providence, RI. He is Textron's principal securities lawyer, advising Textron on issuances of securities, disclosure issues, SEC reporting and corporate governance issues. He also advises Textron on acquisitions and dispositions, antitrust law, and other legal matters.

Prior to joining Textron over 25 years ago, Mr. Cahn was an associate at Cahill Gordon & Reindel in New York City.

Mr. Cahn is chair of ACCA's Corporate and Securities Law Committee and has served on the Advisory Board of the *ACCA Docket*. He previously served on the Board of Directors of the Rhode Island Legal/Educational Partnership, a nonprofit organization that conducts Rhode Island's mock trial competition for high school students and legal courses for high school teachers.

Mr. Cahn received a BA from Michigan State University and a JD from Harvard Law School.

Margaret M. Foran

Margaret M. Foran is vice president-corporate governance, and assistant secretary of Pfizer Inc.

Prior to joining Pfizer, she was an associate general counsel and assistant secretary of ITT Corporation and a vice president, assistant general counsel and assistant secretary for J. P. Morgan & Co., Inc., as well as secretary of Morgan Guaranty Trust Company of New York, where she was employed for approximately 12 years. Previously, she was an associate with Reid & Priest.

Ms. Foran is the past chair of ACCA's Corporate and Securities Law Committee, a member of its New York Chapter, and a recipient of ACCA's 1998 *National Committee Member of the Year Award*. Ms. Foran is a former director, the chair of the Securities Law Committee, and the former treasurer of the American Society of Corporate Secretaries (ASCS). She is also the former president and on the Advisory Committee of the New York Chapter of ASCS. She is the former chair of the Coordinating Committee of the Business Roundtable's Corporate Governance Task Force and the current chair of the SEC Issues Committee. Ms. Foran is a Board Director of The Better Business Bureau of

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Metropolitan New York, The Girl Scout Council of Greater New York, and also serves on the Business Advisory Council of YAI National Institute for People with Disabilities. She holds membership in the New York State and New York City Bar Associations.

Ms. Foran received BA magna cum laude and JD from the University of Notre Dame.

John F. Olson

John F. Olson is a senior partner in the Washington, DC office of Gibson, Dunn & Crutcher.

Mr. Olson serves as the chair of the ABA's committee on corporate governance, is the former chair of the ABA's Federal Regulation Securities Committee, is a current member of the council of the ABA's Section of Business Law, and is a member of the ABA's task force on Corporate Responsibility. He serves on the Legal Advisory Committee of the New York Stock Exchange and has served on the Legal Advisory Board of the National Association of Securities Dealers. He was a founding trustee of the American College of Investment Counsel, and served on a select committee of leading securities lawyers appointed by the chair of the Securities Subcommittee of the Senate Banking Committee.

Mr. Olson served as general counsel of the District of Columbia Bar. He chaired the Task Force on Regulation of Insider Trading of the ABA. He served on the ABA Coordinating Group on Regulatory Reform and served for three years as chair of the ABA's Committee of Foreign Claims. Mr. Olson is a member of the American Law Institute. He recently served on the Blue Ribbon Commission on CEO Succession of the National Association of Corporate Directors and on the NACD's Blue Ribbon Commission on Audit Committees.

Mr. Olson has cochaired the annual program, Proxy Statements, Annual Meetings, and Disclosure Documents, for 21 years. He serves on the advisory committees for the San Diego Securities Regulation Institute and the Practising Law Institute's Annual Securities Regulation Institute. He cochairs the American Law Institute/ABA annual postgraduate course in federal securities law. Mr. Olson is a member of the editorial advisory boards of *Insights: The Corporate and Securities Law Advisor*, the BNA's *Securities Regulation & Law Report*, and the *Corporate Governance Advisor*.

Bart Schwartz

Bart Schwartz is general counsel and senior vice president of The MONY Group Inc., an insurance and diversified financial services company based in New York.

Previously, Mr. Schwartz was senior vice president, general counsel and secretary of Willis Corroon Corporation, an insurance brokerage and risk management consulting company. Mr. Schwartz began his legal career 25 years ago with Debevoise & Plimpton in New York and later joined the Los Angeles office of Skadden, Arps, Slate, Meagher & Flom.

He is a member of the ABA Committee of Corporate General Counsel, the Association of Life Insurance Counsel, the New York City Bar Association, and ACCA. He serves as a member of the Board of ACCA's Greater New York Chapter. Mr. Schwartz is a frequent writer and speaker on corporate law issues.

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He holds an MBA from the Owen School of Management at Vanderbilt University and a JD from the University of Southern California School of Law.

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Final Rule:
Ownership Reports and Trading by Officers, Directors and Principal Security Holders

SECURITIES AND EXCHANGE COMMISSION

17 CFR PARTS 240, 249 and 274

[RELEASE NOS. 34-46421; 35-27563; IC-25720; File No. S7-31-02]

RIN 3235-AI62

Ownership Reports and Trading by Officers, Directors and Principal Security Holders

Agency: Securities and Exchange Commission

Action: Final rule; request for comment

Summary: We are adopting rule and form amendments to implement the accelerated filing deadline applicable to change of beneficial ownership reports required to be filed by officers, directors and principal security holders under Section 16(a) of the Securities Exchange Act of 1934, as amended by the Sarbanes-Oxley Act of 2002. The amendments are intended to facilitate the statutory changes, which become effective August 29, 2002, consistent with their purpose.

Dates: *Effective Date*: August 29, 2002.
Comment Date: Comments on the amended rules must be received on or before September 30, 2002.

Addresses: Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609. Comments also may be submitted electronically at the following electronic mail address: rule-comments@sec.gov. To help us process and review your comments more efficiently, comments should be sent by one method only. All comment letters should refer to File No. S7-31-02; this file number should be included in the subject line if electronic mail is used. Comment letters will be available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, NW, Washington, DC 20549. Electronically submitted comment letters will be posted on the Commission's Internet Web Site (http://www.sec.gov).[1]

For Further Information Contact: Anne M. Krauskopf, Special Counsel, David Lee, Special Counsel, or Carol McGee, Special Counsel at (202) 942-2900, Division of Corporation Finance, U.S. Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0402.

Supplementary Information: We are adopting amendments to Rules 16a-3,[2] 16a-6[3] and 16a-8[4] under the Securities Exchange Act of 1934 ("Exchange Act"),[5] and Forms 3,[6] 4[7] and 5[8] under the Exchange Act.

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I. Executive Summary and Background

Section 16[9] applies to every person who is the beneficial owner of more than 10% of any class of equity security registered under Section 12 of the Exchange Act,[10] and each officer and director (collectively, "reporting persons" or "insiders") of the issuer of such security. Upon becoming a reporting person, or upon the Section 12 registration of that security, Section 16(a) [11] requires a reporting person to file an initial report with the Commission disclosing his or her beneficial ownership of all equity securities of the issuer.[12] To keep this information current, Section 16(a) also requires reporting persons to report changes in such ownership, or the purchase or sale of a security-based swap agreement[13] involving such equity security. Previously, Section 16(a) provided for such transactions to be reported on a monthly basis within 10 days after the close of each calendar month in which such a change in ownership or purchase or sale of a security-based swap agreement occurs.

On July 30, 2002, the Sarbanes-Oxley Act of 2002 (the "Act")[14] was enacted. Section 403(a) of the Act amends Section 16(a) to require reports of such a change in ownership or purchase or sale of a security-based swap agreement "before the end of the second business day following the day on which the subject transaction has been executed, or at such other time as the Commission shall establish, by rule, in any case in which the Commission determines that such 2-day period is not feasible."[15]

Section 403(b) of the Act provides that this amendment becomes effective 30 days after the date of enactment. That effective date is August 29, 2002. Thus, reporting persons will be required to report all transactions subject to Section 16(a) for which the date of execution (trade date) is on or after August 29, 2002 on Form 4 in accordance with the amended two-business day deadline,[16] except where the rules under Section 16(a) provide otherwise.

On August 6, 2002, we announced that we anticipated adopting final rules to implement the new accelerated reporting deadline, effective no later than the August 29, 2002 effective date of the Section 16(a) amendments.[17] The final rules that we adopt today accomplish the following:

* Amend the Section 16(a) forms to conform all references to the Form 4 filing deadline to the amended statutory filing deadline and to reflect that Form 4 is no longer a monthly form.

* Amend Rule 16a-6(b), the small acquisitions rule, to conform the description of the Form 4 deadline contained in that rule to the amended statutory filing deadline.

* Amend Rules 16a-3(f) and 16a-6(a) so that transactions between officers or directors and the issuer exempted from Section 16(b)[18] short-swing profit recovery by Rule 16b-3[19] previously reportable on an annual basis on Form 5[20] will be required to be reported within two business days on Form 4.

* Amend Rule 16a-3(g) to calculate the two-business day Form 4 due date differently for the following transactions, for which we have determined that the amended Section 16(a) statutory reporting period is otherwise not feasible:[21]

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* Transactions pursuant to arrangements that satisfy the affirmative defense conditions of Exchange Act Rule 10b5-1(c)[22] where the reporting person does not select the date of execution; and

* Discretionary Transactions pursuant to employee benefit plans where the reporting person does not select the date of execution. [23]

We are not adopting any rules to calculate the Form 4 filing deadline differently based on non-feasibility for any other categories of transactions.[24] The amendments we adopt today will apply to transactions that occur on or after August 29, 2002. Transactions previously reportable on Form 5 that are not covered by the Rule 16a-3(f) amendments will remain reportable on Form 5 to the same extent as before, and transactions previously exempt from Section 16(a) reporting will remain exempt. An insider's failure to timely file a Section 16(a) report will remain subject to the company's disclosure obligation, [25] which we are not amending.

II. Rule and Form Amendments

A. Conforming Amendments to Rule 16a-6 and Forms 4 and 5

We are amending Form 4 (including the General Instructions to the form) to conform all references to the applicable filing deadline to the amended statutory filing deadline, and to reflect that Form 4 is no longer a monthly form.[26] In particular, the revised form provides that the holdings columns must report holdings following the reported transaction(s), rather than month-end holdings.[27] The form also specifically provides that reportable Rule 16b-3 exempt transactions must be reported on Form 4.[28]

In addition, we are adding new column 2A to Table I of Form 4 and column 3A to Table II to require reporting of deemed execution dates computed in accordance with the Rule 16a-3(g) amendments adopted today.[29] These columns, which must be completed only if such a deemed execution date applies to the transaction reported,[30] will enable investors and members of the Commission staff reading the form to determine if the form was filed on a timely basis as readily as with the current form. Table I column 2 and Table II column 3, which require the transaction date to be reported, will continue to require the transaction's trade date to be reported.

We also are adding new columns 2A and 3A to Form 5, so that investors and members of the Commission staff reading that form similarly will be able to determine how late a transaction was reported.[31] Finally, we revise Form 5 to clarify that reportable Rule 16b-3 exempt transactions no longer may be reported on that form on a deferred basis.[32]

We plan to publish new forms implementing these amendments as soon as possible. Until amended forms are available, reporting persons should continue to use the current versions, but should modify box 4 on Form 4 to state the month, day and year of the transaction. When using the current forms to report a transaction with a deemed execution date computed pursuant to amended Rule 16a-3(g), a reporting person should include an asterisk next to the trade date in the transaction date column, and add a footnote to disclose the deemed execution date.

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Rule 16a-6 permits small acquisitions to be reported on Form 5, subject to specified conditions.33 If the conditions are no longer met, so that the small acquisition no longer qualifies for deferred reporting on Form 5, it must be reported on a Form 4. We are amending the rule to conform the Form 4 due date for this purpose to the two-business day due date provided by the Act, so the Form 4 will be due two business days after the deferral conditions are no longer met.34

We also are amending the rule so that it will not be available to defer reporting of small acquisitions from the issuer (including an employee benefit plan sponsored by the issuer).35 This will prohibit reliance on Rule 16a-6 to report on Form 5 transactions exempted by Rule 16b-3 that will be required to be reported on Form 4, as described immediately below.

B. Amendments to Rule 16a-3

Rule 16a-3 sets forth the general reporting requirements under Section 16(a). We are amending this rule in several respects to address the reporting modifications effected by the Act.

Form 4 reporting within two business days of officers' and directors' transactions with an issuer exempted by Rule 16b-3 that previously were reportable on Form 5 is necessary to satisfy the Act's purpose to require immediate disclosure of insider transactions. Accordingly, we amend the rule to eliminate deferred reporting for these Section 16(b) exempt transactions and specifically require reporting on Form 4.36 We previously solicited comment on this regulatory action.37

Consequently, grants, awards and other acquisitions from the issuer exempted by Rule 16b-3(d), dispositions to the issuer exempted by Rule 16b-3(e), and Discretionary Transactions pursuant to employee benefit plans exempted by Rule 16b-3(f) no longer will be reportable on a deferred basis on Form 5, but instead must be reported on Form 4 within two business days.38 Following these amendments, derivative securities transactions reportable on Form 4 will include, without limitation, issuances, exercises,39 and cancellations and regrants of stock options, including repricings.

Like the other amendments we adopt today, the amendments that accelerate reporting of reportable Rule 16b-3 exempt transactions apply to transactions that occur on or after August 29, 2002. 40 The amendments do not affect such transactions that occur before the effective date.

In requiring reporting before the end of the second business day following the day on which the transaction is executed, the Act provides the Commission rulemaking authority to calculate that deadline differently "in any case in which the Commission determines that such 2-day period is not feasible." If the trade date is considered the date of execution, we have determined that filing Form 4 within the two-business day deadline would not be feasible for two narrowly defined types of transactions where objective criteria prevent the reporting person from controlling the trade date.

The first exception relates to transactions pursuant to Rule 10b5-1(c) arrangements.41 A reporting person generally cannot know whether such a transaction will be executed

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immediately. Where the reporting person has not selected the date of execution, the reporting person generally knows that an order has been placed, but does not control — and may not be able reasonably to predict — when the transaction actually will occur. Instead, price movement in the market may determine the date of execution for these transactions.

The second exception addresses Discretionary Transactions, where the logistics of plan administration may prevent a reporting person from selecting the date of execution.42 A reporting person may not reasonably expect a Discretionary Transaction to be executed immediately, but instead at a time consistent with the plan's particular administrative procedures.

Accordingly, the new rules will define the date of execution differently for these transactions, solely for Section 16(a) reporting purposes. In light of the Act's purpose to effect immediate disclosure of reporting persons' transactions, the alternative calculations we adopt for these transactions require expeditious reporting. We are modifying the calculation of the statutory two-business day period as described below for these transactions:

* For a transaction pursuant to a contract, instruction43 or written plan for the purchase or sale of issuer equity securities that satisfies the affirmative defense conditions of Exchange Act Rule 10b5-1(c) where the reporting person does not select the date of execution, the date on which the executing broker, dealer or plan administrator notifies the reporting person of execution of the transaction is deemed the date of execution, so long as the notification date is not later than the third business day following the trade date.44

* For a Discretionary Transaction where the reporting person does not select the date of execution, the date on which the plan administrator notifies the reporting person that the transaction has been executed is deemed the date of execution, so long as the notification date is not later than the third business day following the trade date.45

In each case, a reporting person must report the transaction on Form 4 before the end of the second business day following the deemed date of execution, as calculated under the applicable rule, for the transaction.46 Defining the date of execution as the notification date enables a reporting person to report on Form 4 a transaction of which he or she otherwise would not have notice. However, neither exception will be available if the reporting person has selected the date of transaction execution, for example where a Rule 10b5-1(c) arrangement provides for a sale on the first business day of each month.

The three-business day period provides reasonable time for notification to be made, and is consistent with the Act's purpose to expedite reporting. For both Rule 10b5-1(c) transactions and Discretionary Transactions, we expect the reporting person will make specific arrangements for the broker, dealer or plan administrator to provide the reporting person actual notice of transaction execution as quickly as feasible.47 By deeming the notification date to be the third business day following the trade date if actual notification does not occur by then, the rule limits the potential delay permitted for reporting these transactions on a timely basis.48

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The broker, dealer or plan administrator may use any means of communication, including oral, paper or electronic means, to notify the reporting person that the transaction has been executed. While a broker or dealer also will have an obligation to provide the reporting person with a transaction confirmation under Exchange Act Rule 10b-10,49 the confirmation may not arrive soon enough to give the reporting person the information he or she needs for Section 16(a) reporting purposes. For example, a confirmation sent through the mail could take several days to arrive. We would, therefore, usually expect brokers and dealers to provide the information needed for Section 16(a) reporting purposes to the reporting person either electronically or by telephone.50

Regarding Rule 10b5-1(c) transactions, the new rule will be available broadly to any transaction that satisfies the affirmative defense conditions of Rule 10b5-1(c), including transactions pursuant to employee benefit plans and dividend or interest reinvestment plans that are not exempt from Section 16(a) reporting. Following effectiveness of Section 403 of the Act, acquisitions pursuant to Qualified Plans, Excess Benefit Plans, Stock Purchase Plans51 and the reinvestment of dividends or interest pursuant to broad-based dividend or interest reinvestment plans52 will remain exempt from Section 16(a) reporting. In contrast, transactions pursuant to non-qualified deferred compensation plans and other dividend or interest reinvestment plan transactions (such as acquisitions pursuant to voluntary contributions of additional funds) will be reportable on Form 4 within two business days after the date of execution. However, to the extent that such a transaction satisfies the affirmative defense conditions of Rule 10b5-1(c), the date of execution for Form 4 reporting purposes may be calculated on the modified basis.

III. Electronic Filing and Website Posting

The Act also amends Section 16(a) to require, not later than one year following enactment, electronic filing of change of beneficial ownership reports, and website posting of such reports by both the Commission and issuers.53 We have announced our intention to begin rulemaking to make the filing of Section 16(a) reports on EDGAR mandatory,54 and are proceeding expeditiously with that rulemaking and related system programming to assure adoption within the one-year period mandated by the Act.

Meanwhile, we encourage reporting persons and companies filing Section 16(a) reports on their behalf to make these filings electronically.55 To facilitate EDGAR conversion under the current filing system, we will accept electronically-filed Section 16(a) reports that are not presented in the standard box format and omit the horizontal and vertical lines separating information items, so long as the captions of the items and all required information are presented in the proper order. Reporting persons who plan to file their Section 16(a) reports electronically should submit Forms ID requesting EDGAR access codes as soon as possible to minimize processing delays.56 When making a request, please indicate whether the person for whom codes are requested is a reporting person with respect to any other companies, and whether a CIK number already has been assigned to that person. We also encourage companies to post Section 16(a) reports on their websites before the July 30, 2003 statutory implementation date.

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IV. Request for Comment

We request comment on the changes we are adopting in this release. Are any other technical amendments necessary to implement Section 403 of the Act? Commenters should address whether the amendments to Rule 16a-3(g) to define the date of execution differently for specified types of transactions will make it feasible for insiders to report those transactions within the two-business day deadline. Is any additional time necessary to make Form 4 reporting feasible for these transactions? Alternatively, do the new rules allow more time than is necessary for this purpose?

Commenters also should address whether any other types of transactions require regulatory changes to make it feasible for insiders to report them within that deadline. In this regard, what factors should we consider in making a feasibility determination?

On a broader issue not otherwise addressed in this release, we seek comment whether any changes are required in the treatment of stock options under Sections 16(a) and 16(b). One set of issues involves whether and how the six-month period of Section 16(b) should be applied and calculated in connection with stock options, exercises and the sale of the underlying stock. For example, should a six-month holding period be required as a mandatory condition to exempt grants under Rule 16b-3(d), rather than be one of the alternative permissible bases for an exemption?

V. Procedural Matters

The Administrative Procedure Act generally requires an agency to publish notice of a proposed rulemaking in the Federal Register.57 This requirement does not apply, however, if the agency "for good cause finds . . . that notice and public procedure are impracticable, unnecessary, or contrary to the public interest."58

The Commission believes that it is appropriate to adopt the amendments to Rules 16a-3 and 16a-6 and Forms 4 and 5 without notice and the opportunity for public comment because they are necessary to conform the Section 16(a) rules and forms to the two-business day reporting deadline provided by the amendments to Section 16(a) enacted in Section 403 of the Act that become effective, by their terms, on August 29, 2002.59

Unless the rule and form amendments become effective by that date, reporting persons may be confused by the longer time period currently specified by the rules and forms. To satisfy the Act's purpose to require immediate disclosure of insider transactions, some of the amendments eliminate deferred reporting of officers' and directors' reportable transactions with an issuer exempted from short-swing profit recovery by Rule 16b-3.60 Without these regulatory amendments, the statutory amendments will become effective without fulfilling their purpose.

The amendments to Rule 16a-3(g) implement specific rulemaking authority granted to the Commission by Section 403 of the Act to compute the two-business day deadline differently in certain narrowly-defined circumstances, based on feasibility. We do not believe Congress intended to require reporting persons to report transactions for which they had no opportunity to

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obtain notice of execution. Without these regulatory amendments, the statutory amendments will become effective in a manner that is not feasible for these transactions.

The technical amendments to Rule 16a-8(a)(1) implement amendments we previously adopted to provide that a trust is subject to Section 16 only if the trust is a more than ten percent beneficial owner.61 The technical amendments to the General Instructions to Forms 3, 4 and 5 to omit references to furnishing the Social Security Numbers of natural persons implement a policy that we previously adopted.62

Accordingly, the Commission for good cause finds that a notice and comment period for these rules would be unnecessary, impracticable and contrary to the public interest.

The Administrative Procedure Act also generally requires that an agency publish an adopted rule in the Federal Register 30 days before it becomes effective.63 This requirement, however, does not apply if the agency finds good cause for making the rule effective sooner.64 For the same reasons as it is waiving notice and comment, the Commission finds good cause to make the rules effective August 29, 2002.65 In addition, the amendments to Rule 16a-3(g) relieve a restriction.

VI. Paperwork Reduction Act

We already have control numbers for Forms 3 (OMB Control No. 3235-0104), 4 (OMB Control No. 3235-0287) and 5 (OMB Control No. 3235-0362). These forms prescribe beneficial ownership information that a reporting person must disclose. Preparing and filing a report on any of these forms is a collection of information. Consistent with the will of Congress, the amendments conform the Section 16(a) rules and forms to the two-business day reporting deadline provided by the amendments to Section 16(a) enacted in Section 403 of the Act.

Following the amendments adopted today, reporting persons will remain obligated to disclose the same information that they were previously required to report on these forms.66 Some transactions previously reported on Form 5 instead will be reported on Form 4. Because of the expedited filing deadline, reporting persons may file Forms 4 more frequently, but each form would report fewer transactions. We therefore believe that the overall information collection burden will remain approximately the same because the same transactions will remain reportable.

VII. Costs and Benefits

The action that the Commission takes today largely represents the implementation of a Congressional mandate. We recognize that implementation of the Act will likely create costs and benefits to the economy. Costs may arise because reporting persons will be required to file Form 4 significantly more quickly after a transaction, and potentially more frequently because Form 4 no longer will be a monthly form. The increased speed of filing also may increase preparation costs. In addition, to the extent that amended Section 16(a) results in an increase in the number of Forms 4 filed — although the total number of reportable transactions has not been changed by Section 403 of the Act or this release — the aggregate cost of providing this information may increase.

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Conversely, amended Section 16(a) is likely to provide significant benefits by making information concerning insiders' transactions in issuer equity securities publicly available substantially sooner than it was before. Making this information available to all investors on a more timely basis should increase market transparency, which will likely enhance market efficiency and liquidity.

In adopting specific rules for transactions for which we have determined that filing Form 4 within the statutory two-business day deadline otherwise would not be feasible, we have considered the associated costs and benefits. The reporting rules that we adopt for these transactions generally involve instances where the reporting person does not control and cannot reasonably be expected to know immediately the precise transaction date. The rules therefore allow reasonable additional time so that reporting is feasible, while requiring expeditious reporting consistent with the Act's purpose to effect immediate disclosure of reporting persons' transactions.

VIII. Promotion of Efficiency, Competition and Capital Formation

Section 23(a)(2) of the Exchange Act67 requires us, when adopting rules under the Exchange Act, to consider the anti-competitive effective of any rules we adopt. Further, Section 3(f) of the Exchange Act68 and Section 2(c) of the Investment Company Act69 require us, when engaging in rulemaking where we are required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition and capital formation.

The amendments generally implement a statute that improves the timeliness of information available to investors about insiders' transactions in issuer equity securities. We are adopting rules to provide certain different calculations for the two-business day standard set by Congress. These rules should have no effect on competition and capital formation. They are designed to increase the efficiency of insider reporting.

IX. Regulatory Flexibility Act

The Regulatory Flexibility Act70 does not apply to the rules we adopt today. The Regulatory Flexibility Act requires agencies to prepare analyses for rulemaking only when the Administrative Procedure Act requires general notice of proposed rulemaking.71 As noted above, the Commission is not required to solicit public comment because the Commission is using the expedited rulemaking procedures under section 553(b) of the Administrative Procedure Act.72

X. Statutory Authority

The amendments contained in this release are adopted under the authority set forth in Sections 3(b),73 16 and 23(a)74 of the Exchange Act, Section 17(a) of the Public Utility Holding Company Act of 1934, 75 Section 30(h) of the Investment Company Act of 1940, and Section 3(a) of the Sarbanes-Oxley Act of 2002.

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Text of Amendments

List of Subjects in 17 CFR Parts 240, 249 and 274

Securities.

In accordance with the foregoing, Title 17, Chapter II of the Code of Federal Regulations is amended as follows:

PART 240 - GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The authority citation for Part 240 continues to read, in part, as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 79q, 79t, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4 and 80b-11, unless otherwise noted.

* * * * *

2. Section 240.16a-3 is amended by revising paragraphs (f)(1)(i)(A) and (g), to read as follows:

§240.16a-3 Reporting transactions and holdings.

* * * * *

(f)(1) * * *

(i) * * *

(A) Exercises and conversions of derivative securities exempt under either §240.16b-3 or §240.16b-6(b), and any transaction exempt under §240.16b-3(d), §240.16b-3(e), or §240.16b-3(f) (these are required to be reported on Form 4);

* * * * *

(g)(1) A Form 4 must be filed to report: all transactions not exempt from section 16(b) of the Act; all transactions exempt from section 16(b) of the Act pursuant to §240.16b-3(d), §240.16b-3(e), or §240.16b-3(f); and all exercises and conversions of derivative securities, regardless of whether exempt from section 16(b) of the Act. Form 4 must be filed before the end of the second business day following the day on which the subject transaction has been executed.

(2) Solely for purposes of section 16(a)(2)(C) of the Act and paragraph (g)(1) of this section, the date on which the executing broker, dealer or plan administrator notifies the reporting person of

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the execution of the transaction is deemed the date of execution for a transaction where the following conditions are satisfied:

(i) the transaction is pursuant to a contract, instruction or written plan for the purchase or sale of equity securities of the issuer (as defined in §16a-1(d)) that satisfies the affirmative defense conditions of §240.10b5-1(c) of this chapter; and

(ii) the reporting person does not select the date of execution.

(3) Solely for purposes of section 16(a)(2)(C) of the Act and paragraph (g)(1) of this section, the date on which the plan administrator notifies the reporting person that the transaction has been executed is deemed the date of execution for a discretionary transaction (as defined in §16b-3(b)(1)) for which the reporting person does not select the date of execution.

(4) In the case of the transactions described in paragraphs (g)(2) and (g)(3) of this section, if the notification date is later than the third business day following the trade date of the transaction, the date of execution is deemed to be the third business day following the trade date of the transaction.

(5) At the option of the reporting person, transactions that are reportable on Form 5 may be reported on Form 4, so long as the Form 4 is filed no later than the due date of the Form 5 on which the transaction is otherwise required to be reported.

* * * * *

3. Section 240.16a-6 is amended by revising the introductory text of paragraph (a) and paragraph (b) to read as follows:

§240.16a-6 Small acquisitions.

(a) Any acquisition of an equity security or the right to acquire such securities, other than an acquisition from the issuer (including an employee benefit plan sponsored by the issuer), not exceeding $10,000 in market value shall be reported on Form 5, subject to the following conditions:

(1) * * *

(2) * * *

(b) If an acquisition no longer qualifies for the reporting deferral in paragraph (a) of this section, all such acquisitions that have not yet been reported must be reported on Form 4 before the end of the second business day following the day on which the conditions of paragraph (a) of this section are no longer met.

4. Section 240.16a-8 is amended by revising paragraph (a)(1) to read as follows:

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§240.16a-8 Trusts.

(a) Persons subject to section 16. (1) Trusts. A trust shall be subject to section 16 of the Act with respect to securities of the issuer if the trust is a beneficial owner, pursuant to §240.16a-1(a)(1), of more than ten percent of any class of equity securities of the issuer registered pursuant to section 12 of the Act ("ten percent beneficial owner").

(2) Trustees, beneficiaries and settlors. * * *

* * * * *

PART 249 - FORMS, SECURITIES EXCHANGE ACT OF 1934

5. The authority citation for Part 249 continues to read, in part, as follows:

Authority: 15 U.S.C. 78a, et seq., unless otherwise noted.

* * * * *

PART 274 - FORMS PRESCRIBED UNDER THE INVESTMENT COMPANY ACT OF 1940

6. The authority citation for Part 274 continues to read as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 78c(b), 78l, 78m, 78n, 78o(d), 80a-8, 80a-24, 80a-26, and 80a-29, unless otherwise noted.

7. Form 3 (referenced in §249.103 and §274.202) and the General Instructions thereto are amended by revising the fourth sentence of paragraph (b)(v) of General Instruction 5, to read as follows:

Note - The text of Form 3 does not and this amendment will not appear in the Code of Federal Regulations.

Form 3 Initial Statement of Beneficial Ownership of Securities

* * * * *

General Instructions

* * * * *

5. Holdings Required to be Reported * * * * *

(b) Beneficial Ownership Reported (Pecuniary Interest)

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* * * * *

(v) * * * Indicate only the name and address of the designated filer in Item 1 of Form 3 and attach a list of the names and addresses (or, if entities, IRS identification numbers instead of addresses) of each other reporting person. * * *

* * * * *

8. Form 4 (referenced in §249.104 and §274.203) and the General Instructions thereto are amended by:

a. revising the first sentence of General Instruction 1(a);

b. revising General Instructions 3(a)(i), 3(a)(ii) and 3(a)(iii);

c. revising General Instruction 4(a)(i) and the first sentence of the Note thereto;

d. adding a sentence at the end of General Instruction 4(a)(ii) before the Note thereto;

e. revising the fourth sentence of General Instruction 4(b)(v);

f. revising Items 4 and 5 to the information preceding Table I;

g. adding column 2A to follow column 2 in Table I;

h. revising column 5 in Table I;

i. adding column 3A to follow column 3 in Table II; and

j. revising column 9 in Table II.

The revisions read as follows:

Note - The text of Form 4 does not and this amendment will not appear in the Code of Federal Regulations.

Form 4 Statement of Changes in Beneficial Ownership of Securities

* * * * *

General Instructions

1. When Form Must Be Filed

(a) This Form must be filed before the end of the second business day following the day on which a transaction resulting in a change in beneficial ownership has been executed (see Rule

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16a-1(a)(2) and Instruction 4 regarding the meaning of "beneficial owner," and Rule 16a-3(g) regarding determination of the date of execution for specified transactions). * * *

* * * * *

3. Class of Securities Reported

(a) (i) Persons reporting pursuant to Section 16(a) of the Exchange Act must report each transaction resulting in a change in beneficial ownership of any class of equity securities of the issuer and the beneficial ownership of that class of securities following the reported transaction(s), even though one or more of such classes may not be registered pursuant to Section 12 of the Exchange Act.

(ii) Persons reporting pursuant to Section 17(a) of the Public Utility Holding Company Act of 1935 must report each transaction resulting in a change in beneficial ownership of any class of securities (equity or debt) of the registered holding company and all of its subsidiary companies and the beneficial ownership of that class of securities following the reported transaction(s). Specify the name of the parent or subsidiary issuing the securities.

(iii) Persons reporting pursuant to Section 30(h) of the Investment Company Act of 1940 must report each transaction resulting in a change in beneficial ownership of any class of securities (equity or debt) of the registered closed-end investment company (other than "short-term paper" as defined in Section 2(a)(38) of the Investment Company Act) and the beneficial ownership of that class of securities following the reported transaction(s).

* * * * *

4. Transactions and Holdings Required To Be Reported

(a) General Requirements

(i) Report, in accordance with Rule 16a-3(g): (1) all transactions not exempt from Section 16(b); (2) all transactions exempt from Section 16(b) pursuant to §240.16b-3(d), §240.16b-3(e), or §240.16b-3(f); and (3) all exercises and conversions of derivative securities, regardless of whether exempt from Section 16(b) of the Act. Every transaction must be reported even though acquisitions and dispositions are equal. Report total beneficial ownership following the reported transaction(s) for each class of securities in which a transaction was reported.

Note: The amount of securities beneficially owned following the reported transaction(s) specified in Column 5 of Table I and Column 9 of Table II should reflect holdings reported or required to be reported by the date of the Form. * * *

(ii) * * * A deemed execution date must be reported in Column 2A of Table I or Column 3A of Table II only if the execution date for the transaction is calculated pursuant to §240.16a-3(g)(2) or §240.16a-3(g)(3).

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* * * * *

(b) Beneficial Ownership Reported (Pecuniary Interest)

* * * * *

(v) * * * Indicate only the name and address of the designated filer in Item 1 of Form 4 and attach a list of the names and addresses (or, if entities, IRS identification numbers instead of addresses) of each other reporting person. * * *

* * * * *

Form 4

* * * * *

4. Statement for Month/Day/Year

5. If Amendment, Date of Original (Month/Day/Year)

* * * * *

Table I - Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

* * * * *

2A. Deemed Execution Date, if any (Month/Day/Year)

* * * * *

5. Amount of Securities Beneficially Owned Following Reported
Transaction(s)

* * * * *

Table II - Derivative Securities Acquired, Disposed of, or Beneficially Owned (e.g., puts, calls, warrants, options, convertible securities)

* * * * *

3A. Deemed Execution Date, if any (Month/Day/Year)

* * * * *

9. Number of Derivative Securities Beneficially Owned Following Reported Transaction(s)

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* * * * *

9. Form 5 (referenced in §249.105) and the General Instructions thereto are amended by:

a. revising General Instruction 4(a)(i)(A);

b. adding a sentence at the end of General Instruction 4(a)(ii);

c. revising the fourth sentence of General Instruction 4(b)(v);

d. adding column 2A to follow column 2 in Table I; and

e. adding column 3A to follow column 3 in Table II.

The revisions read as follows:

Note - The text of Form 5 does not and this amendment will not appear in the Code of Federal Regulations.

Form 5 Annual Statement of Beneficial Ownership of Securities

* * * * *

4. Transactions and Holdings Required to be Reported

(a) General Requirements

(i) * * *

(A) any transaction during the issuer's most recent fiscal year that was exempt from Section 16(b) of the Act, except: (1) any transaction exempt from Section 16(b) pursuant to §240.16b-3(d), §240.16b-3(e), or §240.16b-3(f) (these are required to be reported on Form 4); (2) any exercise or conversion of derivative securities exempt under either §240.16b-3 or §240.16b-6(b) (these are required to be reported on Form 4); (3) any transaction exempt from Section 16(b) of the Act pursuant to §240.16b-3(c), which is exempt from Section 16(a) of the Act; and (4) any transaction exempt from Section 16 of the Act pursuant to another Section 16(a) rule;

* * * * *

(ii) * * * A deemed execution date must be reported in Column 2A of Table I or Column 3A of Table II only if the execution date for the transaction is calculated pursuant to §240.16a-3(g)(2) or §240.16a-3(g)(3).

* * * * *

(b) Beneficial Ownership Reported (Pecuniary Interest)

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* * * * *

(v) * * * Indicate only the name and address of the designated filer in Item 1 of Form 5 and attach a list of the names and addresses (or, if entities, IRS identification numbers instead of addresses) of each other reporting person. * * *

* * * * *

Form 5

* * * * *

Table I - Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

* * * * *

2A. Deemed Execution Date, if any (Month/Day/Year)

* * * * *

Table II - Derivative Securities Acquired, Disposed of, or Beneficially Owned (e.g., puts, calls, warrants, options, convertible securities)

* * * * *

3A. Deemed Execution Date, if any (Month/Day/Year)

* * * * *

By the Commission.

Jill M. Peterson
Assistant Secretary

August 27, 2002

Endnotes

1 We do not edit personal identifying information, such as names or electronic mail addresses, from electronic submissions. You should submit only information that you wish to make available publicly.

2 17 CFR 240.16a-3.

3 17 CFR 240.16a-6.

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4 We adopt a technical amendment to Rule 16a-8(a)(1) [17 CFR 240.16a-8(a)(1)], which defines trusts subject to Section 16, to implement an amendment that we adopted in Exchange Act Release No. 37260 (Jun. 14, 1996) [61 FR 30392]. This amendment provides that a trust is subject to Section 16 only if the trust is a more than ten percent beneficial owner.

5 15 U.S.C. §78a *et seq*.

6 17 CFR 249.103 and 17 CFR 274.202.

7 17 CFR 249.104 and 17 CFR 274.203.

8 17 CFR 249.105.

9 15 U.S.C. 78p.

10 15 U.S.C. 78*l*.

11 15 U.S.C. 78p(a).

12 Rule 3a12-3 [17 CFR 240.3a12-3] provides that securities registered by a foreign private issuer, as defined in Rule 3b-4 [17 CFR 240.3b-4] are exempt from Section 16. The legislative and regulatory actions addressed in this release do not change this exemption.

13 As defined in Section 206B of the Gramm-Leach-Bliley Financial Modernization Act of 1999, as amended by H.R. 4577, P. L. No. 106-554, 114 Stat. 2763.

14 P. L. No. 107-204, 116 Stat. 745.

15 Section 16(a)(2)(C) (15 U.S.C. 78p(a)(2)(C)), as amended by the Act. Section 30(h) of the Investment Company Act of 1940 (15 U.S.C. 80a-29(h)) provides that "Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of outstanding securities (other than short-term paper) of which a registered closed-end company is the issuer or who is an officer, director, member of an advisory board, investment adviser, or affiliated person of an investment adviser of such a company shall in respect of his transactions in any securities of such company (other than short-term paper) be subject to the same duties and liabilities as those imposed by section 16 of the Securities Exchange Act of 1934 upon certain beneficial owners, directors, and officers in respect of their transactions in certain equity securities." Accordingly, the Act's amendments also accelerate the deadline for change of beneficial ownership reports required pursuant to Section 30(h).

16 For example, if a transaction is executed any time on Tuesday, September 3, the Form 4 will be due by the close of business (5:30 p.m. Eastern time) at the Commission on Thursday, September 5. Because the Act does not change the due date for Form 3, situations may arise where a reporting person is required to file a Form 4 before the Form 3 is due. In this situation,

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we encourage the reporting person to file the Form 3 along with the Form 4 at the time the Form 4 is due.

17 Exchange Act Release No. 46313 (Aug. 6, 2002) [67 FR 51900]. Comment letters relating to that release refer to File No. S7-31-02. Comment letters are available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, NW, Washington, DC 20549. Electronically submitted comment letters are posted on the Commission's Internet Web Site (http://www.sec.gov).

18 15 U.S.C. 78p(b).

19 17 CFR 240.16b-3. Rule 16b-3 is available to exempt transactions between an officer or director and the issuer (including an employee benefit plan sponsored by the issuer), subject to satisfaction of the transaction-specific conditions prescribed by the rule.

20 17 CFR 249.105. Form 5 is due within 45 days after the issuer's fiscal year end.

21 In Exchange Act Release No. 46313 we stated that we also would consider calculating the deadline differently for a transaction pursuant to a single market order that is executed over more than one day, but not to exceed a specified number of days. Because we believe that it is feasible to report these transactions as they are executed, we are not modifying the calculation of the statutory two-business day deadline for these transactions.

22 17 CFR 240.10b5-1(c).

23 "Discretionary Transaction" is defined in Rule 16b-3(b)(1).

24 However, we request comment in Section IV, below, as to whether there are other types of transactions that require regulatory changes to make it feasible for insiders to report them within the two-business day deadline.

25 This obligation is set forth in Item 405 of Regulations S-K and S-B [17 CFR 229.405 and 17 CFR 228.405, respectively], and is required disclosure in the annual report on Form 10-K [17 CFR 249.310] or Form 10-KSB [17 CFR 249.310b] and the proxy statement for the annual meeting at which directors are to be elected [17 CFR 240.14a-101, Item 7].

26 See revised Form 4 General Instruction 1(a), and Items 4 and 5.

27 See revised Form 4 General Instructions 3(a)(i), 3(a)(ii), 3(a)(iii), and 4(a)(i), Table I column 5 and Table II column 9. Reporting holdings following the reported transaction(s) will satisfy the statutory requirement to report "ownership by the filing person at the date of filing" set forth in amended Section 16(a)(3)(B). In keeping with current practice, insiders will reflect changes in holdings resulting from transactions exempt from Section 16(a) in the holdings column of the next otherwise required Form 4 or 5 filed to report a transaction in securities of the same class. See Section IV.A of Exchange Act Release No. 37260. An insider may rely in good faith on the

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last plan statement in reporting holdings pursuant to 401(k) plans and other Rule 16b-3(c) exempt plans.

28 See revised Form 4 General Instruction 4(a)(i), and amended Rules 16a-3(f)(1)(i)(A), and 16a-3(g)(1), discussed in Section II.B, below, and amended Rule 16a-6(a), discussed below in this section.

29 See Section II.B, below.

30 See revised Form 4 General Instruction 4(a)(ii).

31 See revised Form 5 General Instruction 4(a)(ii).

32 See revised Form 5 General Instruction 4(a)(i)(A). We also adopt technical amendments to Form 3 General Instruction 5(b)(v), Form 4 General Instruction 4(b)(v) and Form 5 General Instruction 4(b)(v) to omit references to furnishing the Social Security Numbers of natural persons, consistent with the amendments we adopted in Securities Act Release No. 7424 (Jun. 25, 1997) [62 FR 35338].

33 As currently provided in Rule 16a-6(a), a small acquisition is an "acquisition of an equity security not exceeding $10,000 in market value, or of the right to acquire such securities[.]" The conditions for deferring reporting to Form 5 are set forth in Rules 16a-6(a)(1) and 16a-6(a)(2).

34 Rule 16a-6(b).

35 Rule 16a-6(a).

36 Rules 16a-3(f)(1)(i)(A) and 16a-3(g)(1). Rule 16a-3(g)(1) also is amended to conform with the statute by providing that Form 4 must be filed before the end of the second business day following the day on which the subject transaction has been executed.

37 "Form 8-K Disclosure of Certain Management Transactions," Securities Act Release No. 8090, Exchange Act Release No. 45742 (Apr. 12, 2002) [67 FR 19914, at 19920] ("Form 8-K Release"). As we stated in Exchange Releae No. 46313, in light of the statutory amendments to Section 16(a), we do not intend to consider further our proposed amendments to require companies to report on Form 8-K directors' and executive officers' transactions in company equity securities. However, we continue to consider the other amendments we proposed in the Form 8-K Release. These proposed amendments would require companies to disclose information about (1) directors' and executive officers' arrangements intended to satisfy the affirmative defense conditions of Exchange Act Rule 10b5-1(c) and (2) company loans and loan guarantees to directors and executive officers that are not prohibited by Section 402 of the Act.

38 The amendment does not affect the Rule 16b-3 exemptive conditions applicable to these types of transactions, or the reporting status of any other transactions addressed by Rule 16a-3(f)(1).

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39 The current requirements of Rule 16a-3(f)(1)(i)(A) to report on Form 4 exercises and conversions of derivative securities that are exempt from Section 16(b) short-swing profit recovery under either Rule 16b-3 or Rule 16b-6(b) [17 CFR 240.16b-6(b)] will continue.

40 Reporting on Form 5 of other transactions as to which deferred reporting is currently available or for which an insider failed to file a required report remains available. At their option, filing persons may continue to report earlier on Form 4 transactions that are reportable on Form 5, as provided by former Rule 16a-3(g)(2). We redesignate this rule as Rule 16a-3(g)(5) [17 CFR 240.16a-3(g)(5)] and restate it in plain English.

41 Rule 10b5-1 provides that a person trades "on the basis of" material nonpublic information when the person purchases or sells securities while aware of material nonpublic information. However, Rule 10b5-1(c) establishes affirmative defenses that permit a person to trade in circumstances where it is clear that the information was not a factor in the decision to trade. See Securities Act Release No. 7881, Exchange Act Release No. 43154 (Aug. 15, 2000) [65 FR 51716], adopting Rule 10b5-1.

42 A "Discretionary Transaction," which is defined in Rule 16b-3(b)(1), involves an intra-plan transfer of previously invested assets into or out of a plan issuer securities fund, or a cash-out from a plan issuer securities fund.

43 Such an instruction can be in the form of a limit order.

44 Rules 16a-3(g)(2) and 16a-3(g)(4) [17 CFR 240.16a-3(g)(2) and 17 CFR 240.16a-3(g)(4)].

45 Rules 16a-3(g)(3) and 16a-3(g)(4) [17 CFR 240.16a-3(g)(3) and 17 CFR 240.16a-3(g)(4)].

46 As described in Section II.A above, we are adding a column to both Tables I and II on Form 4 to report the deemed date of execution, so investors and members of the Commission staff reading the form will be able to see the applicable date for calculating the due date. We are adding the same column to Form 5, so that form will provide the same information if the transaction is reported on Form 5 because the reporting person failed to file the required Form 4.

47 This may require modification of routine procedures, particularly with respect to employee benefit plans.

48 Rule 16a-3(g)(4).

49 17 CFR 240.10b-10, which requires broker-dealers to disclose specified information in writing to customers at or before completion of a transaction.

50 It is possible, however, that an electronic confirmation provided to a customer could satisfy the requirements of Rule 10b-10 as well as notification for Section 16(a) reporting purposes.

51 "Qualified Plan" is defined in Rule 16b-3(b)(4). "Excess Benefit Plan" is defined in Rule 16b-3(b)(2). "Stock Purchase Plan" is defined in Rule 16b-3(b)(5). Rule 16a-3(f)(1)(i)(B) exempts

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these transactions from Section 16(a) reporting) because Rule 16b-3(c) exempts them from Section 16(b) short-swing profit recovery.

52 Rule 16a-11 [17 CFR 240.16a-11] exempts these acquisitions from Sections 16(a) and 16(b), if the conditions of the rule are met.

53 Section 16(a)(4), as amended by the Act.

54 Securities Act Release No. 7803 (Feb. 25, 2000) [65 FR 11507].

55 For classes of securities listed on the New York Stock Exchange, the American Stock Exchange and the Chicago Stock Exchange, filing Section 16(a) reports on EDGAR satisfies the requirements of Section 16(a)(1) (as amended) and Rule 16a-3(c) to file the reports with the exchange on which the securities are listed. See staff no-action letters to New York Stock Exchange (Jul. 22, 1998), American Stock Exchange (Jul. 22, 1998) and Chicago Stock Exchange (Jan. 13, 1998).

56 Form ID [17 CFR 239.63] is on our website at (http://www.sec.gov/about/forms/formid.pdf). These forms should be sent by facsimile to the Commission at (202) 504-2474 or (703) 914-4240.

57 See 5 U.S.C. §553(b).

58 *Id*.

59 In the release where we announced that we would consider adopting final rules no later than August 29, 2002, we invited public comment on the implementation of the legislative provisions relating to Section 16(a). Exchange Act Release No. 46313 (Aug. 6, 2002) [67 FR 51900].

60 We previously solicited comment on this regulatory action in "Form 8-K Disclosure of Certain Management Transactions," Securities Act Release No. 8090, Exchange Act Release No. 45742 (Apr. 12, 2002) [67 FR 19914, at 19920].

61 Exchange Act Release No. 37260 (Jun. 14, 1996) [61 FR 30392].

62 Securities Act Release No. 7424 (Jun. 25, 1997) [62 FR 35338].

63 See 5 U.S.C. §553(d).

64 *Id*.

65 This finding also satisfies the requirements of 5 U.S.C. §808(2), allowing the rules to become immediately effective notwithstanding the requirements of 5 U.S.C. §801 (if the agency finds that notice and public procedure are "impractical, unnecessary, or contrary to the public interest," the rule "shall take effect at such time as the Federal agency promulgating the rule determines").

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66 The addition of a column on each table — which requires only a date and will be used only for certain narrowly-defined transactions — is a *de minimis* change.

67 15 U.S.C. §78w(a)(2).

68 15 U.S.C. §78c(f).

69 15 U.S.C. §80a-2(c).

70 5 U.S.C. §§601 - 612.

71 5 U.S.C. §603(a).

72 See Section V, above.

73 15 U.S.C. §78c(b).

74 15 U.S.C. §78w(a).

75 15 U.S.C. §79q(a).

http://www.sec.gov/rules/final/34-46421.htm

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Corporate Governance Rule Proposals

Reflecting Recommendations from the

NYSE Corporate Accountability and Listing Standards Committee

As Approved by the NYSE Board of Directors August 1, 2002

The following is the principal text of the rule filing submitted by the Exchange to the Securities and Exchange Commission on August 15, 2002. It includes the proposed corporate governance standards, as well as the related changes made to certain other Exchange rules. It also includes the summary of the written comments received by the Exchange on the June 6, 2002 Report and recommendations of the Corporate Accountability and Listing Standards Committee. This summary of comments is a required part of the rule filing submitted to the SEC. The rule filing is subject to review and approval by the SEC, which includes an additional public comment period.

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The New York Stock Exchange (the "Exchange" or "NYSE") has long pioneered advances in corporate governance. The NYSE has required companies to comply with listing standards for nearly 150 years, and has periodically amended and supplemented those standards when the evolution of our capital markets has demanded enhanced governance standards or disclosure. Now, in the aftermath of the "meltdown" of significant companies due to failures of diligence, ethics and controls, the NYSE has the opportunity – and the responsibility – once again to raise corporate governance and disclosure standards.

On February 13, 2002, Securities and Exchange Commission ("SEC") Chairman Harvey Pitt asked the Exchange to review its corporate governance listing standards. In conjunction with that request, the NYSE appointed a Corporate Accountability and Listing Standards Committee (the "Committee") to review the NYSE's current listing standards, along with recent proposals for reform, with the goal of enhancing the accountability, integrity and transparency of the Exchange's listed companies.

The Committee believed that the Exchange could best fulfill this goal by building upon the strength of the NYSE and its listed companies in the areas of corporate governance and disclosure. This approach recognizes that new prohibitions and mandates, whether adopted by the NYSE, the SEC or Congress, cannot guarantee that directors, officers and employees will always give primacy to the ethical pursuit of shareholders' best interests. The system depends upon the competence and integrity of corporate directors, as it is their responsibility to diligently oversee management while adhering to unimpeachable ethical standards. The Exchange now seeks to strengthen checks and balances and give diligent directors better tools to empower them and encourage excellence. In seeking to empower and encourage the many good and honest people that serve NYSE-listed companies and their shareholders as directors, officers and employees, the Exchange seeks to avoid recommendations that would undermine their energy, autonomy and responsibility.

The proposed new corporate governance listing requirements are designed to further the ability of honest and well-intentioned directors, officers and employees to perform their functions effectively. The resulting proposals will also allow shareholders to more easily and efficiently monitor the performance of companies and directors in order to reduce instances of lax and unethical behavior.

In preparing the recommendations it made to the NYSE Board, the Committee had the benefit of the testimony of 17 witnesses and written submissions from 21 organizations or interested individuals. The Committee also examined the excellent governance practices that many NYSE-listed companies have long followed. In addition, the Committee reviewed extensive commentary recommending improvement in corporate governance and disclosure, statements by the President of the United States and members of his Cabinet, as well as pending SEC proposals and legislation introduced in Congress.

On June 6, 2002, the Committee submitted its Report and initial recommendations to the NYSE Board of Directors.[1] President Bush, SEC Chairman Harvey Pitt, members of Congress, CEOs of listed companies, institutional investors and state pension funds, organizations such as the Business Roundtable and the Council of Institutional Investors, and leading academics and commentators expressed strong support for the Committee's initiatives. The Committee also received insightful and practical suggestions for the improvement of its recommendations from

[1] Report of the NYSE Corporate Accountability and Listing Standards Committee, June 6, 2002.

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experts within the NYSE, listed companies, institutional investors, outside organizations and interested individuals. In addition to many face-to-face meetings and telephone calls, the Exchange received over 300 comment letters.

Many of the commentators argued for, or sought, guidance from the Exchange at a level of detail inconsistent with the role that the Committee was asked to fulfill. However, where appropriate the Committee reflected cogent comments in clarifications and modifications to its recommendations.

The proposals for new corporate governance listing standards for companies listed on the Exchange will be codified in a new section 303A of the Exchange's Listed Company Manual.[2]

The standards in Section 303A will apply to all companies listing common stock on the Exchange, and to business organizations in non-corporate form such as limited partnerships, business trusts and REITs. However, consistent with past practice regarding corporate governance standards, the Exchange does not apply such standards to passive business organizations in the form of trusts (such as royalty trusts), nor does it apply them to derivatives and special purpose securities such as those described in Sections 703.16, 703.19, 703.20 and 703.21 of the Listed Company Manual. The Exchange has traditionally applied its corporate governance standards to listed closed-end management companies. The Exchange considers the significantly expanded standards and requirements provided for in Section 303A to be unnecessary for closed-end management companies given the pervasive federal regulation applicable to them. However, closed-end management companies will be required to continue to comply with the audit committee requirements, as they are enhanced and expanded in subsections 6 and 7 of Section 303A.

Regarding the effective date of these new standards, companies that do not already have majority-independent boards will need time to recruit qualified independent directors. Accordingly, all listed companies are required to achieve majority-independence within 24 months of the date this standard is approved by the SEC. Companies listing in conjunction with their initial public offering must comply within 24 months of listing. Companies listing upon transfer from another market will have 24 months from the date of transfer in which to comply with this standard to the extent the market on which they were listed did not have the same requirement. To the extent the other market has a substantially similar requirement but also had a transition period from the effective date of the rule, which period had not yet expired, the company will have at least as long a transition period as would have been available to it on the other market. Companies will have the same 24-month period to comply with the new

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[2] In its Report to the NYSE Board the Committee set forth basic principles followed in many cases by explanation and clarification. We are adopting the recommendations as standards in substantially the form they were made by the Committee and adopted by the NYSE Board. Accordingly, the format used will state a basic principle, with the additional explanation and clarifications included as "commentary". Readers are advised that the words "must" and "should" have been chosen with care when used. The use of the word "must" indicates a standard or practice with which companies are required to comply. The use of the word "should" indicates a standard or practice that the Exchange believes is appropriate for most if not all companies, but failure to employ or comply with such standard or practice will not constitute a violation of NYSE standards.

While many of the requirements set forth in this new rule are relatively specific, the Exchange is articulating a philosophy and approach to corporate governance that companies are expected to carry out as they apply the requirements to the specific facts and circumstances that they confront from time to time. Companies and their boards are expected to apply the requirements carefully and in good faith, making reasonable interpretations as necessary, and disclosing the interpretations that they make.

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qualification standards applicable to audit committee members. As a general matter, the existing audit committee requirements provided for in Section 303 of the Manual shall continue to apply to NYSE listed companies pending the transition to the new rules.

While the above time periods are needed to recruit directors, the Exchange believes that listed companies, IPOs and transfers can much more quickly implement the other requirements of Section 303A. Certain provisions can be applied as soon as the SEC approves the filing, and this will be the case for stockholder approval of equity compensation plans specified in subsection 8 of Section 303A, and the related amendment to NYSE Rule 452 regarding broker voting of uninstructed shares. The provision for a public reprimand letter in subsection 12 of Section 303A will also be effective upon approval.

The remaining requirements can also be implemented quickly, although companies may need a modest period in which to do the work. Accordingly, all the following will be required within six months from SEC approval:

- Provide for executive sessions of non-management directors (subsection 3);
- Establish nomination and compensation committees with the requisite charters (subsections 4 and 5);
- Increase authority and responsibility of the audit committee, adopt the required audit committee charter, and establish an internal audit function (subsection 7);
- Adopt corporate governance guidelines and a code of business conduct and ethics (subsections 9 and 10);
- Foreign private issuer description of significant differences from NYSE standards (subsection 11); and
- CEO certification of compliance with listing standards (subsection 12).

Once those six months are expired, we will expect all newly listed companies, both IPOs and transfers, to have provided for these requirements by the time of listing on the Exchange.

This leaves only the issue of having nominating and compensation committees that are comprised solely of independent directors. The 24-month rubric will apply here, although we will require companies to have at least one independent director on each such committee within 12, rather than 24, months.

What follows are the requirements as proposed to be codified in Section 303A of the Listed Company Manual:

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Section 303A

1. Listed companies must have a majority of independent directors.

Commentary: Effective boards of directors exercise independent judgment in carrying out their responsibilities. Requiring a majority of independent directors will increase the quality of board oversight and lessen the possibility of damaging conflicts of interest.

A company of which more than 50% of the voting power is held by an individual, a group or another company need not have a majority of independent directors on its board or have nominating/corporate governance and compensation committees composed of independent directors.[3] A controlled company that chooses to take advantage of this exemption must disclose in its annual meeting proxy that it is a controlled company and the basis for that determination. However, all controlled companies must have at least a minimum three person audit committee composed entirely of independent directors, and otherwise comply with the audit committee requirements provided for in this Section 303A.

2. In order to tighten the definition of "independent director" for purposes of these standards:

(a) No director qualifies as "independent" unless the board of directors affirmatively determines that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company). Companies must disclose these determinations.

Commentary: It is not possible to anticipate, or explicitly to provide for, all circumstances that might signal potential conflicts of interest, or that might bear on the materiality of a director's relationship to a listed company. Accordingly, it is best that boards making "independence" determinations broadly consider all relevant facts and circumstances. In particular, when assessing the materiality of a director's relationship with the company, the board should consider the issue not merely from the standpoint of the director, but also from that of persons or organizations with which the director has an affiliation. Material relationships can include commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships (among others). However, as the concern is independence from management, the Exchange does not view ownership of even a significant amount of stock, by itself, as a bar to an independence finding.

The basis for a board determination that a relationship is not material must be disclosed in the company's annual proxy statement. In this regard, a board may adopt and disclose categorical standards to assist it in making determinations of independence and may make a general disclosure if a director meets these standards. Any determination of independence for a director who does not meet these standards must be specifically explained. For example, a board might disclose its determination that affiliation with a customer whose business accounts for less than a specified percentage of the company's revenues is, as a category, immaterial for purposes of determining independence. A company must disclose any standard it adopts. It may then make the general statement that the independent directors meet the standards set by the board without detailing particular aspects of the immaterial relationships between individual directors and the company. In the event that a director with a business or other relationship that does not fit within

[3] The Exchange notes that this exemption will affect a small percentage of its listed companies.

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the disclosed standards is determined to be independent, a board must disclose the basis for its determination. This approach provides investors with an adequate means of assessing the quality of a board's independence and its independence determinations while avoiding excessive disclosure of immaterial relationships.

(b) In addition:

(i) No director who is a former employee of the listed company can be "independent" until five years after the employment has ended.

Commentary: A director who serves as an interim Chairman or CEO may be excluded from the definition of a "former employee" and thus be deemed independent immediately after his or her service as interim Chairman or CEO ends.

(ii) No director who is, or in the past five years has been, affiliated with or employed by a (present or former) auditor of the company (or of an affiliate) can be "independent" until five years after the end of either the affiliation or the auditing relationship.

(iii) No director can be "independent" if he or she is, or in the past five years has been, part of an interlocking directorate in which an executive officer of the listed company serves on the compensation committee of another company that concurrently employs the director.

(iv) Directors with immediate family members in the foregoing categories are likewise subject to the five-year "cooling-off" provisions for purposes of determining "independence."

Commentary: Employment of a family member in a non-officer[4] position does not preclude a board from determining that a director is independent. Such employment arrangements are common and do not present a categorical threat to director independence. In addition, if an executive officer dies or becomes incapacitated, his or her immediate family members may be classified as independent immediately after such death or determination of incapacity, provided that they themselves are otherwise independent. An "immediate family member" includes a person's spouse, parents, children, siblings, mothers and fathers-in-law, sons and daughters-in-law, brothers and sisters-in-law, and anyone (other than employees) who shares such person's home.

3. To empower non-management directors to serve as a more effective check on management, the non-management directors of each company must meet at regularly scheduled executive sessions without management.

Commentary: To promote open discussion among the non-management directors, companies must schedule regular executive sessions in which those directors meet without management participation. ("Non-management" directors are all those who are not company officers, and includes such directors who are not independent by virtue of a material relationship, former status or family membership, or for any other reason.) Regular scheduling of such meetings is

[4] The Exchange notes that consistent with its current practice, the term "officer" is defined in Section 301 of the Listed Company Manual, as amended hereby, to have to meaning specified in the SEC Rule 16a-1(f), 17 CFR 240.16a-1(f). This same definition is found in the current Listed Company Manual in Section 303.02(E).

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important not only to foster better communication among non-management directors, but also to prevent any negative inference from attaching to the calling of executive sessions. There need not be a single presiding director at all executive sessions of the non-management directors. If one director is chosen to preside at these meetings, his or her name must be disclosed in the annual proxy statement. Alternatively, a company may disclose the procedure by which a presiding director is selected for each executive session. For example, a company may wish to rotate the presiding position among the chairs of board committees. In order that interested parties may be able to make their concerns known to the non-management directors, a company must disclose a method for such parties to communicate directly with the presiding director or with the non-management directors as a group.

4. (a) Listed companies must have a nominating/corporate governance committee composed entirely of independent directors.

(b) The nominating/corporate governance committee must have a written charter that addresses:

(i) the committee's purpose – which, at minimum, must be to: identify individuals qualified to become board members, and to select, or to recommend that the board select, the director nominees for the next annual meeting of shareholders; and develop and recommend to the board a set of corporate governance principles applicable to the corporation.

(ii) the committee's goals and responsibilities – which must reflect, at minimum, the board's criteria for selecting new directors, and oversight of the evaluation of the board and management.

(iii) an annual performance evaluation of the committee.

Commentary: A nominating/corporate governance committee is central to the effective functioning of the board. New director and board committee nominations are among a board's most important functions. Placing this responsibility in the hands of an independent nominating/corporate governance committee can enhance the independence and quality of nominees. The committee is also responsible for taking a leadership role in shaping the corporate governance of a corporation.

If a company is legally required by contract or otherwise to provide third parties with the ability to nominate directors (for example, preferred stock rights to elect directors upon a dividend default, shareholder agreements, and management agreements), the selection and nomination of such directors need not be subject to the nominating committee process.

The nominating/corporate governance committee charter should also address the following items: committee member qualifications; committee member appointment and removal; committee structure and operations (including authority to delegate to subcommittees); and committee reporting to the board. In addition, the charter should give the nominating/corporate governance committee sole authority to retain and terminate any search firm to be used to identify director candidates, including sole authority to approve the search firm's fees and other retention terms.

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Boards may allocate the responsibilities of the nominating/corporate governance committee, and the compensation committee described in subsection 5 hereof to committees of their own denomination, provided that the committees are composed entirely of independent directors. Any such committee must have a published committee charter. To avoid any confusion, the functions specified in subsection 7 hereof as belonging to the audit committee may not be allocated to a different committee.

As noted in subsection 1 of this Section 303A, controlled companies need not comply with the requirements of this subsection 4.

5. (a) Listed companies must have a compensation committee composed entirely of independent directors.

(b) The compensation committee must have a written charter that addresses:

(i) the committee's purpose – which, at minimum, must be to discharge the board's responsibilities relating to compensation of the company's executives, and to produce an annual report on executive compensation for inclusion in the company's proxy statement, in accordance with applicable rules and regulations.

(ii) the committee's duties and responsibilities – which, at minimum, must be to:

(A) review and approve corporate goals and objectives relevant to CEO compensation, evaluate the CEO's performance in light of those goals and objectives, and set the CEO's compensation level based on this evaluation.

(B) make recommendations to the board with respect to incentive-compensation plans and equity-based plans.

(iii) an annual performance evaluation of the compensation committee.

Commentary: In determining the long-term incentive component of CEO compensation, the committee should consider the company's performance and relative shareholder return, the value of similar incentive awards to CEOs at comparable companies, and the awards given to the listed company's CEO in past years. To avoid confusion, note that the compensation committee is not precluded from approving awards (with the ratification of the board) as may be required to comply with applicable tax laws (i.e., Rule 162(m)).[5]

The compensation committee charter should also address the following items: committee member qualifications; committee member appointment and removal; committee structure and operations (including authority to delegate to subcommittees); and committee reporting to the board.

Additionally, if a compensation consultant is to assist in the evaluation of director, CEO or senior executive compensation, the compensation committee charter should give that committee sole authority to retain and terminate the consulting firm, including sole authority to approve the firm's fees and other retention terms.

[5] 26 U.S.C. §162(m) (2002).

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As noted in subsection 1 of this Section 303A, controlled companies need not comply with the requirements of this subsection 5.

6. Add to the "independence" requirement for audit committee membership the requirement that director's fees are the only compensation an audit committee member may receive from the company.

Commentary: The Exchange will continue to require each company to have a minimum three person audit committee composed entirely of independent directors. Each member of the committee must be financially literate, as such qualification is interpreted by the company's board in its business judgment, or must become financially literate within a reasonable period of time after his or her appointment to the audit committee. In addition, at least one member of the audit committee must have accounting or related financial management expertise, as the company's board interprets such qualification in its business judgment.[6]

While it is not the audit committee's responsibility to certify the company's financial statements or to guarantee the auditor's report, the committee stands at the crucial intersection of management, independent auditors, internal auditors and the board of directors. The Exchange supports additional directors' fees to compensate audit committee members for the significant time and effort they expend to fulfill their duties as audit committee members, but does not believe that any member of the audit committee should receive any compensation other than such director's fees from the company. If a director satisfies the definition of "independent director" (as provided in subsection 2 of this Section 303A), then his or her receipt of a pension or other form of deferred compensation from the company for prior service (provided such compensation is not contingent in any way on continued service) will not preclude him or her from satisfying the requirement that director's fees are the only form of compensation he or she receives from the company.

An audit committee member may receive his or her fee in cash and/or company stock or options or other in-kind consideration ordinarily available to directors, as well as all of the regular benefits that other directors receive. Because of the significantly greater time commitment of audit committee members, they may receive reasonable compensation greater than that paid to the other directors (as may other directors for other time-consuming committee work). Disallowed compensation for an audit committee member includes fees paid directly or indirectly for services as a consultant or a legal or financial advisor, regardless of the amount. Disallowed compensation also includes compensation paid to such a director's firm for such

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[6] Prior to the adoption of the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002), the Committee had recommended that the audit committee chair be required to have accounting or financial management expertise. However, in light of the express provision in the Sarbanes-Oxley Act that at least one member of the audit committee qualify as a "financial expert," and the existing NYSE requirements that at least one member of the audit committee have "accounting or related financial management expertise," and that all members of the audit committee be financially literate, the Exchange has determined to await the SEC's interpretation of the definition of "financial expert" before acting on this recommendation. See Section 407 of the Sarbanes-Oxley Act and Section 303.01(B)(2)(b) of the Listed Company Manual.

The Committee Report of June 6, 2002 addressed the issue of the potential conflict of interest between a controlling shareholder and the public shareholders in the context of audit committees by recommending that an affiliate of a 20% or greater shareholder may be a non-voting member of the audit committee. In view of the provision of the Sarbanes-Oxley Act of 2002 disqualifying affiliated persons from service on the audit committee, the Board determined not to propose this provision at this time. See Section 301 of the Sarbanes-Oxley Act.

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consulting or advisory services even if the director is not the actual service provider. Disallowed compensation is not intended to include ordinary compensation paid in another customer or supplier or other business relationship that the board has already determined to be immaterial for purposes of its basic director independence analysis. To eliminate any confusion, note that this requirement pertains only to audit committee qualification and not to the independence determinations that the board must make for other directors.

Because of the audit committee's demanding role and responsibilities, and the time commitment attendant to committee membership, each prospective audit committee member should evaluate carefully the existing demands on his or her time before accepting this important assignment. Additionally, if an audit committee member simultaneously serves on the audit committee of more than three public companies, and the NYSE-listed company does not limit the number of audit committees on which its audit committee members serve, then in each case, the board must determine that such simultaneous service would not impair the ability of such member to effectively serve on the listed company's audit committee and disclose such determination in the annual proxy statement.

7. (a) Increase the authority and responsibilities of the audit committee, including granting it the sole authority to hire and fire independent auditors, and to approve any significant non-audit relationship with the independent auditors.

(b) The audit committee must have a written charter that addresses:

(i) the committee's purpose – which, at minimum, must be to:

(A) assist board oversight of (1) the integrity of the company's financial statements, (2) the company's compliance with legal and regulatory requirements, (3) the independent auditor's qualifications and independence, and (4) the performance of the company's internal audit function and independent auditors; and

(B) prepare the report that SEC rules require be included in the company's annual proxy statement.

(ii) the duties and responsibilities of the audit committee – which, at minimum, must be to:

(A) retain and terminate the company's independent auditors (subject, if applicable, to shareholder ratification).

<u>Commentary:</u> In connection with this requirement, the audit committee must have the sole authority to approve all audit engagement fees and terms, as well as all significant non-audit engagements with the independent auditors. This requirement does not preclude the committee from obtaining the input of management, but these responsibilities may not be delegated to management.

(B) at least annually, obtain and review a report by the independent auditor describing: the firm's internal quality-control procedures; any material issues raised by the most recent internal quality-control review, or peer review, of the firm, or by any inquiry or investigation by governmental or

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professional authorities, within the preceding five years, respecting one or more independent audits carried out by the firm, and any steps taken to deal with any such issues; and (to assess the auditor's independence) all relationships between the independent auditor and the company.

Commentary: After reviewing the foregoing report and the independent auditor's work throughout the year, the audit committee will be in a position to evaluate the auditor's qualifications, performance and independence. This evaluation should include the review and evaluation of the lead partner of the independent auditor. In making its evaluation, the audit committee should take into account the opinions of management and the company's internal auditors (or other personnel responsible for the internal audit function). In addition to assuring the regular rotation of the lead audit partner as required by law, the audit committee should further consider whether, in order to assure continuing auditor independence, there should be regular rotation of the audit firm itself. The audit committee should present its conclusions with respect to the independent auditor to the full board.

(C) discuss the annual audited financial statements and quarterly financial statements with management and the independent auditor, including the company's disclosures under "Management's Discussion and Analysis of Financial Condition and Results of Operations."

(D) discuss earnings press releases, as well as financial information and earnings guidance provided to analysts and rating agencies.

Commentary: The audit committee's responsibility to discuss earnings releases as well as financial information and earnings guidance may be done generally (i.e., discussion of the types of information to be disclosed and the type of presentation to be made). The audit committee need not discuss in advance each earnings release or each instance in which a company may provide earnings guidance.

(E) as appropriate, obtain advice and assistance from outside legal, accounting or other advisors.

Commentary: In the course of fulfilling its duties, the audit committee may wish to consult with independent advisors. The audit committee must be empowered to retain these advisors without seeking board approval.

(F) discuss policies with respect to risk assessment and risk management.

Commentary: While it is the job of the CEO and senior management to assess and manage the company's exposure to risk, the audit committee must discuss guidelines and policies to govern the process by which this is handled. The audit committee should discuss the company's major financial risk exposures and the steps management has taken to monitor and control such exposures. The audit committee is not required to be the sole body responsible for risk assessment and management, but, as stated above, the committee must discuss guidelines and policies to govern the process by which risk assessment and management is undertaken. Many companies, particularly financial companies, manage and assess their risk through mechanisms other than the audit committee. The processes these companies have in place should be reviewed in a general manner by the audit committee, but they need not be replaced by the audit committee.

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(G) meet separately, periodically, with management, with internal auditors (or other personnel responsible for the internal audit function) and with independent auditors.

Commentary: To perform its oversight functions most effectively, the audit committee must have the benefit of separate sessions with management, the independent auditors and those responsible for the internal audit function. As noted herein, all NYSE listed companies must have an internal audit function. These separate sessions may be more productive than joint sessions in surfacing issues warranting committee attention.

(H) review with the independent auditor any audit problems or difficulties and management's response.

Commentary: The audit committee must regularly review with the independent auditor any difficulties the auditor encountered in the course of the audit work, including any restrictions on the scope of the independent auditor's activities or on access to requested information, and any significant disagreements with management. Among the items the audit committee may want to review with the auditor are: any accounting adjustments that were noted or proposed by the auditor but were "passed" (as immaterial or otherwise); any communications between the audit team and the audit firm's national office respecting auditing or accounting issues presented by the engagement; and any "management" or "internal control" letter issued, or proposed to be issued, by the audit firm to the company. The review should also include discussion of the responsibilities, budget and staffing of the company's internal audit function.

(I) set clear hiring policies for employees or former employees of the independent auditors.

Commentary: Employees or former employees of the independent auditor are often valuable additions to corporate management. Such individuals' familiarity with the business, and personal rapport with the employees, may be attractive qualities when filling a key opening. However, the audit committee should set hiring policies taking into account the pressures that may exist for auditors consciously or subconsciously seeking a job with the company they audit.

(J) report regularly to the board of directors.

Commentary: The audit committee should review with the full board any issues that arise with respect to the quality or integrity of the company's financial statements, the company's compliance with legal or regulatory requirements, the performance and independence of the company's independent auditors, or the performance of the internal audit function.

(iii) an annual performance evaluation of the audit committee.

Commentary: While the fundamental responsibility for the company's financial statements and disclosures rests with management and the independent auditor, the audit committee must review: (A) major issues regarding accounting principles and financial statement presentations, including any significant changes in the company's selection or application of accounting principles, and major issues as to the adequacy of the company's internal controls and any special audit steps adopted in light of material control deficiencies; (B) analyses prepared by management and/or the independent auditor setting forth significant financial reporting issues and judgments made in connection with the preparation of the financial statements, including

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analyses of the effects of alternative GAAP methods on the financial statements; (C) the effect of regulatory and accounting initiatives, as well as off-balance sheet structures, on the financial statements of the company; and (D) earnings press releases (paying particular attention to any use of "pro forma," or "adjusted" non-GAAP, information), as well as financial information and earnings guidance provided to analysts and rating agencies.

(c) Each listed company must have an internal audit function.

Commentary: This requirement does not necessarily mean that a company must establish a separate internal audit department or dedicate employees to the task on a full-time basis; it is enough for a company to have in place an appropriate control process for reviewing and approving its internal transactions and accounting. A company may choose to outsource this function to a firm other than its independent auditor.

8. To increase shareholder control over equity-compensation plans, shareholders must be given the opportunity to vote on all equity-compensation plans, except inducement options, plans relating to mergers or acquisitions, and tax qualified and excess benefit plans.

Commentary: Equity-compensation plans can help align shareholder and management interests, and equity-based awards have become very important components of employee compensation. In order to provide checks and balances on the process of earmarking shares to be used for equity-based awards, and to provide shareholders a voice regarding the resulting dilution, the Exchange requires that all equity-compensation plans, and any material revisions to the terms of such plans (including the repricing of existing options), be subject to stockholder approval.

There are certain types of plans, however, which are appropriately exempt from this requirement. Employment inducement awards and option plans acquired in corporate acquisitions and mergers will not be subject to shareholder approval under this rule. The Exchange recognizes the urgency that may attach to the granting of options in the inducement or merger or acquisition context and the resulting impracticality of obtaining a shareholder vote in these situations. Because inducement awards and mergers or acquisitions are not routine occurrences, and are not likely to be abused, the Exchange does not consider that these exceptions alter the fundamental policy involved in this standard. Similarly, any plan intended to meet the requirements of Section 401(a)[7] or 423[8] of the Internal Revenue Code, as amended (e.g., ESOPs) or the definition of an "excess benefit plan" within the meaning of Section 3(36)[9] of the Employee Retirement Income Security Act is exempt from the shareholder approval requirement. Tax qualified equity purchase plans such as Section 401(a) plans and Section 423 plans are already regulated under internal revenue regulations which, in some cases, require shareholder approval. In the limited instances in which shareholder approval for these plans is not required, the transactions in which shares are acquired from and issued under the plans in question are either not dilutive to existing shareholders (i.e., the shares are not purchased at a discount to market price) or must be "expensed" (i.e., treated as a compensation expense). An

[7] 26 U.S.C. §401(a) (1988).

[8] 26 U.S.C. §423 (1988).

[9] 29 U.S.C. §1002 (1999).

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excess benefit plan is a plan that is designed to work in parallel with a related qualified plan, to provide those benefits that exceed the limitation imposed by the Code on qualified plans.

In the circumstances in which equity compensation plans are not subject to shareholder approval, the plans must be subject to the approval of the company's compensation committee.[10]

In addition, the Exchange will preclude its member organizations from giving a proxy to vote on equity-compensation plans unless the beneficial owner of the shares has given voting instructions. This is codified in NYSE Rule 452.[11]

9. Listed companies must adopt and disclose corporate governance guidelines.

Commentary: No single set of guidelines would be appropriate for every company, but certain key areas of universal importance include director qualifications and responsibilities, responsibilities of key board committees, and director compensation. Given the importance of corporate governance, each listed company's website must include its corporate governance guidelines, the charters of its most important committees (including at least the audit, compensation and nominating committees) and the company's code of business conduct and ethics (see subsection 10 below). Each company's annual report must state that the foregoing information is available on its website, and that the information is available in print to any shareholder who requests it. Making this information publicly available should promote better investor understanding of the company's policies and procedures, as well as more conscientious adherence to them by directors and management.

The following subjects must be addressed in the corporate governance guidelines:

- **Director qualification standards.** These standards should, at minimum, reflect the independence requirements set forth in subsections 1 and 2 of this Section 303A. Companies may also address other substantive qualification requirements, including policies limiting the number of boards on which a director may sit, and director tenure, retirement and succession.

- **Director responsibilities.** These responsibilities should clearly articulate what is expected from a director, including basic duties and responsibilities with respect to attendance at board meetings and advance review of meeting materials.

- **Director access to management and, as necessary and appropriate, independent advisors.**

- **Director compensation.** Director compensation guidelines should include general principles for determining the form and amount of director compensation (and for reviewing those principles, as appropriate). The board should be aware that questions as to directors' independence may be raised when directors' fees and emoluments exceed what is customary. Similar concerns may be raised when the company makes substantial

[10] For the sake of clarity, the Exchange notes that its traditional "treasury stock exception" will no longer be available with respect to this requirement.

[11] The NYSE will establish a working group to advise with respect to the need for, and design of, mechanisms to facilitate implementation of the proposal that brokers may not vote on equity compensation plans presented to shareholders without instructions from the beneficial owners. This will not delay the immediate effectiveness of the broker-may-not-vote proposal.

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charitable contributions to organizations in which a director is affiliated, or enters into consulting contracts with (or provides other indirect forms of compensation to) a director. The board should critically evaluate each of these matters when determining the form and amount of director compensation, and the independence of a director.

- **Director orientation and continuing education.**

- **Management succession.** Succession planning should include policies and principles for CEO selection and performance review, as well as policies regarding succession in the event of an emergency or the retirement of the CEO.

- **Annual performance evaluation of the board.** The board should conduct a self-evaluation at least annually to determine whether it and its committees are functioning effectively.

10. Listed companies must adopt and disclose a code of business conduct and ethics for directors, officers and employees, and promptly disclose any waivers of the code for directors or executive officers.

Commentary: No code of business conduct and ethics can replace the thoughtful behavior of an ethical director, officer or employee. However, such a code can focus the board and management on areas of ethical risk, provide guidance to personnel to help them recognize and deal with ethical issues, provide mechanisms to report unethical conduct, and help to foster a culture of honesty and accountability.

Each code of business conduct and ethics must require that any waiver of the code for executive officers or directors may be made only by the board or a board committee and must be promptly disclosed to shareholders. This disclosure requirement should inhibit casual and perhaps questionable waivers, and should help assure that, when warranted, a waiver is accompanied by appropriate controls designed to protect the company. It will also give shareholders the opportunity to evaluate the board's performance in granting waivers.

Each code of business conduct and ethics must also contain compliance standards and procedures that will facilitate the effective operation of the code. These standards should ensure the prompt and consistent action against violations of the code.

Each company may determine its own policies, but all listed companies should address the most important topics, including the following:

- **Conflicts of interest.** A "conflict of interest" occurs when an individual's private interest interferes in any way – or even appears to interfere – with the interests of the corporation as a whole. A conflict situation can arise when an employee, officer or director takes actions or has interests that may make it difficult to perform his or her company work objectively and effectively. Conflicts of interest also arise when an employee, officer or director, or a member of his or her family, receives improper personal benefits as a result of his or her position in the company. Loans to, or guarantees of obligations of, such persons are of special concern. The company should have a policy prohibiting such conflicts of interest, and providing a means for employees, officers and directors to communicate potential conflicts to the company.

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- **Corporate opportunities.** Employees, officers and directors should be prohibited from (a) taking for themselves personally opportunities that are discovered through the use of corporate property, information or position; (b) using corporate property, information, or position for personal gain; and (c) competing with the company. Employees, officers and directors owe a duty to the company to advance its legitimate interests when the opportunity to do so arises.

- **Confidentiality.** Employees, officers and directors should maintain the confidentiality of information entrusted to them by the company or its customers, except when disclosure is authorized or legally mandated. Confidential information includes all non-public information that might be of use to competitors, or harmful to the company or its customers, if disclosed.

- **Fair dealing.** Each employee, officer and director should endeavor to deal fairly with the company's customers, suppliers, competitors and employees. None should take unfair advantage of anyone through manipulation, concealment, abuse of privileged information, misrepresentation of material facts, or any other unfair-dealing practice.

- **Protection and proper use of company assets.** All employees, officers and directors should protect the company's assets and ensure their efficient use. Theft, carelessness and waste have a direct impact on the company's profitability. All company assets should be used for legitimate business purposes.

- **Compliance with laws, rules and regulations (including insider trading laws).** The company should proactively promote compliance with laws, rules and regulations, including insider trading laws. Insider trading is both unethical and illegal, and should be dealt with decisively.

- **Encouraging the reporting of any illegal or unethical behavior.** The company should proactively promote ethical behavior. The company should encourage employees to talk to supervisors, managers or other appropriate personnel when in doubt about the best course of action in a particular situation. Additionally, employees should report violations of laws, rules, regulations or the code of business conduct to appropriate personnel. To encourage employees to report such violations, the company must ensure that employees know that the company will not allow retaliation for reports made in good faith.

11. Listed foreign private issuers must disclose any significant ways in which their corporate governance practices differ from those followed by domestic companies under NYSE listing standards.

Commentary: Both SEC rules and NYSE policies have long recognized that foreign private issuers differ from domestic companies in the regulatory and disclosure regimes and customs they follow, and that it is appropriate to accommodate those differences. For this reason, the NYSE for many years has permitted listed non-U.S. companies to follow home-country practices with respect to a number of corporate governance matters, such as the audit committee requirement and the NYSE shareholder approval and voting rights rules. While the NYSE will continue to respect different approaches, listed foreign private issuers must make their U.S. investors aware of the significant ways in which their home-country practices differ from those followed by domestic companies under NYSE listing standards. However, listed foreign private issuers are not required to present a detailed, item-by-item analysis of these differences. Such a

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disclosure would be long and unnecessarily complicated. Moreover, this requirement is not intended to suggest that one country's corporate governance practices are better or more effective than another. The Exchange simply believes that U.S. shareholders should be aware of the significant ways that the governance of a listed foreign private issuer differs from that of a U.S. listed company. The Exchange underscores that what is required is a brief, general summary of the significant differences, not a cumbersome analysis.[12]

Listed foreign private issuers may provide this disclosure either on their web site (provided it is in the English language and accessible from the U.S.) and/or in their annual report as distributed to shareholders in the U.S. (again, in the English language). If the disclosure is only made available on the web site, the annual report shall so state and provide the web address at which the information may be obtained.

12. Each listed company CEO must certify to the NYSE each year that he or she is not aware of any violation by the company of NYSE corporate governance listing standards.

Commentary: The CEO's annual certification to the NYSE that he or she is unaware of any violation by the company of NYSE corporate governance listing standards will focus the CEO and senior management on the company's compliance with the listing standards.[13] Both this certification to the NYSE, and any CEO/CFO certifications required to be filed with the SEC regarding the quality of the company's public disclosure, must be disclosed in the listed company's annual report to shareholders.

13. The NYSE may issue a public reprimand letter to any listed company that violates an NYSE listing standard.

Commentary: Suspending trading in or delisting a company can be harmful to the very shareholders that the NYSE listing standards seek to protect; the NYSE must therefore use these measures sparingly and judiciously. For this reason it is appropriate for the NYSE to have the ability to apply a lesser sanction to deter companies from violating its corporate governance (or other) listing standards. Accordingly, the NYSE may issue a public reprimand letter to a company that it determines has violated an NYSE listing standard. For companies that repeatedly or flagrantly violate NYSE listing standards, suspension and delisting remain the ultimate penalties. For clarification, this lesser sanction is not intended for use in the case of

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[12] The NYSE will work with its counterparts throughout the world to strive for harmony in corporate governance principles, with the goal of establishing global principles to be implemented by global companies no matter where those companies are based.

[13] The Committee's original recommendations to the NYSE Board included a CEO certification that the company had established procedures for verifying the accuracy and completeness of the information provided to investors, that those procedures had been carried out, that the CEO had no reasonable cause to believe that the information provided to investors is not accurate and complete in all material respects, and that the CEO had reviewed with the company's board those procedures and the company's compliance with them. Given the recent SEC emergency order and the provisions of the Sarbanes-Oxley Act regarding CEO certifications relating to the quality of financial disclosure, the Committee recommended, and the NYSE agreed, that there was no purpose to requiring under NYSE rules a similar but separate certification regarding a company's public disclosure. See File No. 4-460: Order Requiring the Filing of Sworn Statements Pursuant to Section 21(a)(1) of the Securities Exchange Act of 1934 (June 27, 2002) and Sections 302 and 906 of the Sarbanes-Oxley Act. The Committee noted to the NYSE Board that there has been a great deal of concern expressed by commentators regarding the additional potential liability created by the various certification proposals and the Committee recommended, and the NYSE agreed, that the SEC should have exclusive authority to enforce the requirement of a CEO and CFO certification and that no certification should give rise to private rights of action.

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companies that fall below the financial and other continued listing standards provided in Chapter 8 of the Listed Company Manual. The processes and procedures provided for in Chapter 8 will continue to govern the treatment of companies falling below those standards.

* * * *

Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants or Others

Overview

Widespread Support for the Recommendations. The vast majority of commentators, including listed companies, institutional investors, and other interested organizations and individuals enthusiastically embraced the Committee's recommendations for new corporate governance and listing standards for the NYSE.

Concerns of Smaller Companies. While most large companies, law firms and institutions expressed general support for the proposals, commentators who characterized themselves as smaller businesses voiced concern. All of these companies complained that the recommendations seem to have been structured for a large-company model, without taking into account the disproportionate impact the proposed rules would have on smaller companies. In particular, they argued that the Committee's recommendations for separate nominating and compensation committees, together with its requirement of majority-independent boards, combined to effectively require that smaller companies enlarge their relatively small boards. These constituents were particularly concerned with the increased costs that compliance with the recommendations would entail. They argued that this will cause the diversion of shareholder value to unrelated third parties and the misdirection of board and management time and effort from productive to bureaucratic activities.

Difficulty of Obtaining Independent Directors. Several large companies expressed concern that the new rules will make it more difficult for companies to find quality independent directors because of the increased responsibilities and time commitment that the rules will require of independent directors (especially audit committee members), as well as a perceived increase in such directors' exposure to liability.

Majority-Independent Boards

Many commentators applauded the recommendation that listed companies be required to maintain majority-independent boards. However, numerous constituents, large and small, raised concerns that the requirement would have a variety of adverse consequences.

A. Controlled Companies

Most prominently, more than half of the commenting companies noted that the majority-independent board requirement would create insuperable difficulties for companies controlled by a shareholder or parent company. They argued that the rule would be inequitable as applied to them in that it would deprive a majority holder of its shareholder rights; unnecessary in that the

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Committee's other recommendations (in particular the independent committee and disclosure requirements) would adequately protect minority shareholders; and undesirable in that it would reduce access to capital markets by discouraging spin-offs, by inducing some currently public companies to go private rather than lose control of their subsidiary, and by discouraging those who manage buyout funds and venture capital funds from using initial public offerings and NYSE listings as a means for achieving liquidity and raising capital. One company argued that the majority-independent board requirement would vitiate the ability of a parent to effectively manage its subsidiary, in the process denying to shareholders of the parent the benefits associated with its controlling stake in the subsidiary and requiring them instead to transfer control of the subsidiary to third parties.

Similarly, commentators suggested that companies that are majority-owned by officers and directors should be exempt from this recommendation. One such company argued that where corporate insiders own a majority of the stock of a company, the interests of outside minority shareholders can be adequately protected by the proposed requirement of an independent compensation committee. Family-owned companies also expressed concern with the majority-independence requirement because the proposal would limit the families' involvement with the board.

The provision in subsection 1 of Section 303A exempting controlled companies from the requirements to have a majority independent board and independent nominating and compensation committees is intended to address these concerns.

B. Shareholder Agreements and Multiple Classes of Stock

Companies with multiple classes of securities, some of which have a right of representation on the board, argued that they should not have to meet the majority-independence requirement because doing so would be in direct conflict with their equity structure and the shareholder rights embedded therein.

Companies with multiple classes of stock representing different constituencies also had difficulty with this recommendation. One company that recently gave organized labor the right to appoint a director to the board as part of a collective bargaining agreement requested that the NYSE allow grandfathering of such arrangements. This company noted that compliance with this recommendation would effect a retroactive change in the bargains that brought about these arrangements and might trigger stockholder approval requirements.

The Exchange clarified in subsection 4 of Section 303A that the selection and nomination of such directors need not be subject to the nominating committee process.

Tighter "Independent Director" Definition

Most commentators were in favor of tightening the definition of "independence," with only a quarter advocating the continued use of existing standards. Certain institutional investors praised with particular emphasis the five-year look-back on compensation committee interlocks. However, commentators have raised several general questions, described below, as well as numerous specific questions with respect to materiality determinations.

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A. Share Ownership

Many commentators expressed a desire for additional clarification of the interaction between share ownership and independence.

Several commentators opposed viewing any degree of share ownership as a *per se* bar to "independence" (absent such other factors as an employment relationship or other financial or personal tie to the company). They argued that directors who own or represent institutions that own very significant economic stakes in the listed companies are often effective guardians of shareholders' interests not only as members of the full board but also of compensation and nominating committees, while directors whose only stake in the membership on the board is the director's fee may be unduly loyal to management. Several venture capitalists raised a similar concern that they will run afoul of the new independence definition, even though venture capitalists, acting as fiduciaries to funds with significant shareholdings, typically have all the qualities that the independent director definition is intended to ensure.

The question of the impact of ownership on independence was particularly vexing to companies with listed subsidiaries. They were concerned that a director who is deemed independent with respect to a parent company may not be considered independent with respect to the parent-controlled subsidiary.

The Exchange has clarified in subsection 2 of Section 303A that, since the concern is independence from management, ownership of even a significant amount of stock, by itself, is not necessarily a bar to an independence finding.

B. Safe Harbors for Independence Determinations

Several financial institutions specifically applauded the committee's recommendation that non-materiality determinations be made on a case-by-case basis and publicly disclosed and justified. However, a number of companies objected to the affirmative determination requirement, requesting that the NYSE specify a safe harbor for materiality. These companies cite the competing demands on the board's time and attention; the likelihood that the "no material relationship" requirement will unduly shrink the pool of qualified directorship candidates; and the possibility that the fact-specific inquiry required will expose directors to additional scrutiny and potential liability, which they may be unwilling to assume without additional compensation and/or protection.

Many commentators would like to be able to fulfill their affirmative determination requirement through the establishment of their own safe harbors. For example, one commentator attached a detailed safe harbor proposal covering various types of credit transactions. In addition, a vast majority of commenting banks and financial institutions asked for clarification regarding the treatment of loans to directors. In light of the existing regulatory framework that controls relationships between a bank and its directors and affiliated entities, banks desired to establish categorically that arm's-length loans to directors do not negate independence.

Numerous companies and organizations argue that if there are no material relationships, the NYSE should allow the statement of reasons for the board's determination of independence to be omitted from the proxy statement, and suggest that the rules should not require details of each relationship regardless of size.

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The Exchange has clarified in subsection 2 of Section 303A that categorical standards are permissible.

C. Five-Year Cooling-Off Period

More than half of the companies commenting on this issue protested that five years is too long, advocating a two-to-three year period instead. Five companies, reflecting their individual circumstances, requested an exemption for interim CEOs who have served for less than one year. One commentator objected to subjecting all former employees to the cooling-off period, recommending that the prohibition be limited to former executive officers only.

Several commentators agreed with the five-year period for former employees, but found the period too long with respect to compensation committee interlocking directorates. Notably, one company thought that the five-year look-back on interlocking directorates would strain parent-subsidiary relations. Likewise, one parent of a controlled public subsidiary expressed its belief that its executives should be able to sit on the subsidiary's compensation committee to ensure that subsidiary's compensation policies are compatible with those of its parent. In addition, a few companies asked whether the inquiry ends by examining the present and past relationships at companies where directors are currently employed, or if one must search back for possible interlocks at companies that may have since been acquired or dissolved – pointing out that with the immediate family overlay to the rule, the latter inquiry could become extremely cumbersome.

Several financial institutions (along with several smaller companies) took issue with the blanket exclusion of family members for five years. One company argued that when a family member's relationship has terminated, there should be independence. Another commentator recommended that relatives of deceased or disabled former officers be classified as independent as long as they themselves have no financial involvement other than ownership in the company.

The Exchange has clarified several of these issues with specified provisions in subsection 2(b) of Section 303A.

<u>Non-Management Executive Sessions</u>

The great majority of the commentators objected to the executive session requirement, to the requirement to designate and disclose a presiding director for such sessions, or to both. They argued that the sessions (a) were unnecessary because the mandated audit, compensation and nominating committees would provide sufficient checks; (b) would bifurcate the board into two tiers, turning management directors into second-class directors; and (c) would deprive directors of guidance by management. In addition, they argued that mandating such sessions could result in mechanical, pro forma meetings.

The majority of commentators argued that the presiding director requirement would have a divisive effect. In addition, they argued that the requirement would deprive the board of needed flexibility; they would like the NYSE to allow any independent director to preside over a given executive session. Some commentators also complained that the presiding director requirement amounts to the NYSE's mandating separation of the roles of Chairman and CEO. (Conversely, one non-U.S. company urged the NYSE to require the designation of a "lead director", or to mandate separation of these roles.) One organization suggested that the NYSE should instead require that the corporate governance guidelines specify procedures for the

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selection of a chair for each executive session. Even commentators who did not vigorously object to the recommendation that a presiding director be designated objected to the requirement that such designation be publicly disclosed.

The Exchange has clarified in subsection 3 of Section 303A that no designation of a "lead director" is intended, and that companies have some flexibility in how they provide for conduct of the executive sessions.

General Comments on the Committee Requirements

More than half of all commentators thought that boards should have the flexibility to divide responsibilities among committees differently than as contemplated in the Report. In addition, a number of commentators were concerned that the recommendations have a tendency to blur the line between the roles of the board and management, involving the board too deeply in the day-to-day operations of listed companies.

A substantial number of commentators argued that the board as a whole should be allowed to retain its major oversight responsibilities, such as decisions on nominating director candidates, adopting governance guidelines, adopting incentive plans, and hiring outside consultants.

One company suggested that, as with the majority-independent director requirement, there should be a 24-month transition period for the requirements that audit, compensation and nominating committees be comprised entirely of independent directors.

The Exchange has clarified in subsection 4 of Section 303A that the nomination/corporate governance and compensation committee responsibilities may be allocated to other or different committees, as long as they have published charters.

Independent Nomination/Corporate Governance Committee

Approximately one-fifth of the commenting companies thought that nominating committees should not have to consist solely of independent directors, some arguing that a majority of non-management directors would be sufficient, some requesting that at least one insider be allowed on the nominating committee. Some commentators suggested that a nominating committee is not necessary.

Independent Compensation Committee

There was opposition to this recommendation from several companies. One company argued that the full board should set the salary of the CEO. Similarly, several commentators commented that although the procedure for determining CEO compensation could originate from the compensation committee, the results of the compensation committee's work should be presented to the entire board, with ultimate decision-making responsibility residing in the board as a whole. Another company objected to the committee's exclusive role in evaluation of CEO and senior executive compensation on the ground that management should be free to explore new compensation arrangements with consultants.

Audit Committee Member Qualification

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There was a broad call from attorneys, associations and companies alike for clarification on the question of what constitutes "directors' fees." Questions arose in particular with respect to pension and other deferred compensation, long-term incentive awards, and compensation in the form of company products, use of company facilities and participation in plans available generally to the listed company's employees.

Several companies and law firms objected to the recommendation that audit committee members' fees be limited solely to directors' fees, arguing that this would reduce a company's access to its directors' expertise and suggesting instead a more liberal restriction, such as an annual cap on consulting fees.

The Exchange has clarified this issue in commentary to subsection 6 of Section 303A.

Though one institutional investor specifically applauded the 20% ownership ceiling for voting participation in the audit committee, approximately ten commentators objected on the ground that this would disqualify certain types of large shareholders, such as venture capital investors, who may be excellent audit committee members.

The requirement that the chair of the audit committee have accounting or related financial management expertise drew opposition from a number of commentators who felt that it was enough for one member of the committee to have such expertise. Several companies protested that the requirement unduly limits the number of candidates available to chair the audit committee and unnecessarily dictates which member should be chair.

As noted, the Exchange did not make proposals in these two areas in view of provisions in the recently adopted Sarbanes-Oxley legislation.

Audit Committee Charter

The majority of commentators were concerned about the capacity of the audit committee to handle the list of responsibilities assigned to it by the recommendation. There were also numerous requests for clarification as to whether the recommendation mandates review of all 10-Qs, press releases, and disclosures to analysts on a case-by-case basis, or whether the audit committee's task is rather to set policy with regard to the form of the financials in those releases. Commentators emphasized that the former alternative would be overly burdensome to the audit committee, would tie management's hands to the point where it would not be able to respond to analyst calls without first obtaining approval from the audit committee and would ultimately chill the distribution of information to the public.

The Exchange has clarified this issue in its commentary to subsection 7(b)(ii)(D) of Section 303A.

About a quarter of the commentators objected to the recommendation that sole authority to retain and terminate independent auditors be granted to the audit committee, suggesting that the entire board should be able to act on the recommendation of the audit committee and arguing that this would not pose any governance problems in light of the majority-independence requirement.

Some commentators rejected wholesale the committee's enumeration of minimum duties and responsibilities for the audit committee, arguing, for example, that the board should have the flexibility to allocate responsibility for the oversight of compliance with legal and regulatory

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requirements as it deems appropriate, and that the audit committee should not be obligated to assist board oversight of such compliance. Several commentators objected to the recommendation's requirement that the audit committee discuss policies with respect to risk assessment and management. For example, one company has a risk committee devoted solely to this purpose and would like the requirement to accommodate such arrangements.

The Exchange has clarified this issue in commentary to subsection 7(b)(ii)(F) of Section 303A.

Some commentators requested that the audit committee be allowed to delegate to a member or subcommittee some of the proposed responsibilities, particularly the review of guidance given to analysts and earnings releases, on the ground that without such delegation the roster of duties was too burdensome.

A few commentators pointed out that it was unclear whether and to what extent there would be an internal audit requirement.

The Exchange has clarified this matter in subsection 7(c) of Section 303A.

<u>Shareholder Vote on Equity Compensation Plans</u>

This recommendation received particular support from the institutional investor community. They urged the NYSE Board not to dilute either the shareholder vote requirement or the broker vote prohibition. However, numerous constituents expressed concerns about both recommendations.

A. Shareholder Approval

More than half of the larger companies, financial institutions and associations that commented on this issue maintained that only plans that offer options to officers and/or directors should be subject to shareholder approval. Many companies argued that subjecting broad-based equity compensation plans to the shareholder approval requirement would lessen their ability to compensate rank-and-file employees with stock options, putting NYSE-listed companies at a competitive disadvantage in the labor market. They urged that the board should be able to adopt stock option plans for non-executive employees without shareholder approval; some suggested instead a requirement that all plans be approved by an independent compensation committee.

Some commentators advocated exceptions for inducement awards or new hire grants (citing competitive employment markets) and tax-qualified plan awards (citing the alternative regulatory framework provided by the tax code), subject perhaps to approval by the independent compensation committee. One company suggested that there should be an exemption for situations where full-value stock is used to deliver an award that would otherwise be paid in cash. Another company noted that some plans are part of collective bargaining arrangements and urged that these be excluded from the shareholder approval requirement.

In addition, there were a number of detailed questions regarding plans approved prior to effectiveness of the new rules, amendments to plans, and plans run by an acquired company.

The Exchange has clarified that inducement options, plans acquired in mergers, and tax qualified plans would be exempt, but all other plans would require shareholder approval.

B. Elimination of Broker Voting

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The institutional investor community gave strong support to this proposal. Many large companies, however, strongly urged the NYSE to maintain its existing rules, fearing primarily the increased proxy costs and increased uncertainty that the proposed change would entail. Large and small companies alike cited quorum difficulties and solicitation expenses that result when brokers are not allowed to vote uninstructed shares after a 10-day period. One such commentator warned that because of retail investor confusion about voting mechanics, there is a risk that the elimination of the discretionary broker vote will disenfranchise investors if not accompanied by an aggressive and vigorous program to educate them about how to vote their shares. Many commentators also expressed concern that institutional shareholders may simply vote their shares in accordance with strict internal or third-party guidelines or policies, rather than giving each plan individual consideration. One organization suggested proportional or mirror voting by brokers of uninstructed shares.

Required Adoption and Disclosure of Corporate Governance Guidelines

A number of commentators argued that companies should have broader discretion in drafting their governance guidelines.

Required Adoption and Disclosure of a Code of Business Conduct and Ethics

Many of those who commented on this recommendation urged that only material waivers of the business ethics policy be required to be disclosed.

Disclosure by Foreign Private Issuers

Two commentators urged tougher treatment of foreign companies, with one suggesting that exemptions from listing requirements for foreign private issuers should be the exception rather than the rule.

CEO Certification

More than half of the commenting companies and organizations opposed this recommendation. The overwhelming majority of comments protested that the requirement would duplicate the recent SEC rules requiring CEO certification for periodic reports. They opposed the expansion of the certification requirement to all statements made by the company to investors and urged the NYSE to defer final action on this subject until the SEC issues a final rule, or to coordinate its action on this issue with the SEC, so as to avoid different standards by different regulatory bodies. Some commentators suggested language enabling the CEO to rely on the CFO, external auditors, internal auditors, the audit committee, inside and outside counsel and other consultants in making his certification.

A few commentators expressed concern that the recommendation raised potential for pernicious private litigation and urged the NYSE to make clear that the certification requirement, if adopted, creates no private cause of action.

The Exchange has decided not to require its own CEO certification of financials in light of the certifications required by the Sarbanes-Oxley legislation and SEC rules.

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Public Reprimand Letter from NYSE

Several companies stressed the importance of providing offenders with due process through notice and an opportunity to cure prior to any public reprimand.

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Exhibit A-1

Text of the Proposed Rule Change
(All language is new)

Listed Company Manual

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303.00 Corporate Governance Standards

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303A

1. Listed companies must have a majority of independent directors.

Commentary: Effective boards of directors exercise independent judgment in carrying out their responsibilities. Requiring a majority of independent directors will increase the quality of board oversight and lessen the possibility of damaging conflicts of interest.

A company of which more than 50% of the voting power is held by an individual, a group or another company need not have a majority of independent directors on its board or have nominating/corporate governance and compensation committees composed of independent directors. A controlled company that chooses to take advantage of this exemption must disclose in its annual meeting proxy that it is a controlled company and the basis for that determination. However, all controlled companies must have at least a minimum three person audit committee composed entirely of independent directors, and otherwise comply with the audit committee requirements provided for in this Section 303A.

2. In order to tighten the definition of "independent director" for purposes of these standards:

(a) No director qualifies as "independent" unless the board of directors affirmatively determines that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company). Companies must disclose these determinations.

Commentary: It is not possible to anticipate, or explicitly to provide for, all circumstances that might signal potential conflicts of interest, or that might bear on the materiality of a director's relationship to a listed company. Accordingly, it is best that boards making "independence" determinations broadly consider all relevant facts and circumstances. In particular, when assessing the materiality of a director's relationship with the company, the board should consider the issue not merely from the standpoint of the director, but also from that of persons or organizations with which the director has an affiliation. Material relationships can include commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships (among others). However, as the concern is independence from management, the Exchange does not view ownership of even a significant amount of stock, by itself, as a bar to an independence finding.

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The basis for a board determination that a relationship is not material must be disclosed in the company's annual proxy statement. In this regard, a board may adopt and disclose categorical standards to assist it in making determinations of independence and may make a general disclosure if a director meets these standards. Any determination of independence for a director who does not meet these standards must be specifically explained. For example, a board might disclose its determination that affiliation with a customer whose business accounts for less than a specified percentage of the company's revenues is, as a category, immaterial for purposes of determining independence. A company must disclose any standard it adopts. It may then make the general statement that the independent directors meet the standards set by the board without detailing particular aspects of the immaterial relationships between individual directors and the company. In the event that a director with a business or other relationship that does not fit within the disclosed standards is determined to be independent, a board must disclose the basis for its determination. This approach provides investors with an adequate means of assessing the quality of a board's independence and its independence determinations while avoiding excessive disclosure of immaterial relationships.

(b) In addition:

(i) No director who is a former employee of the listed company can be "independent" until five years after the employment has ended.

Commentary: A director who serves as an interim Chairman or CEO may be excluded from the definition of a "former employee" and thus be deemed independent immediately after his or her service as interim Chairman or CEO ends.

(ii) No director who is, or in the past five years has been, affiliated with or employed by a (present or former) auditor of the company (or of an affiliate) can be "independent" until five years after the end of either the affiliation or the auditing relationship.

(iii) No director can be "independent" if he or she is, or in the past five years has been, part of an interlocking directorate in which an executive officer of the listed company serves on the compensation committee of another company that concurrently employs the director.

(iv) Directors with immediate family members in the foregoing categories are likewise subject to the five-year "cooling-off" provisions for purposes of determining "independence."

Commentary: Employment of a family member in a non-officer position does not preclude a board from determining that a director is independent. Such employment arrangements are common and do not present a categorical threat to director independence. In addition, if an executive officer dies or becomes incapacitated, his or her immediate family members may be classified as independent immediately after such death or determination of incapacity, provided that they themselves are otherwise independent. An "immediate family member" includes a person's spouse, parents, children, siblings, mothers and fathers-in-law, sons and daughters-in-law, brothers and sisters-in-law, and anyone (other than employees) who shares such person's home.

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3. To empower non-management directors to serve as a more effective check on management, the non-management directors of each company must meet at regularly scheduled executive sessions without management.

Commentary: To promote open discussion among the non-management directors, companies must schedule regular executive sessions in which those directors meet without management participation. ("Non-management" directors are all those who are not company officers, and includes such directors who are not independent by virtue of a material relationship, former status or family membership, or for any other reason.) Regular scheduling of such meetings is important not only to foster better communication among non-management directors, but also to prevent any negative inference from attaching to the calling of executive sessions. There need not be a single presiding director at all executive sessions of the non-management directors. If one director is chosen to preside at these meetings, his or her name must be disclosed in the annual proxy statement. Alternatively, a company may disclose the procedure by which a presiding director is selected for each executive session. For example, a company may wish to rotate the presiding position among the chairs of board committees. In order that interested parties may be able to make their concerns known to the non-management directors, a company must disclose a method for such parties to communicate directly with the presiding director or with the non-management directors as a group.

4. (a) Listed companies must have a nominating/corporate governance committee composed entirely of independent directors.

(b) The nominating/corporate governance committee must have a written charter that addresses:

(i) the committee's purpose – which, at minimum, must be to: identify individuals qualified to become board members, and to select, or to recommend that the board select, the director nominees for the next annual meeting of shareholders; and develop and recommend to the board a set of corporate governance principles applicable to the corporation.

(ii) the committee's goals and responsibilities – which must reflect, at minimum, the board's criteria for selecting new directors, and oversight of the evaluation of the board and management.

(iii) an annual performance evaluation of the committee.

Commentary: A nominating/corporate governance committee is central to the effective functioning of the board. New director and board committee nominations are among a board's most important functions. Placing this responsibility in the hands of an independent nominating/corporate governance committee can enhance the independence and quality of nominees. The committee is also responsible for taking a leadership role in shaping the corporate governance of a corporation.

If a company is legally required by contract or otherwise to provide third parties with the ability to nominate directors (for example, preferred stock rights to elect directors upon a dividend default, shareholder agreements, and management agreements), the selection and nomination of such directors need not be subject to the nominating committee process.

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The nominating/corporate governance committee charter should also address the following items: committee member qualifications; committee member appointment and removal; committee structure and operations (including authority to delegate to subcommittees); and committee reporting to the board. In addition, the charter should give the nominating/corporate governance committee sole authority to retain and terminate any search firm to be used to identify director candidates, including sole authority to approve the search firm's fees and other retention terms.

Boards may allocate the responsibilities of the nominating/corporate governance committee, and the compensation committee described in subsection 5 hereof to committees of their own denomination, provided that the committees are composed entirely of independent directors. Any such committee must have a published committee charter. To avoid any confusion, the functions specified in subsection 7 hereof as belonging to the audit committee may not be allocated to a different committee.

As noted in subsection 1 of this Section 303A, controlled companies need not comply with the requirements of this subsection 4.

5. (a) Listed companies must have a compensation committee composed entirely of independent directors.

(b) The compensation committee must have a written charter that addresses:

(i) the committee's purpose – which, at minimum, must be to discharge the board's responsibilities relating to compensation of the company's executives, and to produce an annual report on executive compensation for inclusion in the company's proxy statement, in accordance with applicable rules and regulations.

(ii) the committee's duties and responsibilities – which, at minimum, must be to:

(A) review and approve corporate goals and objectives relevant to CEO compensation, evaluate the CEO's performance in light of those goals and objectives, and set the CEO's compensation level based on this evaluation.

(B) make recommendations to the board with respect to incentive-compensation plans and equity-based plans.

(iii) an annual performance evaluation of the compensation committee.

Commentary: In determining the long-term incentive component of CEO compensation, the committee should consider the company's performance and relative shareholder return, the value of similar incentive awards to CEOs at comparable companies, and the awards given to the listed company's CEO in past years. To avoid confusion, note that the compensation committee is not precluded from approving awards (with the ratification of the board) as may be required to comply with applicable tax laws (i.e., Rule 162(m)).

The compensation committee charter should also address the following items: committee member qualifications; committee member appointment and removal; committee structure and operations (including authority to delegate to subcommittees); and committee reporting to the board.

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Additionally, if a compensation consultant is to assist in the evaluation of director, CEO or senior executive compensation, the compensation committee charter should give that committee sole authority to retain and terminate the consulting firm, including sole authority to approve the firm's fees and other retention terms.

As noted in subsection 1 of this Section 303A, controlled companies need not comply with the requirements of this subsection 5.

6. Add to the "independence" requirement for audit committee membership the requirement that director's fees are the only compensation an audit committee member may receive from the company.

Commentary: The Exchange will continue to require each company to have a minimum three person audit committee composed entirely of independent directors. Each member of the committee must be financially literate, as such qualification is interpreted by the company's board in its business judgment, or must become financially literate within a reasonable period of time after his or her appointment to the audit committee. In addition, at least one member of the audit committee must have accounting or related financial management expertise, as the company's board interprets such qualification in its business judgment.

While it is not the audit committee's responsibility to certify the company's financial statements or to guarantee the auditor's report, the committee stands at the crucial intersection of management, independent auditors, internal auditors and the board of directors. The Exchange supports additional directors' fees to compensate audit committee members for the significant time and effort they expend to fulfill their duties as audit committee members, but does not believe that any member of the audit committee should receive any compensation other than such director's fees from the company. If a director satisfies the definition of "independent director" (as provided in subsection 2 of this Section 303A), then his or her receipt of a pension or other form of deferred compensation from the company for prior service (provided such compensation is not contingent in any way on continued service) will not preclude him or her from satisfying the requirement that director's fees are the only form of compensation he or she receives from the company.

An audit committee member may receive his or her fee in cash and/or company stock or options or other in-kind consideration ordinarily available to directors, as well as all of the regular benefits that other directors receive. Because of the significantly greater time commitment of audit committee members, they may receive reasonable compensation greater than that paid to the other directors (as may other directors for other time-consuming committee work). Disallowed compensation for an audit committee member includes fees paid directly or indirectly for services as a consultant or a legal or financial advisor, regardless of the amount. Disallowed compensation also includes compensation paid to such a director's firm for such consulting or advisory services even if the director is not the actual service provider. Disallowed compensation is not intended to include ordinary compensation paid in another customer or supplier or other business relationship that the board has already determined to be immaterial for purposes of its basic director independence analysis. To eliminate any confusion, note that this requirement pertains only to audit committee qualification and not to the independence determinations that the board must make for other directors.

Because of the audit committee's demanding role and responsibilities, and the time commitment attendant to committee membership, each prospective audit committee member

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should evaluate carefully the existing demands on his or her time before accepting this important assignment. Additionally, if an audit committee member simultaneously serves on the audit committee of more than three public companies, and the NYSE-listed company does not limit the number of audit committees on which its audit committee members serve, then in each case, the board must determine that such simultaneous service would not impair the ability of such member to effectively serve on the listed company's audit committee and disclose such determination in the annual proxy statement.

7. (a) Increase the authority and responsibilities of the audit committee, including granting it the sole authority to hire and fire independent auditors, and to approve any significant non-audit relationship with the independent auditors.

(b) The audit committee must have a written charter that addresses:

(i) the committee's purpose – which, at minimum, must be to:

(A) assist board oversight of (1) the integrity of the company's financial statements, (2) the company's compliance with legal and regulatory requirements, (3) the independent auditor's qualifications and independence, and (4) the performance of the company's internal audit function and independent auditors; and

(B) prepare the report that SEC rules require be included in the company's annual proxy statement.

(ii) the duties and responsibilities of the audit committee – which, at minimum, must be to:

(A) retain and terminate the company's independent auditors (subject, if applicable, to shareholder ratification).

Commentary: In connection with this requirement, the audit committee must have the sole authority to approve all audit engagement fees and terms, as well as all significant non-audit engagements with the independent auditors. This requirement does not preclude the committee from obtaining the input of management, but these responsibilities may not be delegated to management.

(B) at least annually, obtain and review a report by the independent auditor describing: the firm's internal quality-control procedures; any material issues raised by the most recent internal quality-control review, or peer review, of the firm, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, respecting one or more independent audits carried out by the firm, and any steps taken to deal with any such issues; and (to assess the auditor's independence) all relationships between the independent auditor and the company.

Commentary: After reviewing the foregoing report and the independent auditor's work throughout the year, the audit committee will be in a position to evaluate the auditor's qualifications, performance and independence. This evaluation should include the review and evaluation of the lead partner of the independent auditor. In making its evaluation, the audit

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committee should take into account the opinions of management and the company's internal auditors (or other personnel responsible for the internal audit function). In addition to assuring the regular rotation of the lead audit partner as required by law, the audit committee should further consider whether, in order to assure continuing auditor independence, there should be regular rotation of the audit firm itself. The audit committee should present its conclusions with respect to the independent auditor to the full board.

(C) discuss the annual audited financial statements and quarterly financial statements with management and the independent auditor, including the company's disclosures under "Management's Discussion and Analysis of Financial Condition and Results of Operations."

(D) discuss earnings press releases, as well as financial information and earnings guidance provided to analysts and rating agencies.

Commentary: The audit committee's responsibility to discuss earnings releases as well as financial information and earnings guidance may be done generally (i.e., discussion of the types of information to be disclosed and the type of presentation to be made). The audit committee need not discuss in advance each earnings release or each instance in which a company may provide earnings guidance.

(E) as appropriate, obtain advice and assistance from outside legal, accounting or other advisors.

Commentary: In the course of fulfilling its duties, the audit committee may wish to consult with independent advisors. The audit committee must be empowered to retain these advisors without seeking board approval.

(F) discuss policies with respect to risk assessment and risk management.

Commentary: While it is the job of the CEO and senior management to assess and manage the company's exposure to risk, the audit committee must discuss guidelines and policies to govern the process by which this is handled. The audit committee should discuss the company's major financial risk exposures and the steps management has taken to monitor and control such exposures. The audit committee is not required to be the sole body responsible for risk assessment and management, but, as stated above, the committee must discuss guidelines and policies to govern the process by which risk assessment and management is undertaken. Many companies, particularly financial companies, manage and assess their risk through mechanisms other than the audit committee. The processes these companies have in place should be reviewed in a general manner by the audit committee, but they need not be replaced by the audit committee.

(G) meet separately, periodically, with management, with internal auditors (or other personnel responsible for the internal audit function) and with independent auditors.

Commentary: To perform its oversight functions most effectively, the audit committee must have the benefit of separate sessions with management, the independent auditors and those responsible for the internal audit function. As noted herein, all NYSE listed companies must

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have an internal audit function. These separate sessions may be more productive than joint sessions in surfacing issues warranting committee attention.

(H) review with the independent auditor any audit problems or difficulties and management's response.

Commentary: The audit committee must regularly review with the independent auditor any difficulties the auditor encountered in the course of the audit work, including any restrictions on the scope of the independent auditor's activities or on access to requested information, and any significant disagreements with management. Among the items the audit committee may want to review with the auditor are: any accounting adjustments that were noted or proposed by the auditor but were "passed" (as immaterial or otherwise); any communications between the audit team and the audit firm's national office respecting auditing or accounting issues presented by the engagement; and any "management" or "internal control" letter issued, or proposed to be issued, by the audit firm to the company. The review should also include discussion of the responsibilities, budget and staffing of the company's internal audit function.

(I) set clear hiring policies for employees or former employees of the independent auditors.

Commentary: Employees or former employees of the independent auditor are often valuable additions to corporate management. Such individuals' familiarity with the business, and personal rapport with the employees, may be attractive qualities when filling a key opening. However, the audit committee should set hiring policies taking into account the pressures that may exist for auditors consciously or subconsciously seeking a job with the company they audit.

(J) report regularly to the board of directors.

Commentary: The audit committee should review with the full board any issues that arise with respect to the quality or integrity of the company's financial statements, the company's compliance with legal or regulatory requirements, the performance and independence of the company's independent auditors, or the performance of the internal audit function.

(iii) an annual performance evaluation of the audit committee.

Commentary: While the fundamental responsibility for the company's financial statements and disclosures rests with management and the independent auditor, the audit committee must review: (A) major issues regarding accounting principles and financial statement presentations, including any significant changes in the company's selection or application of accounting principles, and major issues as to the adequacy of the company's internal controls and any special audit steps adopted in light of material control deficiencies; (B) analyses prepared by management and/or the independent auditor setting forth significant financial reporting issues and judgments made in connection with the preparation of the financial statements, including analyses of the effects of alternative GAAP methods on the financial statements; (C) the effect of regulatory and accounting initiatives, as well as off-balance sheet structures, on the financial statements of the company; and (D) earnings press releases (paying particular attention to any use of "pro forma," or "adjusted" non-GAAP, information), as well as financial information and earnings guidance provided to analysts and rating agencies.

(c) Each listed company must have an internal audit function.

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Commentary: This requirement does not necessarily mean that a company must establish a separate internal audit department or dedicate employees to the task on a full-time basis; it is enough for a company to have in place an appropriate control process for reviewing and approving its internal transactions and accounting. A company may choose to outsource this function to a firm other than its independent auditor.

8. To increase shareholder control over equity-compensation plans, shareholders must be given the opportunity to vote on all equity-compensation plans, except inducement options, plans relating to mergers or acquisitions, and tax qualified and excess benefit plans.

Commentary: Equity-compensation plans can help align shareholder and management interests, and equity-based awards have become very important components of employee compensation. In order to provide checks and balances on the process of earmarking shares to be used for equity-based awards, and to provide shareholders a voice regarding the resulting dilution, the Exchange requires that all equity-compensation plans, and any material revisions to the terms of such plans (including the repricing of existing options), be subject to stockholder approval.

There are certain types of plans, however, which are appropriately exempt from this requirement. Employment inducement awards and option plans acquired in corporate acquisitions and mergers will not be subject to shareholder approval under this rule. The Exchange recognizes the urgency that may attach to the granting of options in the inducement or merger or acquisition context and the resulting impracticality of obtaining a shareholder vote in these situations. Because inducement awards and mergers or acquisitions are not routine occurrences, and are not likely to be abused, the Exchange does not consider that these exceptions alter the fundamental policy involved in this standard. Similarly, any plan intended to meet the requirements of Section 401(a) or 423 of the Internal Revenue Code, as amended (e.g., ESOPs) or the definition of an "excess benefit plan" within the meaning of Section 3(36) of the Employee Retirement Income Security Act is exempt from the shareholder approval requirement. Tax qualified equity purchase plans such as Section 401(a) plans and Section 423 plans are already regulated under internal revenue regulations which, in some cases, require shareholder approval. In the limited instances in which shareholder approval for these plans is not required, the transactions in which shares are acquired from and issued under the plans in question are either not dilutive to existing shareholders (i.e., the shares are not purchased at a discount to market price) or must be "expensed" (i.e., treated as a compensation expense). An excess benefit plan is a plan that is designed to work in parallel with a related qualified plan, to provide those benefits that exceed the limitation imposed by the Code on qualified plans.

In the circumstances in which equity compensation plans are not subject to shareholder approval, the plans must be subject to the approval of the company's compensation committee.

In addition, the Exchange will preclude its member organizations from giving a proxy to vote on equity-compensation plans unless the beneficial owner of the shares has given voting instructions. This is codified in NYSE Rule 452.

9. Listed companies must adopt and disclose corporate governance guidelines.

Commentary: No single set of guidelines would be appropriate for every company, but certain key areas of universal importance include director qualifications and responsibilities, responsibilities of key board committees, and director compensation. Given the importance of corporate governance, each listed company's website must include its corporate governance

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guidelines, the charters of its most important committees (including at least the audit, compensation and nominating committees) and the company's code of business conduct and ethics (see subsection 10 below). Each company's annual report must state that the foregoing information is available on its website, and that the information is available in print to any shareholder who requests it. Making this information publicly available should promote better investor understanding of the company's policies and procedures, as well as more conscientious adherence to them by directors and management.

The following subjects must be addressed in the corporate governance guidelines:

- **Director qualification standards.** These standards should, at minimum, reflect the independence requirements set forth in subsections 1 and 2 of this Section 303A. Companies may also address other substantive qualification requirements, including policies limiting the number of boards on which a director may sit, and director tenure, retirement and succession.

- **Director responsibilities.** These responsibilities should clearly articulate what is expected from a director, including basic duties and responsibilities with respect to attendance at board meetings and advance review of meeting materials.

- **Director access to management and, as necessary and appropriate, independent advisors.**

- **Director compensation.** Director compensation guidelines should include general principles for determining the form and amount of director compensation (and for reviewing those principles, as appropriate). The board should be aware that questions as to directors' independence may be raised when directors' fees and emoluments exceed what is customary. Similar concerns may be raised when the company makes substantial charitable contributions to organizations in which a director is affiliated, or enters into consulting contracts with (or provides other indirect forms of compensation to) a director. The board should critically evaluate each of these matters when determining the form and amount of director compensation, and the independence of a director.

- **Director orientation and continuing education.**

- **Management succession.** Succession planning should include policies and principles for CEO selection and performance review, as well as policies regarding succession in the event of an emergency or the retirement of the CEO.

- **Annual performance evaluation of the board.** The board should conduct a self-evaluation at least annually to determine whether it and its committees are functioning effectively.

10. Listed companies must adopt and disclose a code of business conduct and ethics for directors, officers and employees, and promptly disclose any waivers of the code for directors or executive officers.

<u>Commentary:</u> No code of business conduct and ethics can replace the thoughtful behavior of an ethical director, officer or employee. However, such a code can focus the board and management on areas of ethical risk, provide guidance to personnel to help them recognize and deal with

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ethical issues, provide mechanisms to report unethical conduct, and help to foster a culture of honesty and accountability.

Each code of business conduct and ethics must require that any waiver of the code for executive officers or directors may be made only by the board or a board committee and must be promptly disclosed to shareholders. This disclosure requirement should inhibit casual and perhaps questionable waivers, and should help assure that, when warranted, a waiver is accompanied by appropriate controls designed to protect the company. It will also give shareholders the opportunity to evaluate the board's performance in granting waivers.

Each code of business conduct and ethics must also contain compliance standards and procedures that will facilitate the effective operation of the code. These standards should ensure the prompt and consistent action against violations of the code.

Each company may determine its own policies, but all listed companies should address the most important topics, including the following:

- **Conflicts of interest.** A "conflict of interest" occurs when an individual's private interest interferes in any way – or even appears to interfere – with the interests of the corporation as a whole. A conflict situation can arise when an employee, officer or director takes actions or has interests that may make it difficult to perform his or her company work objectively and effectively. Conflicts of interest also arise when an employee, officer or director, or a member of his or her family, receives improper personal benefits as a result of his or her position in the company. Loans to, or guarantees of obligations of, such persons are of special concern. The company should have a policy prohibiting such conflicts of interest, and providing a means for employees, officers and directors to communicate potential conflicts to the company.

- **Corporate opportunities.** Employees, officers and directors should be prohibited from (a) taking for themselves personally opportunities that are discovered through the use of corporate property, information or position; (b) using corporate property, information, or position for personal gain; and (c) competing with the company. Employees, officers and directors owe a duty to the company to advance its legitimate interests when the opportunity to do so arises.

- **Confidentiality.** Employees, officers and directors should maintain the confidentiality of information entrusted to them by the company or its customers, except when disclosure is authorized or legally mandated. Confidential information includes all non-public information that might be of use to competitors, or harmful to the company or its customers, if disclosed.

- **Fair dealing.** Each employee, officer and director should endeavor to deal fairly with the company's customers, suppliers, competitors and employees. None should take unfair advantage of anyone through manipulation, concealment, abuse of privileged information, misrepresentation of material facts, or any other unfair-dealing practice.

- **Protection and proper use of company assets.** All employees, officers and directors should protect the company's assets and ensure their efficient use. Theft, carelessness and waste have a direct impact on the company's profitability. All company assets should be used for legitimate business purposes.

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- **Compliance with laws, rules and regulations (including insider trading laws).** The company should proactively promote compliance with laws, rules and regulations, including insider trading laws. Insider trading is both unethical and illegal, and should be dealt with decisively.

- **Encouraging the reporting of any illegal or unethical behavior.** The company should proactively promote ethical behavior. The company should encourage employees to talk to supervisors, managers or other appropriate personnel when in doubt about the best course of action in a particular situation. Additionally, employees should report violations of laws, rules, regulations or the code of business conduct to appropriate personnel. To encourage employees to report such violations, the company must ensure that employees know that the company will not allow retaliation for reports made in good faith.

11. Listed foreign private issuers must disclose any significant ways in which their corporate governance practices differ from those followed by domestic companies under NYSE listing standards.

Commentary: Both SEC rules and NYSE policies have long recognized that foreign private issuers differ from domestic companies in the regulatory and disclosure regimes and customs they follow, and that it is appropriate to accommodate those differences. For this reason, the NYSE for many years has permitted listed non-U.S. companies to follow home-country practices with respect to a number of corporate governance matters, such as the audit committee requirement and the NYSE shareholder approval and voting rights rules. While the NYSE will continue to respect different approaches, listed foreign private issuers must make their U.S. investors aware of the significant ways in which their home-country practices differ from those followed by domestic companies under NYSE listing standards. However, listed foreign private issuers are not required to present a detailed, item-by-item analysis of these differences. Such a disclosure would be long and unnecessarily complicated. Moreover, this requirement is not intended to suggest that one country's corporate governance practices are better or more effective than another. The Exchange simply believes that U.S. shareholders should be aware of the significant ways that the governance of a listed foreign private issuer differs from that of a U.S. listed company. The Exchange underscores that what is required is a brief, general summary of the significant differences, not a cumbersome analysis.

Listed foreign private issuers may provide this disclosure either on their web site (provided it is in the English language and accessible from the U.S.) and/or in their annual report as distributed to shareholders in the U.S. (again, in the English language). If the disclosure is only made available on the web site, the annual report shall so state and provide the web address at which the information may be obtained.

12. Each listed company CEO must certify to the NYSE each year that he or she is not aware of any violation by the company of NYSE corporate governance listing standards.

Commentary: The CEO's annual certification to the NYSE that he or she is unaware of any violation by the company of NYSE corporate governance listing standards will focus the CEO and senior management on the company's compliance with the listing standards. Both this certification to the NYSE, and any CEO/CFO certifications required to be filed with the SEC regarding the quality of the company's public disclosure, must be disclosed in the listed company's annual report to shareholders.

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13. The NYSE may issue a public reprimand letter to any listed company that violates an NYSE listing standard.

Commentary: Suspending trading in or delisting a company can be harmful to the very shareholders that the NYSE listing standards seek to protect; the NYSE must therefore use these measures sparingly and judiciously. For this reason it is appropriate for the NYSE to have the ability to apply a lesser sanction to deter companies from violating its corporate governance (or other) listing standards. Accordingly, the NYSE may issue a public reprimand letter to a company that it determines has violated an NYSE listing standard. For companies that repeatedly or flagrantly violate NYSE listing standards, suspension and delisting remain the ultimate penalties. For clarification, this lesser sanction is not intended for use in the case of companies that fall below the financial and other continued listing standards provided in Chapter 8 of the Listed Company Manual. The processes and procedures provided for in Chapter 8 will continue to govern the treatment of companies falling below those standards.

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Exhibit A-2

Text of the Proposed Rule Change
(New language is underscored, deletions are [bracketed])

Listed Company Manual

* * * *

301.00 Introduction

* * * *

This section describes the Exchange's policies and requirements with respect to independent [audit committees] directors, [ownership interests of corporate directors and officers,] shareholders' voting rights, and other matters affecting [shareholders' ownership interests and the maintenance of fair and orderly markets in listed securities] corporate governance.

When used in this Section 3, "officer" shall have the meaning specified in Rule 16a-1(f) under the Securities Exchange Act of 1934, or any successor rule.

303.00 Corporate Governance Standards

Pending the implementation of the new corporate governance standards set forth in Section 303A infra, in accordance with the transition provisions adopted by the Exchange, the standards contained in this Section 303.00 will continue to apply.

* * * *

312.00 Shareholder Approval Policy

* * * *

312.03 Shareholder Approval

Shareholder approval is a prequisite to listing in [four] three situations:

(a) This section is reserved. New provisions regarding shareholder approval of equity compensation plans are now contained in subsection 8 of Section 303A. [Shareholder approval is required with respect to a stock option or purchase plan, or any other arrangement, pursuant to which officers or directors may acquire stock (collectively, a "Plan") except:

(1) for warrants or rights issued generally to security holders of the company;
(2) pursuant to a broadly-based Plan;

(3) where options or shares are to be issued to a person not previously employed by the company, as a material inducement to such person's entering into an employment contract with the company; or
(4) pursuant to a Plan that provides that (i) no single officer or director may acquire under the Plan more than one percent of the shares of the issuer's common stock outstanding at the time the Plan is adopted, and (ii) together with all Plans of the issuer (other than Plans for which shareholder approval is not required under subsections (1) to (3) above), does not authorize the issuance of more than five percent of the issuer's common stock outstanding at the time the Plan is adopted.]

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Exhibit A-3

Text of the Proposed Rule Change
(New language is underscored, deletions are [bracketed])

NYSE Constitution and Rules

* * * *

Rule 452
Giving Proxies by Member Organization

A member organization shall give or authorize the giving of a proxy for stock registered in its name, or in the name of its nominee, at the direction of the beneficial owner. If the stock is not in the control or possession of the member organization, satisfactory proof of the beneficial ownership as of the record date may be required.

* * * *

Supplementary Material:

Giving a Proxy To Vote Stock

* * * *

.11 When member organization may not vote without customer instructions. In the list of meetings of stockholders appearing in the Weekly Bulletin, after proxy material has been reviewed by the Exchange, each meeting will be designated by an appropriate symbol to indicate either (a) that members may vote a proxy without instructions of beneficial owners, (b) that members may not vote specific matters on the proxy, or (c) that members may not vote the entire proxy.

Generally speaking, a member organization may not give a proxy to vote without instructions from beneficial owners when the matter to be voted upon:

* * * *

(12) [authorizes issuance of stock, or options to purchase stock, to directors, officers, or employees in an amount which exceeds 5% of the total amount of the class outstanding] authorizes the implementation of any equity compensation plan, or any material revision to the terms of any existing equity compensation plan (whether or not stockholder approval of such plan is required by subsection 8 of Section 303A of the Exchange's Listed Company Manual);

* * * *

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Final Rule: Certification of Disclosure in Companies' Quarterly and Annual Reports

Securities and Exchange Commission

17 CFR PARTS 228, 229, 232, 240, 249, 270 and 274

[RELEASE NOS. 33-8124, 34-46427, IC-25722; File No. S7-21-02]
RIN 3235-AI54

Certification of Disclosure in Companies' Quarterly and Annual Reports

Agency: Securities and Exchange Commission.

Action: Final rule; request for comments.

Summary: As directed by Section 302(a) of the Sarbanes-Oxley Act of 2002, we are adopting rules to require an issuer's principal executive and financial officers each to certify the financial and other information contained in the issuer's quarterly and annual reports. The rules also require these officers to certify that: they are responsible for establishing, maintaining and regularly evaluating the effectiveness of the issuer's internal controls; they have made certain disclosures to the issuer's auditors and the audit committee of the board of directors about the issuer's internal controls; and they have included information in the issuer's quarterly and annual reports about their evaluation and whether there have been significant changes in the issuer's internal controls or in other factors that could significantly affect internal controls subsequent to the evaluation. In addition, we are adopting previously proposed rules to require issuers to maintain, and regularly evaluate the effectiveness of, disclosure controls and procedures designed to ensure that the information required in reports filed under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported on a timely basis.

Dates: *Effective Date:* August 29, 2002.
Comment Date: Comments on the extension of the certification requirement to definitive proxy and information statements should be received on or before 30 days after publication in the *Federal Register*.

Addresses: Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609. Comments also may be submitted electronically at the following electronic mail address: rule-comments@sec.gov. To help us process and review your comments more efficiently, comments should be submitted by one method only. All comment letters should refer to File No. S7-21-02; this file number should be included in the subject line if electronic mail is used. Comment letters will be available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, NW, Washington, DC 20549. Electronically submitted comment letters will be posted on the Commission's Internet website (http://www.sec.gov).[1]

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For Further Information Contact: Mark A. Borges, Special Counsel, or Elizabeth M. Murphy, Chief, Office of Rulemaking, Division of Corporation Finance, at (202) 942-2910, or, with respect to issuers of asset-backed securities, Paula Dubberly, Chief Counsel, Division of Corporation Finance, at (202) 942-2900, or, with respect to investment companies, Tara L. Royal, Attorney, Office of Disclosure Regulation, Division of Investment Management, at (202) 942-0721, at the Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549.

Supplementary Information: We are adopting new Item 307[2] of Regulation S-B,[3] new Item 307[4] of Regulation S-K,[5] new Rules 13a-14,[6] 13a-15,[7] 15d-14[8] and 15d-15[9] under the Securities Exchange Act of 1934 ("Exchange Act")[10] and new Rule 30a-2[11] under the Investment Company Act of 1940 ("Investment Company Act").[12] We also are adopting amendments to Rules 12b-15,[13] 13a-10[14] and 15d-10[15] and Forms 10-Q,[16] 10-QSB,[17] 10-K,[18] 10-KSB,[19] 20-F[20] and 40-F[21] under the Exchange Act, Rule 30b1-3 under the Investment Company Act,[22] Rule 302 of Regulation S-T[23] and Form N-SAR[24] under the Exchange Act and the Investment Company Act.

I. Introduction

On July 30, 2002, the Sarbanes-Oxley Act of 2002 (the "Act") was enacted.[25] Section 302 of the Act, entitled "Corporate Responsibility for Financial Reports," requires the Commission to adopt final rules that must be effective by August 29, 2002, 30 days after the date of enactment, under which the principal executive officer or officers and the principal financial officer or officers, or persons providing similar functions, of an issuer each must certify the information contained in the issuer's quarterly and annual reports. Section 302 also requires these officers to certify that: they are responsible for establishing, maintaining and regularly evaluating the effectiveness of, the issuer's internal controls; they have made certain disclosures to the issuer's auditors and the audit committee of the board of directors about the issuer's internal controls; and they have included information in the issuer's quarterly and annual reports about their evaluation and whether there have been significant changes in the issuer's internal controls or in other factors that could significantly affect internal controls subsequent to the evaluation.

On June 14, 2002, we proposed rules that would have required a company's principal executive officer and principal financial officer to certify the contents of the company's quarterly and annual reports.[26] The June Proposals also would have required companies to maintain procedures to provide reasonable assurance that they are able to collect, process and disclose the information required in their Exchange Act reports. Finally, the June Proposals would have required companies to undertake an annual evaluation of these procedures under the supervision of management. Shortly after enactment of the Act, we provided supplemental information on the Act and the June Proposals.[27]

In light of Congress' directive in Section 302 of the Act, we are adopting rules that implement the certification mandated by the Act instead of the certification contained in the June Proposals. We received 102 comment letters in response to the June Proposals.[28] Although responding to the form of certification set forth in the June Proposals, a majority of the commenters supported

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a certification requirement for senior corporate officers.29 In addition, the comment letters we have received since the enactment of the Act also express support for a certification requirement.30 Because Section 302 of the Act prescribes the form of certification that we are to adopt, the new rules do not reflect many of the comments and suggestions that we received on the June Proposals.

While Section 302 of the Act requires an issuer's principal executive and financial officers to make specific certifications regarding their responsibilities to establish and maintain internal controls, it does not directly address the issuer's responsibility for controls and procedures related to the issuer's Exchange Act reporting obligations.31 The June Proposals included requirements that companies maintain sufficient procedures to provide reasonable assurances that they are able to collect, process and disclose, within the time periods specified in the Commission's rules and forms, the information required to be disclosed in their Exchange Act reports.32 We have adopted this requirement largely as proposed. Because of the broad scope of Section 302 of the Act, the new rules are applicable to all types of issuers that file reports under Section 13(a) or 15(d) of the Exchange Act, including foreign private issuers, banks and savings associations, issuers of asset-backed securities, small business issuers and registered investment companies.33

II. Certification of Quarterly and Annual Reports

A. Rule Requirements

As adopted, new Exchange Act Rules 13a-14 and 15d-14 require an issuer's principal executive officer or officers and the principal financial officer or officers, or persons performing similar functions, each to certify in each quarterly and annual report, including transition reports, filed or submitted by the issuer under Section 13(a) or 15(d) of the Exchange Act34 that:

* he or she has reviewed the report;

* based on his or her knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by the report;35

* based on his or her knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition, results of operations and cash flows of the issuer as of, and for, the periods presented in the report;

* he or she and the other certifying officers:

* are responsible for establishing and maintaining "disclosure controls and procedures" (a newly-defined term reflecting the concept of controls and procedures related to disclosure embodied in Section 302(a)(4) of the Act) for the issuer;

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* have designed such disclosure controls and procedures to ensure that material information is made known to them, particularly during the period in which the periodic report is being prepared;

* have evaluated the effectiveness of the issuer's disclosure controls and procedures as of a date within 90 days prior to the filing date of the report; and

* have presented in the report their conclusions about the effectiveness of the disclosure controls and procedures based on the required evaluation as of that date;

* he or she and the other certifying officers have disclosed to the issuer's auditors and to the audit committee of the board of directors (or persons fulfilling the equivalent function):

* all significant deficiencies in the design or operation of internal controls (a pre-existing term relating to internal controls regarding financial reporting)36 which could adversely affect the issuer's ability to record, process, summarize and report financial data and have identified for the issuer's auditors any material weaknesses in internal controls; and

* any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls; and

* he or she and the other certifying officers have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

For purposes of the new rules, "disclosure controls and procedures" are defined as controls and other procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer in the reports filed or submitted by it under the Exchange Act37 is recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms.38 "Disclosure controls and procedures" include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in its Exchange Act reports is accumulated and communicated to the issuer's management, including its principal executive and financial officers, as appropriate to allow timely decisions regarding required disclosure.

B. Discussion of Certification Requirement

1. Issuers Subject to Certification Requirement

Section 302 of the Act states that the certification requirement is to apply to each company filing periodic reports under Section 13(a) or 15(d) of the Exchange Act.39 Accordingly, new Exchange Act Rules 13a-14 and 15d-14 apply to the principal executive officers and principal financial officers, or persons performing similar functions, of any issuer that files quarterly and annual reports with the Commission under either Section 13(a) or 15(d) of the Exchange Act,

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including foreign private issuers, banks and savings associations, issuers of asset-backed securities and small business issuers.[40]

a) Foreign Private Issuers

While the June Proposals would not have applied to foreign private issuers, [41] Section 302 of the Act makes no distinction between domestic and foreign issuers and, by its terms, clearly applies to foreign private issuers. New Exchange Act Rules 13a-14 and 15d-14, therefore, apply the certification requirement to the principal executive officers and principal financial officers of foreign private issuers that file reports under Section 13(a) or 15(d) of the Exchange Act.[42]

b) Banks and Saving Associations

The certification requirement of Section 302 of the Act also applies to principal executive officers and principal financial officers of banks and savings associations that file periodic reports under Section 13(a) or 15(d) of the Exchange Act. The Act amended Section 12(i) of the Exchange Act to make it clear that the federal banking agencies have the authority to administer and enforce various provisions of the Act, including the certification required by Section 302.[43]

c) Asset-Backed Securities Issuers

Issuers of asset-backed securities in public offerings have a reporting obligation under either Section 13(a) or 15(d) of the Exchange Act, at least for a period of time.[44] Because of the nature of asset-backed issuers, the staff of the Division of Corporation Finance has granted requests allowing asset-backed issuers to file modified reports under the Exchange Act.[45]

The modified reporting structure for asset-backed issuers allows issuers or depositors to file modified annual reports on Form 10-K and to file reports tied to payments on the underlying assets in the trust. These reports include a copy of the servicing or distribution report required by the issuer's governing documents and information on the performance of the assets, payments on the asset-backed securities and any other material developments that affect the issuer. Because the reported information for asset-backed issuers differs significantly from that for other issuers, the certification requirement of Section 302 of the Act must be specifically tailored for asset-backed issuers. The new rules require asset-backed issuers to certify their reports. The staff of the Division of Corporation Finance today is providing guidance for asset-backed issuers regarding compliance with the certification requirement.

d) Small Business Issuers

The June Proposals generally did not distinguish between large and small issuers. Similarly, Section 302 of the Act directs that the certification requirement apply to any company filing periodic reports under Section 13(a) or 15(d) of the Exchange Act. Accordingly, new Rules 13a-14 and 15d-14 apply to all issuers that file Exchange Act periodic reports regardless of their size. We note, however, that because many small business issuers do not file Exchange Act reports, not all small business issuers will be subject to the certification requirement.

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2. Reports Subject to Certification Requirement

Section 302 of the Act states that the required certification is to be included in each annual or quarterly report filed or submitted under either Section 13(a) or 15(d) of the Exchange Act.46 Accordingly, the certification requirement applies to annual reports on Forms 10-K, 10-KSB, 20-F and 40-F.47 The certification requirement also applies to quarterly reports on Forms 10-Q and 10-QSB. Finally, the certification requirement applies to amendments to, and transition reports on, any of the foregoing reports.48

Reports that are current reports, such as reports on Forms 6-K49 and 8-K, rather than periodic (quarterly and annual) reports are not covered by the certification requirement.50 Disclosure controls and procedures, however, are required to be designed, maintained and evaluated to ensure full and timely disclosure in current reports, as well as definitive proxy materials and definitive information statements, even though there is no specific certification requirement relating to reports on those forms.51

The new rules apply the certification requirement to foreign private issuers filing annual reports on Form 20-F and Canadian issuers filing annual reports on Form 40-F under our Multi-jurisdictional Disclosure System. Although Form 20-F is not required to be signed by any specific executive officer of a foreign registrant,52 we believe that it is the clear intent of Congress to require that the appropriate officers execute and submit the required certification in an annual report filed under the Exchange Act on Form 20-F or 40-F.

As we first indicated in the June Proposals, we continue to consider whether we should extend a certification requirement to other documents filed under the Exchange Act, such as registration statements on Forms 10 and 10-SB53 and definitive proxy and information statements. We solicit comment on whether any or all of these documents, or any other documents, should be certified by an issuer's senior officers.

3. Content of Certification

Section 302 of the Act states that the required certification is to made by an issuer's principal executive officer or officers and principal financial officer or officers, or persons performing similar functions. The required certification contains several statements. The certification statement concerning the material accuracy and completeness of the periodic reports that are covered by the statement mirrors the existing statutory disclosure standards for "material" accuracy and completeness of information contained in reports.54

The certification statement regarding fair presentation of financial statements and other financial information included in the report was not part of the June Proposals. This statement separately addresses the presentation of an issuer's financial disclosure. This financial disclosure includes financial statements (including footnote disclosure), selected financial data, management's discussion and analysis of financial condition and results of operations and other financial information in a report. The certification, as adopted, states that the overall financial disclosure fairly presents, in all material respects, the company's financial condition, results of operations and cash flows. We have added a specific reference to cash flows even though Section 302 of the

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Act does not include such an explicit reference. We believe that it is consistent with Congressional intent to include both income or loss and cash flows within the concept of "fair presentation" of an issuer's results of operations.

The certification statement regarding fair presentation of financial statements and other financial information is not limited to a representation that the financial statements and other financial information have been presented in accordance with "generally accepted accounting principles" and is not otherwise limited by reference to generally accepted accounting principles. We believe that Congress intended this statement to provide assurances that the financial information disclosed in a report, viewed in its entirety, meets a standard of overall material accuracy and completeness that is broader than financial reporting requirements under generally accepted accounting principles.55 In our view, a "fair presentation" of an issuer's financial condition, results of operations and cash flows encompasses the selection of appropriate accounting policies, proper application of appropriate accounting policies, disclosure of financial information that is informative and reasonably reflects the underlying transactions and events and the inclusion of any additional disclosure necessary to provide investors with a materially accurate and complete picture of an issuer's financial condition, results of operations and cash flows.56

Both of the foregoing certification statements are to be made based on the knowledge of the certifying officer. This is not meant to change the current obligations of corporate officers in connection with the discharge of their duties. Both of the foregoing statements are also made in the context of the requirements of the reports in which they are included. In particular, quarterly reports on Forms 10-Q and 10-QSB have less extensive disclosure and financial statement and footnote requirements than annual reports. The certification requirement is not intended to require expansion of quarterly reports to satisfy the requirements of annual reports. Rather, completeness of disclosure will be determined through application of standards derived from our existing rules, forms and interpretations.57

While the certification described in the June Proposals contained a statement regarding the completion of a review of an issuer's internal procedures and controls aimed at assuring adequate disclosure, the certification required by Section 302 of the Act includes several, more detailed, statements concerning an issuer's "internal controls" and the ongoing oversight of these controls. For purposes of the certification required by Section 302(a)(4) of the Act, we have defined the term "disclosure controls and procedures" to incorporate a broader concept of controls and procedures designed to ensure compliance with disclosure requirements generally. This definition is included in new Exchange Act Rules 13a-14 and 15d-14 and applies to the portion of the certification required by Section 302(a)(4) of the Act.58

We have defined the term "disclosure controls and procedures" to make it explicit that the controls contemplated by Section 302(a)(4) of the Act are intended to embody controls and procedures addressing the quality and timeliness of disclosure. We also have included this definition to differentiate this concept of disclosure controls and procedures from the pre-existing concept of "internal controls" that pertains to an issuer's financial reporting and control of its assets, as currently embodied in Section 13(b) of the Exchange Act59 and as addressed in Sections 302(a)(5) and (a)(6) and Section 404 of the Act. We make this distinction based on our

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review of Section 302 of the Act as well as to effectuate what we believe to be Congress' intent - to have senior officers certify that required material non-financial information, as well as financial information, is included in an issuer's quarterly and annual reports. Under this interpretation, we maintain the pre-existing concept of internal controls without expanding it by relating it to non-financial information.

As discussed in the June Proposals, we are not requiring any particular procedures for conducting the required review and evaluation. Instead, we expect each issuer to develop a process that is consistent with its business and internal management and supervisory practices. We do recommend, however, that, if it has not already done so, an issuer create a committee with responsibility for considering the materiality of information and determining disclosure obligations on a timely basis.60 As is implicit in Section 302(a)(4) of the Act, such a committee would report to senior management, including the principal executive and financial officers, who bear express responsibility for designing, establishing, maintaining, reviewing and evaluating the issuer's disclosure controls and procedures.

We believe that the concept of "internal controls" contemplated by Sections 302(a)(5) and (6) of the Act concern an issuer's controls and procedures for financial reporting purposes as required by Section 13(b) of the Exchange Act. They also relate to the "internal controls" addressed in Section 404 of the Act.61 The certification required by new Exchange Act Rules 13a-14 and 15d-14 makes reference to certain disclosures regarding both disclosure controls and procedures and internal controls that must be made in the reports in which the certification is contained. These disclosure requirements appear in new Item 307 of Regulation S-K, Item 307 of Regulation S-B, Item 15 of Form 20-F and General Instruction B(6) of Form 40-F.

Because the statements involving disclosure controls and procedures and internal controls require the certifying officers to take certain specified actions, such as evaluating the effectiveness of the disclosure controls and procedures prior to the date of the report to which the certification relates, these statements will be required as part of the certification only with respect to any reports that cover periods ending on or after August 29, 2002, the effective date of the rules required by Section 302 of the Act. 62

4. Form of Certification

The certification required by new Exchange Act Rules 13a-14 and 15d-14 must be in the exact form set forth in the amendments to the affected reports. The wording of the required certification may not be changed in any respect (even if the change would appear to be inconsequential in nature).63

5. Location of Certification

Section 302 of the Act states that the required certification is to be included "in" each quarterly or annual report filed or submitted under either Section 13(a) or 15(d) of the Exchange Act. To implement this directive, we have amended Forms 10-Q, 10-QSB, 10-K, 10-KSB, 20-F and 40-F under the Exchange Act to require that the certifications follow immediately after the signature sections of these reports.

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The required certification is in addition to, and, thus, does not alter, the current signature requirements for quarterly and annual reports filed under the Exchange Act. The signatures required by the certifications will be part of these reports, and, therefore, also will be subject to the signature requirement of our rules.64 We have amended Rule 302 of Regulation S-T65 to make it clear that its requirements apply to the signatures appearing in these certifications.

6. Liability for False Certification

An issuer's principal executive and financial officers already are responsible as signatories for the issuer's disclosures under the Exchange Act liability provisions66 and can be liable for material misstatements or omissions under general antifraud standards67 and under our authority to seek redress against those who cause or aid or abet securities law violations.68 An officer providing a false certification potentially could be subject to Commission action for violating Section 13(a) or 15(d) of the Exchange Act and to both Commission and private actions for violating Section 10(b) of the Exchange Act69 and Exchange Act Rule 10b-5.70

III. Disclosure Controls and Procedures

A. Rule Requirements

As adopted, new Exchange Act Rules 13a-15 and 15d-15 require each issuer filing reports under Section 13(a) or Section 15(d) of the Exchange Act to maintain disclosure controls and procedures (as defined in new Exchange Act Rules 13a-14(c) and 15d-14(c)). We believe that, to assist principal executive and financial officers in the discharge of their responsibilities in making the required certifications, as well as to discharge their responsibilities in providing accurate and complete information to security holders, it is necessary for companies to ensure that their internal communications and other procedures operate so that important information flows to the appropriate collection and disclosure points in a timely manner.

B. Discussion of Disclosure Controls and Procedures

New Exchange Act Rules 13a-15 and 15d-15 complement existing requirements for reporting companies to establish and maintain systems of internal controls with respect to their financial information.71 They are intended to ensure that an issuer maintains commensurate procedures for gathering, analyzing and disclosing all information that is required to be disclosed in its Exchange Act reports.

As discussed in the June Proposals, these procedures are intended to cover a broader range of information than is covered by an issuer's internal controls related to financial reporting. For example, the procedures should ensure timely collection and evaluation of information potentially subject to disclosure under the requirements of Regulation S-X,72 Regulation S-K or S-B and Forms 20-F and 40-F. The procedures should capture information that is relevant to an assessment of the need to disclose developments and risks that pertain to the issuer's businesses.73 They also should cover information that must be evaluated in the context of the disclosure requirement of Exchange Act Rule 12b-20. We believe that the new rules will help to

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ensure that an issuer's systems grow and evolve with its business and are capable of producing Exchange Act reports that are timely, accurate and reliable.74

New Exchange Act Rules 13a-15 and 15d-15 also are entirely complementary to the objectives of Section 302 of the Act. While Section 302 requires an issuer's principal executive and financial officers to make specific statements in their certifications and to take the actions satisfying the representations made in the statements as to the issuer's disclosure controls and procedures, it does not directly address the issuer's obligations with respect to these controls and procedures. The new rules will ensure that an issuer also has a responsibility to maintain adequate disclosure controls and procedures, so that its principal executive and financial officers can supervise and review these periodic evaluations and report the results to security holders through the issuer's Exchange Act reports.75

New Exchange Act Rules 13a-15 and 15d-15 also require the issuer, under the supervision of the principal executive and financial officers, to conduct an evaluation of the effectiveness of the design and operation of the issuer's disclosure controls and procedures within 90 days of the filing date of any quarterly or annual report filed under the Exchange Act. While the new rules do not provide detailed procedures for such an evaluation, the evaluation must, at a minimum, address the matters specified by the rules. We expect that this evaluation would be carried out in a manner that would form the basis for the certification statements required by Section 302 of the Act regarding disclosure controls and procedures required by new Exchange Act Rules 13a-14(b)(4)(ii)-(iii) and 15d-14(b)(4)(ii)-(iii) in an issuer's quarterly and annual reports.

We noted in the June Proposals that mandatory requirements regarding disclosure controls and procedures may raise several issues for foreign private issuers. Section 302 of the Act, however, does not provide any exception to the certification requirement for foreign private issuers. Because we believe that the maintenance of disclosure controls and procedures is an important part of satisfying the certification requirement, it is appropriate to require foreign private issuers to comply with new Exchange Act Rules 13a-15 and 15d-15 with respect to the implementation of the controls and procedures outlined in Section 302(a)(4) of the Act.

IV. Certification of Registered Investment Company Annual and Semi-Annual Reports

We are implementing Section 302 of the Act with respect to registered investment companies by adopting new Investment Company Act Rule 30a-2. This rule requires a registered investment company that files periodic reports under Section 13(a) or 15(d) of the Exchange Act (that is, Form N-SAR) to include the certification specified by Section 302 in those periodic reports. We are also amending the instructions to Form N-SAR, the annual and semi-annual reporting form for registered investment companies, to require the specified certification to be filed as an exhibit to Form N-SAR.76

Section 302 requires the specified certification to be included in "each annual or quarterly report filed or submitted" under either Section 13(a) or 15(d) of the Exchange Act.77 Form N-SAR is the form designated for registered investment companies to comply with their reporting requirements under Sections 13(a) and 15(d) of the Exchange Act, as well as periodic reporting requirements under Sections 30(a) and 30(b)(1)78 of the Investment Company Act.79 Registered

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management investment companies are required to file annual and semi-annual reports on Form N-SAR not more than 60 calendar days after the close of each fiscal year and fiscal second quarter.[80] Registered unit investment trusts are required to file annual reports on Form N-SAR with respect to each calendar year, not more than 60 calendar days after the close of each year.[81]

Unlike Forms 10-K and 10-Q, Form N-SAR does not require the filing of financial statements. However, Form N-SAR requires management investment companies to provide certain financial information based on the financial statements as of the same date contained in the investment company's annual and semi-annual reports to shareholders.[82] Therefore, we are requiring the signing officers of a registered management investment company to certify under new Investment Company Act Rule 30a-2(b)(3) that the financial information included in the report and the financial statements on which the financial information is based fairly present, in all material respects, the financial condition, results of operations, changes in net assets and cash flows (if the financial statements are required to include a statement of cash flows) of the investment company.[83] We have added a specific reference to changes in net assets and cash flows even though Section 302 of the Act does not include such an explicit reference. We believe that it is consistent with Congressional intent to include both income or loss, and changes in net assets and, in the case where the financial statements are required to include a statement of cash flows, within the concept of "fair presentation" of an investment company's results of operations.

The certification required by new Investment Company Act Rule 30a-2 must be in the exact form set forth in the amendments to Form N-SAR.[84] The wording of the required certification may not be changed in any respect (even if the change would appear to be inconsequential in nature).

Investment companies filing reports on Form N-SAR under Sections 13(a) and 15(d) of the Exchange Act will also be required to maintain disclosure controls and procedures under new Exchange Act Rules 13a-15 and 15d-15.[85] New Rules 13a-15 and 15d-15 also require an investment company, under the supervision and with the participation of the principal executive and financial officers, to conduct an evaluation of the effectiveness of the design and operation of the investment company's disclosure controls and procedures within 90 days of the filing date of each report requiring certification under new Investment Company Act Rule 30a-2. We expect that this evaluation would be carried out in a manner that would form the basis for the certification statements required by Section 302 of the Act regarding disclosure controls and procedures required by new Investment Company Act Rule 30a-2(b)(4)(i)-(iii) in an investment company's Form N-SAR.[86]

The certification required by new Investment Company Act Rule 30a-2 makes reference to certain disclosures regarding both disclosure controls and procedures and internal controls that must be made in the reports in which the certification is contained. These disclosure requirements appear in the new instructions to Form N-SAR.[87]

Unit investment trusts will be required to provide the specified certification with respect to the items of Form N-SAR specific to them, which include very limited financial information.[88] We recognize that unit investment trusts, which are unmanaged, fixed portfolios of securities, have no corporate management structure and hence will not have a principal executive officer or

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principal financial officer. Therefore, in the case of a unit investment trust, the required certification should be signed by personnel of the sponsor, trustee, depositor or custodian who perform functions similar to those of a principal executive officer and principal financial officer on behalf of the trust.89

Unit investment trusts and small business investment companies are not required to transmit reports to their shareholders containing their financial statements, and Form N-SAR does not require unit investment trusts and small business investment companies to report financial information based on their financial statements.90 Therefore, the certification requirement applicable to these investment companies does not include the requirement of new Investment Company Act Rule 30a-2(b)(3) that the signing officers certify that the financial information included in the periodic report and the financial statements on which it is based fairly present, in all material respects, the financial condition, results of operations, changes in net assets and cash flows (if the financial statements are required to include a statement of cash flows) of the investment company.91

Business development companies and face-amount certificate companies file periodic reports on Forms 10-K and 10-Q under the Exchange Act, and they are required to comply with the certification requirements applicable to these forms.92

We note that, in a companion release, we are proposing to require registered management investment companies to file certified shareholder reports with the Commission on new Form N-CSR and would designate these certified shareholder reports as reports that are required under Sections 13(a) and 15(d) of the Exchange Act. For registered management investment companies, the required reports to shareholders, rather than Form N-SAR, are the primary vehicle for providing financial statements to investors. We believe that the information in these reports to shareholders should be certified. In addition, we are proposing an amendment to Form N-SAR that would uniformly apply to all registered investment companies, and not just those subject to Section 13(a) or 15(d) of the Exchange Act, the requirement to include in Form N-SAR the certification required by Section 302 of the Act. We are also proposing a new rule to apply disclosure controls and procedures requirements, similar to those contained in Exchange Act Rules 13a-15 and 15d-15, uniformly to all registered investment companies.

V. Transition Provisions

Paragraphs (b)(1), (2) and (3) of new Exchange Act Rules 13a-14 and 15d-14 apply to quarterly and annual reports, including transition reports, filed after the Effective Date. Paragraphs (b)(4), (5) and (6) of Rules 13a-14 and 15d-14 apply to quarterly and annual reports, including transition reports, filed for periods ending after the Effective Date. Paragraph (a) of Item 307 of Regulations S-B and S-K and paragraph (b) of new Exchange Act Rules 13a-15 and 15d-15 apply to quarterly and annual reports, including transition reports, filed for periods ending after the Effective Date.

Paragraphs (b)(1), (2) and (3) of new Investment Company Act Rule 30a-2 apply to annual and semi-annual reports, including transition reports, on Form N-SAR filed after the Effective Date. Paragraphs (b)(4), (5) and (6) of Rule 30a-2 apply to annual and semi-annual reports, including

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transition reports, filed for periods ending after the Effective Date. Paragraph (a)(i) of the Instruction to sub-item 77Q3 of Form N-SAR and paragraph (b) of new Exchange Act Rules 13a-15 and 15d-15 apply to annual and semi-annual reports, including transition reports, on Form N-SAR filed for periods ending after the Effective Date.

VI. Paperwork Reduction Act

The new rules and amendments to existing rules and forms contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA").93 We published a notice requesting comment on the collection of information requirements in the June Proposals, and submitted these requirements to the Office of Management and Budget ("OMB") for review in accordance with the PRA.94 The titles for those collections of information are "Form 10-K," "Form 10-KSB," "Form 10-Q" and "Form 10-QSB."95

While we received only one comment letter specifically remarking on our PRA estimates included in the June Proposals,96 we revised the proposed amendments in response to the directives in Section 302 of the Act. The revisions made to the rules and amendments do not alter the burden estimates for Forms 10-K (OMB Control No. 3235-0063), 10-KSB (OMB Control No. 3235-0420), 10-Q (OMB Control No. 3235-0070) and 10-QSB (OMB Control No. 3235-0416) previously submitted to and approved by OMB.

The new rules and form amendments that we are adopting cover the more expansive reach of Section 302 of the Act and contain additional "collection of information requirements" within the meaning of the PRA. Accordingly, we submitted additional materials to OMB for emergency review in accordance with the PRA.97 The titles for these collections of information are "Form 20-F" (OMB Control No. 3235-0288), "Form 40-F" (OMB Control No. 3235-0381) and "Form N-SAR" (OMB Control No. 3235-0330). An agency may not conduct or sponsor, and a person is not required to respond to, an information collection unless it displays a currently valid OMB control number.

Form 10-K prescribes information that registrants must disclose annually to the market about its business. Form 10-KSB prescribes information that registrants that are "small business issuers" as defined under our rules must disclose annually to the market about its business.

Form 10-Q prescribes information that registrants must disclose quarterly to the market about its business. Form 10-QSB prescribes information that registrants that are "small business issuers" as defined under our rules must disclose quarterly to the market about its business.

Form 20-F is used by foreign private issuers to either register a class of securities under the Exchange Act or provide an annual report required under the Exchange Act. Form 40-F is used by foreign private issuers to file reports under the Exchange Act after having registered securities under the Securities Act and by certain Canadian registrants. Form N-SAR is used by registered investment companies to file annual and semi-annual reports under the Exchange Act and the Investment Company Act.

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New Exchange Act Rules 13a-14 and 15d-14[98] require an issuer's principal executive and financial officers to certify the information contained in the issuer's quarterly and annual reports and that they have taken certain actions with respect to the issuer's internal controls for the collection and reporting of financial and other information that is subject to disclosure in the issuer's quarterly and annual Exchange Act reports. This certification requirement would become part of the "collection of information" required in each quarterly and annual report.

New Exchange Act Rules 13a-15 and 15d-15[99] require an issuer to maintain disclosure controls and procedures to provide reasonable assurance that the issuer is able to record, process, summarize and report the information required in the issuer's Exchange Act reports. These procedures would become part of the "collection of information" required in these reports.

New Investment Company Act Rule 30a-2 requires an investment company's principal executive and financial officers to certify the information contained in the investment company's annual and semi-annual reports on Form N-SAR and that they have taken certain actions with respect to the investment company's internal controls for the collection and reporting of financial and other information that is subject to disclosure in the investment company's reports on Form N-SAR. This certification requirement would become part of the "collection of information" required in each report on Form N-SAR.

The purpose of the certification and disclosure controls and procedures requirements is to ensure that the information that is collected and disclosed in Exchange Act reports is complete and accurate. Consequently, the senior officer certification, as well as the periodic evaluations of internal reporting systems, required by the rules and amendments will become part of the process in which issuers engage to comply with the reporting requirements of the affected forms.

The compliance burden estimates for the collections of information are based on several assumptions.[100] The number of foreign private issuers that file annual reports on Form 20-F or 40-F is approximately 1,300 entities.[101] The number of registered investment companies that file Form N-SAR is approximately 4,450 entities.[102]

New Exchange Act Rule 13a-14 and new Investment Company Act Rule 30a-2 require an issuer's principal executive and financial officers to certify the information contained in the issuer's periodic reports. The compliance burden associated with new Exchange Act Rule 13a-14 and new Investment Company Act Rule 30a-2 is the burden associated with reading and thinking critically about each quarterly and annual report to be filed by the issuer so that the certifying officers can make the required certification. For purposes of the PRA, we estimate that the new certification requirement will result in an increase of five burden hours[103] per issuer in connection with preparing each annual report on Form 20-F or 40-F and an increase of five burden hours per issuer in connection with preparing each report on Form N-SAR.

New Exchange Act Rule 13a-15 requires an issuer to maintain sufficient procedures to collect, process and disclose the information required in its Exchange Act reports. We expect that issuers already maintain procedures, whether formal or informal, to comply with their Exchange Act disclosure obligations and for their own internal purposes. We do not believe that this

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requirement will result in any change in either the reporting or cost burden associated with preparing annual reports on Forms 20-F and 40-F or reports on Form N-SAR.

Based on a burden hour estimate of five hours per respondent per year, we estimate that the total burden hours of complying with Form 20-F and Form 40-F, revised to include the burden hours expected from the new rules, is estimated to be 586,248 hours for Form 20-F, an increase of 4,500 hours104 from the current annual burden of 581,748 hours, and 525 hours for Form 40-F, an increase of 475 hours105 from the current annual burden of 50 hours. The total burden hours of complying with Form N-SAR, revised to include the burden hours expected from the new rules, is estimated to be 154,450 hours,106 an increase of 52,702 hours107 from the current annual burden of 101,748 hours.

The total burden hours of complying with Forms 10-Q and 10-QSB, revised to include the burden hours expected from the new rules, is estimated to be 3,129,283 hours for Form 10-Q, an increase of 100,298 hours108 from the current annual burden of 3,028,985 hours, and 1,288,488 hours for Form 10-QSB, an increase of 43,530 hours109 from the current annual burden of 1,244,958 hours. The total burden hours of complying with Forms 10-K and 10-KSB, revised to include the burden hours expected from the new rules, is estimated to be 12,344,652 hours for Form 10-K, an increase of 35,190 hours110 from the current annual burden of 12,309,462 hours, and 3,438,518 hours for Form 10-KSB, an increase of 14,209 hours111 from the current annual burden of 3,424,309 hours.

In addition to the internal hours they will expend to comply with Forms 20-F and 40-F, we expect that respondents will retain outside professionals to assist in compliance with the information collection requirements. The total dollar cost of complying with Forms 20-F and 40-F, revised to include outside professional costs expected from the new rules, is estimated to be $523,596,000 for Form 20-F, an increase of $450,000112 from the current annual burden of $523,146,000, and $52,500 for Form 40-F, an increase of $26,500113 from the current annual burden of $26,000.

The total dollar cost of complying with Forms 10-Q and 10-QSB, revised to include outside professional costs expected from the new rules, is estimated to be $312,929,000 for Form 10-Q, an increase of $10,030,000114 from the current annual burden of $302,899,000, and $128,849,000 for Form 10-QSB, an increase of $4,353,000115 from the current annual burden of $124,496,000. The total dollar cost of complying with Forms 10-K and 10-KSB, revised to include outside professional costs expected from the new rules, is estimated to be $1,234,465,000 for Form 10-K, an increase of $3,519,000116 from the current annual burden of $1,230,946,000, and $343,852,000 for Form 10-KSB, an increase of $1,421,000117 from the current annual burden of $342,431,000.

Comments concerning the accuracy of these burden estimates, and any suggestions for reducing the burden, should be directed to the Commission. Compliance with the new rules is mandatory. Under our rules for the retention of manual signatures, issuers will be required to maintain the certifications for five years.118 The information required by the new rules will not be kept confidential.

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VII. Cost-Benefit Analysis

The certification requirement that we are adopting today implements a Congressional mandate. We recognize that any implementation of the Sarbanes-Oxley Act will likely result in costs as well as benefits and have an effect on the economy. We are sensitive to the costs and benefits of our adoption of a rule that requires issuers to maintain disclosure controls and procedures. We discuss these costs and benefits below.

The new certification requirement may lead to some additional costs for issuers. The new rules require an issuer's principal executive and financial officers to review the issuer's periodic reports and to make the required certification. To the extent that corporate officers would need to spend additional time thinking critically about the overall context of their company's disclosure, issuers would incur costs (although investors would benefit from improved disclosure). The certification requirement creates a new legal obligation for an issuer's principal executive and financial officers, but does not change the standard of legal liability.

Issuers are already required to maintain reporting controls and procedures for identifying and processing the information needed to satisfy their disclosure obligations under the Exchange Act. The new rules do not dictate that issuers follow any particular procedure. By allowing issuers to determine what procedures are necessary to meet the obligation of the rules, we are mitigating the costs associated with compliance. Some issuers may need to institute appropriate controls and procedures. Other issuers may need to enhance existing informal or ad hoc controls and procedures. These incremental costs are difficult to quantify. While we requested comment and supporting data in connection with the June Proposals on the cost of implementing, or upgrading and strengthening existing, reporting controls and procedures, we received no specific comment letters in response to that request.

The required periodic evaluation of reporting controls and procedures likely will result in costs for issuers. The new certification requirement likely will require issuers to create or strengthen internal controls to enable their senior executive officers to meet their certification obligations under the new rules. Many issuers already regularly monitor and evaluate their controls and procedures. Because the size and scope of these internal reporting systems is likely to vary among issuers, it is difficult to provide an accurate cost estimate.

Conversely, the new rules are likely to provide significant benefits by ensuring that information about an issuer's business and financial condition is adequately reviewed by the issuer's principal executive and financial officers and the issuer's internal systems keep pace with the growth of the business.

We believe that investor confidence in corporate disclosure has suffered, in part, because of a belief that corporate officers may not devote sufficient attention to the preparation of their companies' periodic reports and to the disclosure controls and procedures that generate the data from which they are prepared.

The new rules should help to ensure that issuers maintain sufficient internal reporting controls and procedures to provide reasonable assurance that they can record, process, summarize and

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report the information that is required in all Exchange Act reports. To the extent that issuers do not maintain adequate controls and procedures, the new rules should lead to the development, or enhancement and modernization, of these controls and procedures. The required periodic evaluation of these controls and procedures should ensure that issuers devote adequate resources and attention to the maintenance of their internal reporting systems. Additionally, the required evaluation should help to identify potential weaknesses and deficiencies in advance of a system breakdown, thereby ensuring the continuous, orderly and timely flow of information within the company and, ultimately, to investors and the marketplace.

VIII. Final Regulatory Flexibility Analysis

This Final Regulatory Flexibility Analysis, or FRFA, has been prepared in accordance with the Regulatory Flexibility Act.119 The FRFA pertains to new Exchange Act Rules 13a-15 and 15d-15 adopted for operating companies, for which we gave notice and sought comment. The Sarbanes-Oxley Act of 2002 directs us to adopt rules for registered investment companies. Because we find good cause to adopt those rules without notice and comment, we do not analyze them in the FRFA. New Exchange Act Rules 13a-15 and 15d-15 require an issuer to maintain disclosure controls and procedures to provide reasonable assurance that the issuer is able to record, process, summarize and report the information required in their Exchange Act reports.120

A. Reasons for, and Objectives of, New Rules

New Exchange Act Rules 13a-15 and 15d-15 complement existing requirements for reporting companies to establish and maintain systems of internal controls with respect to their financial information. They are intended to ensure that an issuer maintains commensurate procedures for gathering, analyzing and disclosing all information that is required to be disclosed in its Exchange Act reports.

B. Legal Basis

We are adopting the new rules under the authority set forth in Sections 10(b), 13, 15(d) and 23(a) of the Exchange Act and Sections 3(a) and 302 of the Act.

C. Small Entities Subject to the Final Rules

The new rules will affect small entities that are subject to the reporting requirements of Section 13(a) or 15(d) of the Exchange Act. For purposes of the Regulatory Flexibility Act, the Exchange Act121 defines the term "small business," other than an investment company, to be an issuer that, on the last day of its most recent fiscal year, has total assets of $5 million or less.122 We estimate that there are approximately 2,500 companies subject to the reporting requirements of Section 13(a) or 15(d) of the Exchange Act that are not investment companies and that have assets of $5 million or less.123

D. Significant Issues Raised by Public Comment

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The IRFA appeared in the June Proposals.124 We requested comment on any aspect of the IRFA, including the number of small businesses that would be affected by the proposals, the nature of the impact, how to quantify the number of small entities that would be affected and how to quantify the impact of the proposals. We received one comment letter responding to that request.125 This commenter recommended that we provide a transition period for small businesses and that we clarify the need for small businesses to audit their internal controls quarterly. This release contains a transition provision that delays compliance with the certification requirement as it relates to disclosure controls and procedures and internal controls.126 The requirements for periodic audit of an issuer's internal controls will be considered at a future date.

E. Reporting, Recordkeeping and Other Compliance Requirements

The new rules require issuers, including "small businesses," to maintain sufficient procedures to provide reasonable assurance that the issuer is able to record, process, summarize and report the information required in their Exchange Act reports filed with the Commission, and to periodically review and evaluate these procedures. We do not dictate the specifics of these procedures. The new rules may increase the costs associated with compliance with issuers' Exchange Act reporting obligations.

F. Duplicative, Overlapping or Conflicting Federal Rules

Section 13(b)(2)(B) of the Exchange Act127 requires issuers that are subject to the reporting requirements of Section 13(a) or 15(d) to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that the transactions and information are recorded as necessary to permit the preparation of the issuer's financial statements. New Exchange Act Rules 13a-15 and 15d-15 are intended to address the issuer's controls and procedures for recording, processing summarizing and reporting the information that is required to be disclosed in Exchange Act reports.

G. Agency Action to Minimize Effect on Small Entities

The Regulatory Flexibility Act directs us to consider significant alternatives that would accomplish the stated objectives, while minimizing any significant adverse impact on small entities. In that regard, we considered the following alternatives: (a) establishing different compliance or reporting requirements that take into account the resources of small entities, (b) clarifying, consolidating or simplifying compliance and reporting requirements under the rules for small entities and (c) exempting small entities from all or part of the proposed rules. We solicited comment as to whether small business issuers should be excluded from the new rules. We received no comment letters responding to that request.

The periodic review and evaluation of information collection and reporting procedures required by the new rules involves a performance standard. The new rules do not mandate how issuers should conduct this review and evaluation. This flexibility will enable small and large entities to develop approaches for the review and evaluation that are appropriate to their individual circumstances. Because Congress has directed the senior officers of all issuers, regardless of size,

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to certify issuers' quarterly and annual reports, we do not believe it is consistent with that mandate to exempt small issuers from the new rules. We are not aware of any way to further clarify or simplify compliance for small entities.

IX. Consideration of Burden on Competition and Promotion of Efficiency, Competition and Capital Formation

Section 23(a)(2) of the Exchange Act 128 requires us, when adopting rules under the Exchange Act, to consider the impact that any new rule would have on competition. In addition, Section 23(a)(2) prohibits us from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. Section 3(f) of the Exchange Act 129 and Section 2(c) of the Investment Company Act130 requires us, when engaging in rulemaking where we are required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition and capital formation.

The new rules are intended to enhance investor confidence in the quality of the information available to them in quarterly and annual reports filed under the Exchange Act. We believe that by requiring an issuer's principal executive and financial officers to provide the required certification, investor confidence in the securities markets will be enhanced, thereby leading to a more efficient market.

We do not believe that the new rules will impose any burden on competition. Issuers will incur some costs in complying with the new rules. These costs will include conducting periodic evaluations of the issuer's internal controls and procedures to record, process, summarize and report, on a timely basis, the information required in periodic and current reports filed by the issuer under the Exchange Act. We requested comment in connection on the June Proposals on whether the proposed rules, if adopted, would impose a burden on competition. We received no comment letters in response to that request.

X. Administrative Procedure Act

The Administrative Procedure Act, or APA, generally requires an agency to publish notice of a proposed rulemaking in the Federal Register.131 The APA's notice and comment requirement does not apply, however, if the agency "for good cause finds . . . that notice and public procedure are impracticable, unnecessary, or contrary to the public interest."132 The Commission believes that it is appropriate to waive notice and comment for the portions of the new rules that were not included in the June Proposals and for the application of the new rules to investment companies. Congress has directed the Commission to implement Section 302 of the Act by rule within 30 days after the date of enactment.133 It is impractical to provide notice and comment within the statutory deadline. It would be unnecessary and against the public interest to provide notice and opportunity for comment on a directive from Congress to implement specific rules. Accordingly, the Commission for good cause finds that delaying adoption of these rules until after a notice and comment period would be impractical, unnecessary and contrary to the public interest.

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The APA also generally requires that an agency publish an adopted rule in the Federal Register 30 days before it becomes effective.134 This requirement, however, does not apply if the agency finds good cause for making the rule effective sooner.135 For the same reasons as it is waiving notice and comment, the Commission finds good cause to make the new Exchange Act Rules 13a-14 and 15d-14 and new Investment Company Act Rule 30a-2, and the amendments to related rules and forms, effective immediately. In addition, because new Exchange Act Rules 13a-15 and 15d-15 effectuate the purpose of the Section 302 certification requirement and might create a hardship if they did not become effective simultaneously with new Exchange Act Rules 13a-14 and 15d-14, the Commission finds good cause to make the rules effective immediately as to all issuers filing reports under Section 13(a) or 15(d) of the Exchange Act.136

XI. Statutory Authority

The rules and amendments contained in this release are being adopted under the authority set forth in Sections 10(b), 13, 15(d) and 23(a) of the Exchange Act, Section 8, 30 and 38 of the Investment Company Act and Sections 3(a) and 302 of the Sarbanes-Oxley Act of 2002.

List of Subjects in 17 CFR Parts 228, 229, 232, 240, 249, 270 and 274

Securities.

Investment Companies.

Reporting and recordkeeping requirements.

TEXT OF FINAL RULES AND AMENDMENTS

In accordance with the foregoing, Title 17, Chapter II, of the Code of Federal Regulations is amended as follows:

Part 228 - INTEGRATED DISCLOSURE SYSTEM FOR SMALL BUSINESS ISSUERS

1. The authority citation for Part 228 is amended by adding the following citation to read as follows:

Authority: 15 U.S.C. 77e, 77f, 77g, 77h, 77j, 77k, 77s, 77z-2, 77z-3, 77aa(25), 77aa(26), 77ddd, 77eee, 77ggg, 77hhh, 77jjj, 77nnn, 77sss, 78l, 78m, 78n, 78o, 78u-5, 78w, 78ll, 78mm, 80a-8, 80a-29, 80a-30, 80a-37 and 80b-11.

Section 228.307 is also issued under secs. 3(a) and 302, Pub.L.No. 107-204, 116 Stat. 745.

2. By adding §228.307 to read as follows:

§228.307 Controls and Procedures.

(a) Evaluation of disclosure controls and procedures. Disclose the conclusions of the small business issuer's principal executive officer or officers and principal financial officer or officers, or persons performing similar functions, about the effectiveness of the small business issuer's disclosure controls and procedures (as defined in §§240.13a-14(c) and 240.15d-14(c)) based on their evaluation of these controls and procedures as of a date within 90 days of the filing date of the quarterly or annual report that includes the disclosure required by this paragraph.

(b) Changes in internal controls. Disclose whether or not there were significant changes in the small business issuer's internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

(c) Asset-Backed Issuers. A small business issuer that is an Asset-Backed Issuer (as defined in Rule 13a-14(g) and Rule 15d-14(g) under the Securities Exchange Act of 1934 [17 CFR 240.13a-14(g) and 17 CFR 240.15d-14(g)] is not required to disclose the information required by this Item.

Part 229 - STANDARD INSTRUCTIONS FOR FILING FORMS UNDER SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934 AND ENERGY POLICY AND CONSERVATION ACT OF 1975 - REGULATION S-K

3. The authority citation for Part 229 is amended by adding the following citation to read as follows:

Authority: 15 U.S.C. 77e, 77f, 77g, 77h, 77j, 77k, 77s, 77z-2, 77z-3, 77aa(25), 77aa(26), 77ddd, 77eee, 77ggg, 77hhh, 77iii, 77jjj, 77nnn, 77sss, 78c, 78i, 78j, 78l, 78m, 78n, 78o, 78u-5, 78w, 78ll(d), 78mm, 79e, 79n, 79t, 80a-8, 80a-29, 80a-30, 80a-31(c), 80a-37, 80a-38(a) and 80b-11, unless otherwise noted.

Section 229.307 is also issued under secs. 3(a) and 302, Pub.L.No. 107-204, 116 Stat. 745.

4. By adding §229.307 to read as follows:

§229.307 Controls and Procedures.

(a) Evaluation of disclosure controls and procedures. Disclose the conclusions of the registrant's principal executive officer or officers and principal financial officer or officers, or persons performing similar functions, about the effectiveness of the registrant's disclosure controls and procedures (as defined in §§240.13a-14(c) and 240.15d-14(c)) based on their evaluation of these controls and procedures as of a date within 90 days of the filing date of the quarterly or annual report that includes the disclosure required by this paragraph.

(b) Changes in internal controls. Disclose whether or not there were significant changes in the registrant's internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

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(c) Asset-Backed Issuers. A registrant that is an Asset-Backed Issuer (as defined in §240.13a-14(g) and §240.15d-14(g)) is not required to disclose the information required by this Item.

PART 232 - REGULATION S-T - GENERAL RULES AND REGULATIONS FOR ELECTRONIC FILINGS

5. The authority citation for Part 232 is amended by adding the following citation to read as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s(a), 77sss(a), 78c(b), 78l, 78m, 78n, 78o(d), 78w(a), 78ll(d), 79t(a), 80a-8, 80a-29, 80a-30 and 80a-37.

Section 232.302 is also issued under secs. 3(a) and 302, Pub.L.No. 107-204, 116 Stat. 745.

6. By amending §232.302 by revising paragraphs (a) and (b) to read as follows:

§232.302 Signatures.

(a) Required signatures to, or within, any electronic submission (including, without limitation, signatories within the certifications required by §§240.13a-14, 240.15d-14 and 270.30a-2 of this chapter) must be in typed form rather than manual format. Signatures in an HTML document that are not required may, but are not required to, be presented in an HTML graphic or image file within the electronic filing, in compliance with the formatting requirements of the EDGAR Filer Manual. When used in connection with an electronic filing, the term "signature" means an electronic entry in the form of a magnetic impulse or other form of computer data compilation of any letters or series of letters or characters comprising a name, executed, adopted or authorized as a signature. Signatures are not required in unofficial PDF copies submitted in accordance with §232.104.

(b) Each signatory to an electronic filing (including, without limitation, each signatory to the certifications required by §§240.13a-14, 240.15d-14 and 270.30a-2 of this chapter) shall manually sign a signature page or other document authenticating, acknowledging or otherwise adopting his or her signature that appears in typed form within the electronic filing. Such document shall be executed before or at the time the electronic filing is made and shall be retained by the filer for a period of five years. Upon request, an electronic filer shall furnish to the Commission or its staff a copy of any or all documents retained pursuant to this section.

* * * * *

PART 240 - GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

7. The authority citation for Part 240 is amended by adding the following citations in numerical order to read as follows:

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Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 79q, 79t, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4 and 80b-11, unless otherwise noted.

* * * * *

Section 240.12b-15 is also issued under secs. 3(a) and 302, Pub.L.No. 107-204, 116 Stat. 745.

Section 240.13a-10 is also issued under secs. 3(a) and 302, Pub.L.No. 107-204, 116 Stat. 745.

Section 240.13a-14 is also issued under secs. 3(a) and 302, Pub.L.No. 107-204, 116 Stat. 745.

Section 240.13a-15 is also issued under secs. 3(a) and 302, Pub.L.No. 107-204, 116 Stat. 745.

Section 240.15d-10 is also issued under secs. 3(a) and 302, Pub.L.No. 107-204, 116 Stat. 745.

Section 240.15d-14 is also issued under secs. 3(a) and 302, Pub.L.No. 107-204, 116 Stat. 745.

Section 240.15d-15 is also issued under secs. 3(a) and 302, Pub.L.No. 107-204, 116 Stat. 745.

* * * * *

8. By revising §240.12b-15 to read as follows:

§240.12b-15 Amendments.

All amendments must be filed under cover of the form amended, marked with the letter "A" to designate the document as an amendment, e.g., "10-K/A," and in compliance with pertinent requirements applicable to statements and reports. Amendments filed pursuant to this section must set forth the complete text of each item as amended. Amendments must be numbered sequentially and be filed separately for each statement or report amended. Amendments to a statement may be filed either before or after registration becomes effective. Amendments must be signed on behalf of the registrant by a duly authorized representative of the registrant. In addition, each principal executive officer and principal financial officer of the registrant must provide a new certification as specified in §240.13a-14 or §240.15d-14. The requirements of the form being amended will govern the number of copies to be filed in connection with a paper format amendment. Electronic filers satisfy the provisions dictating the number of copies by filing one copy of the amendment in electronic format. See Rule 309 of Regulation S-T (§232.309 of this chapter).

9. By amending §240.13a-10 to add an "Additional Note" after the "Note" at the end of the section to read as follows:

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§240.13a-10 Transition reports.

* * * * *

Additional Note: The report or reports to be filed pursuant to this section must include the certification required by §240.13a-14.

10. By adding §240.13a-14 to read as follows:

§240.13a-14 Certification of disclosure in annual and quarterly reports.

(a) Each report, including transition reports, filed on Form 10-Q, Form 10-QSB, Form 10-K, Form 10-KSB, Form 20-F or Form 40-F (§§249.308a, 249.308b, 249.310, 249.310b, 249.220f and 249.240f of this chapter) under section 13(a) of the Act (15 U.S.C. 78m(a)), other than a report filed by an Asset-Backed Issuer (as defined in paragraph (g) of this section), must include a certification containing the information set forth in paragraph (b) of this section in the form specified in the report. Each principal executive officer or officers and principal financial officer or officers of the issuer, or persons performing similar functions, at the time of filing of the report must sign the certification.

(b) The certification included in each report specified in paragraph (a) of this section must be in the form specified in the report and consist of a statement of the certifying officer that:

(1) He or she has reviewed the report being filed;

(2) Based on his or her knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by the report;

(3) Based on his or her knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition, results of operations and cash flows of the issuer as of, and for, the periods presented in the report;

(4) He or she and the other certifying officers are responsible for establishing and maintaining disclosure controls and procedures (as such term is defined in paragraph (c) of this section) for the issuer and have:

(i) Designed such disclosure controls and procedures to ensure that material information relating to the issuer, including its consolidated subsidiaries, is made known to them by others within those entities, particularly during the period in which the periodic reports are being prepared;

(ii) Evaluated the effectiveness of the issuer's disclosure controls and procedures as of a date within 90 days prior to the filing date of the report ("Evaluation Date"); and

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(iii) Presented in the report their conclusions about the effectiveness of the disclosure controls and procedures based on their evaluation as of the Evaluation Date;

(5) He or she and the other certifying officers have disclosed, based on their most recent evaluation, to the issuer's auditors and the audit committee of the board of directors (or persons fulfilling the equivalent function):

(i) All significant deficiencies in the design or operation of internal controls which could adversely affect the issuer's ability to record, process, summarize and report financial data and have identified for the issuer's auditors any material weaknesses in internal controls; and

(ii) Any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls; and

(6) He or she and the other certifying officers have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

(c) For purposes of this section and §240.13a-15 of this chapter, the term "disclosure controls and procedures" means controls and other procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer in the reports that it files or submits under the Act (15 U.S.C. 78a et seq.) is recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the Act is accumulated and communicated to the issuer's management, including its principal executive officer or officers and principal financial officer or officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

(d) A person required to provide the certification specified in paragraph (a) of this section may not have the certification signed on his or her behalf pursuant to a power of attorney or other form of confirming authority.

(e) Each annual report filed by an Asset-Backed Issuer (as defined in paragraph (g) of this section) under section 13(a) of the Act (15 U.S.C. 78m(a)) must include a certification addressing the following items:

(1) Review by the certifying officer of the annual report and other reports containing distribution information for the period covered by the annual report;

(2) The absence in these reports, to the best of the certifying officer's knowledge, of any untrue statement of material fact or omission of a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading;

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(3) The inclusion in these reports, to the best of the certifying officer's knowledge, of the financial information required to be provided to the trustee under the governing documents of the issuer; and

(4) Compliance by the servicer with its servicing obligations and minimum servicing standards.

(f) With respect to Asset-Backed Issuers, the certification required by paragraph (e) of this section must be signed by the trustee of the trust (if the trustee signs the annual report) or the senior officer in charge of securitization of the depositor (if the depositor signs the annual report). Alternatively, the senior officer in charge of the servicing function of the master servicer (or entity performing the equivalent functions) may sign the certification.

(g) For purposes of this section, the term Asset-Backed Issuer means any issuer whose reporting obligation results from the registration of securities it issued that are primarily serviced by the cash flows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to security holders.

11. By adding §240.13a-15 to read as follows:

§240.13a-15 Issuer's disclosure controls and procedures related to preparation of required reports.

(a) Every issuer that has a class of securities registered pursuant to section 12 of the Act (15 U.S.C. 78l), other than an Asset-Backed Issuer (as defined in §240.13a-14(g) of this chapter), must maintain disclosure controls and procedures (as defined in §240.13a-14(c) of this chapter).

(b) Within the 90-day period prior to the filing date of each report requiring certification under §240.13a-14 and §270.30a-2 of this chapter, an evaluation must be carried out under the supervision and with the participation of the issuer's management, including the issuer's principal executive officer or officers and principal financial officer or officers, or persons performing similar functions, of the effectiveness of the design and operation of the issuer's disclosure controls and procedures.

12. By amending §240.15d-10 to add an "Additional Note" after the "Note" at the end of the section to read as follows:

§240.15d-10 Transition reports.

* * * * *

<u>Additional Note: The report or reports to be filed pursuant to this section must include the certification required by §240.15d-14.</u>

13. By adding §240.15d-14 to read as follows:

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§240.15d-14 Certification of disclosure in annual and quarterly reports.

(a) Each report, including transition reports, filed on Form 10-Q, Form 10-QSB, Form 10-K, Form 10-KSB, Form 20-F or Form 40-F (§§249.308a, 249.308b, 249.310, 249.310b, 249.220f and 249.240f of this chapter) under section 15(d) of the Act (15 U.S.C. 78o(d)), other than a report filed by an Asset-Backed Issuer (as defined in paragraph (g) of this section), must include a certification containing the information set forth in paragraph (b) of this section in the form specified in the report. Each principal executive officer or officers and principal financial officer or officers of the issuer, or persons performing similar functions, at the time of filing of the report must sign the certification.

(b) The certification included in each report specified in paragraph (a) of this section must be in the form specified in the report and consist of a statement of the certifying officer that:

(1) He or she has reviewed the report being filed;

(2) Based on his or her knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by the report;

(3) Based on his or her knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition, results of operations and cash flows of the issuer as of, and for, the periods presented in the report;

(4) He or she and the other certifying officers are responsible for establishing and maintaining disclosure controls and procedures (as such term is defined in paragraph (c) of this section) for the issuer and have:

(i) Designed such disclosure controls and procedures to ensure that material information relating to the issuer, including its consolidated subsidiaries, is made known to them by others within those entities, particularly during the period in which the periodic reports are being prepared;

(ii) Evaluated the effectiveness of the issuer's disclosure controls and procedures as of a date within 90 days prior to the filing date of the report (the "Evaluation Date"); and

(iii) Presented in the report their conclusions about the effectiveness of the disclosure controls and procedures based on their evaluation as of the Evaluation Date;

(5) He or she and the other certifying officers have disclosed, based on their most recent evaluation, to the issuer's auditors and the audit committee of the board or directors (or persons fulfilling the equivalent function):

(i) All significant deficiencies in the design or operation of internal controls which could adversely affect the issuer's ability to record, process, summarize and report financial data and have identified for the issuer's auditors any material weaknesses in internal controls; and

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(ii) Any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls; and

(6) He or she and the other certifying officers have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

(c) For purposes of this section and §240.15d-15 of this chapter, the term "disclosure controls and procedures" means controls and other procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer in the reports that it files or submits under the Act (15 U.S.C. 78a et seq.) is recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the Act is accumulated and communicated to the issuer's management, including its principal executive officer or officers and principal financial officer or officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

(d) A person required to provide the certification specified in paragraph (a) of this section may not have the certification signed on his or her behalf pursuant to a power of attorney or other form of confirming authority.

(e) Each annual report filed by an Asset-Backed Issuer (as defined in paragraph (g) of this section) under section 13(a) of the Act (15 U.S.C. 78m(a)) must include a certification addressing the following items:

(1) Review by the certifying officer of the annual report and other reports containing distribution information for the period covered by the annual report;

(2) The absence in these reports, to the best of the certifying officer's knowledge, of any untrue statement of material fact or omission of a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading;

(3) The inclusion in these reports, to the best of the certifying officer's knowledge, of the financial information required to be provided to the trustee under the governing documents of the issuer; and

(4) Compliance by the servicer with its servicing obligations and minimum servicing standards.

(f) With respect to Asset-Backed Issuers, the certification required by paragraph (e) of this section must be signed by the trustee of the trust (if the trustee signs the annual report) or the senior officer in charge of securitization of the depositor (if the depositor signs the annual report). Alternatively, the senior officer in charge of the servicing function of the master servicer (or entity performing the equivalent functions) may sign the certification.

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(g) For purposes of this section, the term Asset-Backed Issuer means any issuer whose reporting obligation results from the offering of securities it issued that are primarily serviced by the cash flows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to security holders.

14. By adding §240.15d-15 to read as follows:

§240.15d-15 Issuer's disclosure controls and procedures related to preparation of required reports.

(a) Every issuer that files reports under section 15(d) of the Act (15 U.S.C. 78o(d)), other than an Asset-Backed Issuer (as defined in §240.15d-14(g) of this chapter), must maintain disclosure controls and procedures (as defined in §240.15d-14(c) of this chapter).

(b) Within the 90-day period prior to the filing date of each report requiring certification under §240.13a-14 and §270.30a-2 of this chapter, an evaluation must be carried out under the supervision and with the participation of the issuer's management, including the issuer's principal executive officer or officers and principal financial officer or officers, or persons performing similar functions, of the effectiveness of the design and operation of the issuer's disclosure controls and procedures.

PART 249 - FORMS, SECURITIES EXCHANGE ACT OF 1934

15. The authority citation for Part 249 is amended by adding the following citations in numerical order to read as follows:

Authority: 15 U.S.C. 78a et seq., unless otherwise noted.

* * * * *

Section 249.308a is also issued under secs. 3(a) and 302, Pub.L.No. 107-204, 116 Stat. 745.

Section 249.308b is also issued under secs. 3(a) and 302, Pub.L.No. 107-204, 116 Stat. 745.

Section 249.310 is also issued under secs. 3(a) and 302, Pub.L.No. 107-204, 116 Stat. 745.

Section 249.310b is also issued under secs. 3(a) and 302, Pub.L.No. 107-204, 116 Stat. 745.

Section 249.220f is also issued under secs. 3(a) and 302, Pub.L.No. 107-204, 116 Stat. 745.

Section 249.240f is also issued under secs. 3(a) and 302, Pub.L.No. 107-204, 116 Stat. 745.

* * * * *

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16. By amending Form 10-Q (referenced in §249.308a) by revising General Instruction G, by adding new Item 4 to "Part I - Financial Information" and by adding a "Certifications" section after the "Signatures" section to read as follows:

Note: The text of Form 10-Q does not, and this amendment will not, appear in the Code of Federal Regulations.

FORM 10-Q

* * * * *

GENERAL INSTRUCTIONS

* * * * *

G. Signature and Filing of Report.

If the report is filed in paper pursuant to a hardship exemption from electronic filing (see Item 201 et seq. of Regulation S-T (17 CFR 232.201 et seq.), three complete copies of the report, including any financial statements, exhibits or other papers or documents filed as a part thereof, and five additional copies which need not include exhibits must be filed with the Commission. At least one complete copy of the report, including any financial statements, exhibits or other papers or documents filed as a part thereof, must be filed with each exchange on which any class of securities of the registrant is registered. At least one complete copy of the report filed with the Commission and one such copy filed with each exchange must be manually signed on the registrant's behalf by a duly authorized officer of the registrant and by the principal financial or chief accounting officer of the registrant. (See Rule 12b-11(d) (17 CFR 240.12b-11(d).) Copies not manually signed must bear typed or printed signatures. In the case where the principal executive officer, principal financial officer or chief accounting officer is also duly authorized to sign on behalf of the registrant, one signature is acceptable provided that the registrant clearly indicates the dual responsibilities of the signatory. In addition, each principal executive officer and principal financial officer of the registrant must provide the certification required by Rule 13a-14 (17 CFR 240.13a-14) or Rule 15d-14 (17 CFR 240.15d-14) exactly as specified in this form.

* * * * *

PART I - FINANCIAL INFORMATION

* * * * *

Item 4. Controls and Procedures.

Furnish the information required by Item 307 of Regulation S-K (§229.307 of this chapter).

* * * * *

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SIGNATURES

* * * * *

CERTIFICATIONS*

I, [identify the certifying individual], certify that:

1. I have reviewed this quarterly report on Form 10-Q of [identify registrant];

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):

a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

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6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: ....

____
[Signature]
[Title]

* Provide a separate certification for each principal executive officer and principal financial officer of the registrant. See Rules 13a-14 and 15d-14. The required certification must be in the exact form set forth above.

17. By amending Form 10-QSB (referenced in §249.308b) by revising General Instruction F, by adding new Item 3 to "Part I - Financial Information" and by adding a "Certifications" section after the "Signatures" section to read as follows:

Note: The text of Form 10-QSB does not, and this amendment will not, appear in the Code of Federal Regulations.

FORM 10-QSB

* * * * *

GENERAL INSTRUCTIONS

* * * * *

F. Signature and Filing of Report

1. If the report is filed in paper pursuant to a hardship exemption from electronic filing (see Item 201 et seq. of Regulation S-T (17 CFR 232.201 et seq.), file three "complete" copies and five "additional" copies of the report with the Commission and file at least one complete copy with each exchange on which any class of securities of the small business issuer is registered. A "complete" copy includes financial statements, exhibits and all other papers and documents. An "additional" copy excludes exhibits.

2. Manually sign at least one complete copy of the report filed with the Commission and with each exchange; other copies should have typed or printed signatures. (See Rule 12b-11(d) (17 CFR 240.12b-11(d).) In the case where the principal executive officer, principal financial officer or chief accounting officer is also duly authorized to sign on behalf of the small business issuer, one signature is acceptable provided that the issuer clearly indicates the dual responsibilities of the signatory. Each principal executive officer and principal financial officer of the small

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business issuer must provide the certification required by Rule 13a-14 (17 CFR 240.13a-14) or Rule 15d-14 (17 CFR 240.15d-14) exactly as specified in this form.

* * * * *

PART I - FINANCIAL INFORMATION

* * * * *

Item 3. Controls and Procedures.

Furnish the information required by Item 307 of Regulation S-B (§228.307 of this chapter).

* * * * *

SIGNATURES

* * * * *

CERTIFICATIONS*

I, [identify the certifying individual], certify that:

1. I have reviewed this quarterly report on Form 10-QSB of [identify registrant];

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:

a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

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c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):

a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: ....

____
[Signature]
[Title]

* Provide a separate certification for each principal executive officer and principal financial officer of the registrant. See Rules 13a-14 and 15d-14. The required certification must be in the exact form set forth above.

* * * * *

18. By amending Form 10-K (referenced in § 249.310):

a. by revising General Instruction D(2)(a),

b. by redesignating Item 14 as Item 15 in Part IV,

c. adding new Item 14 to Part III, and

d. by adding a "Certifications" section after the "Signatures" section and before the reference to "Supplemental information to be Furnished With Reports Filed Pursuant to Section 15(d) of the Act by Registrants Which Have Not Registered Securities Pursuant to Section 12 of the Act." The revisions read as follows:

Note: The text of Form 10-K does not, and this amendment will not, appear in the Code of Federal Regulations.

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FORM 10-K

* * * * *

GENERAL INSTRUCTIONS

* * * * *

D. Signature and Filing of Report.

(1) * * *

(2)(a) The report must be signed by the registrant, and on behalf of the registrant by its principal executive officer or officers (who also must provide the certification required by Rule 13a-14 (17 CFR 240.13a-14) or Rule 15d-14 (17 CFR 240.15d-14) exactly as specified in this form), its principal financial officer or officers (who also must provide the certification required by Rule 13a-14 (17 CFR 240.13a-14) or Rule 15d-14 (17 CFR 240.15d-14) exactly as specified in this form), its controller or principal accounting officer, and by at least the majority of the board of directors or persons performing similar functions. Where the registrant is a limited partnership, the report must be signed by the majority of the board of directors of any corporate general partner who signs the report.

* * * * *

Annual Report Pursuant to Section 13 or 15(d)

of the Securities Exchange Act of 1934

* * * * *

PART III

* * * * *

Item 14. Controls and Procedures.

Furnish the information required by Item 307 of Regulation S-K (§229.307 of this chapter).

* * * * *

SIGNATURES

* * * * *

CERTIFICATIONS*

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I, [identify the certifying individual], certify that:

1. I have reviewed this annual report on Form 10-K of [identify registrant];

2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;

3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:

a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;

b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the "Evaluation Date"); and

c) presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):

a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this annual report whether there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: ....

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____
[Signature]
[Title]

* Provide a separate certification for each principal executive officer and principal financial officer of the registrant. See Rules 13a-14 and 15d-14. The required certification must be in the exact form set forth above.

* * * * *

19. By amending Form 10-KSB (referenced in § 249.310b):

a. by revising General Instruction C.2.,

b. by adding new Item 14 to Part III, and

c. by adding a "Certifications" section after the "Signatures" section and before the reference to "Supplemental information to be Furnished With Reports Filed Pursuant to Section 15(d) of the Exchange Act By Non-reporting Issuers." The revisions read as follows:

Note: The text of Form 10-KSB does not, and this amendment will not, appear in the Code of Federal Regulations.

FORM 10-KSB

* * * * *

GENERAL INSTRUCTIONS

* * * * *

PART III

* * * * *

Item 14. Controls and Procedures.

Furnish the information required by Item 307 of Regulation S-B (§228.307 of this chapter).

* * * * *

C. Signature and Filing of Report.

1. * * *

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2. Who must sign. The small business issuer, its principal executive officer or officers (who also must provide the certification required by Rule 13a-14 (17 CFR 240.13a-14) or Rule 15d-14 (17 CFR 240.15d-14) exactly as specified in this form), its principal financial officer (who also must provide the certification required by Rule 13a-14 (17 CFR 240.13a-14) or Rule 15d-14 (17 CFR 240.15d-14) exactly as specified in this form), its controller or principal accounting officer and at least a majority of the board of directors or persons performing similar functions. If the small business issuer is a limited partnership, then the general partner and a majority of its board of directors if a corporation must sign the report. Any person who occupies more than one of the specified positions must indicate each capacity in which he or she signs the report. See Rule 12b-11 concerning manual signatures under powers of attorney.

* * * * *

SIGNATURES

* * * * *

CERTIFICATIONS*

I, [identify the certifying individual], certify that:

1. I have reviewed this annual report on Form 10-KSB of [identify registrant];

2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;

3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:

a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;

b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the "Evaluation Date"); and

c) presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

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5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):

a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this annual report whether there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: ....

____
[Signature]
[Title]

* Provide a separate certification for each principal executive officer and principal financial officer of the registrant. See Rules 13a-14 and 15d-14. The required certification must be in the exact form set forth above.
* * * * *
20. By amending Form 20-F (referenced in §249.220f):

a. by adding a new paragraph (e) to General Instruction B,

b. by adding new Item 15, and

c. by adding a "Certifications" section after the "Signatures" section and before the section referencing "Instructions as to Exhibits." The revisions read as follows:

Note: The text of Form 20-F does not, and this amendment will not, appear in the Code of Federal Regulations.

FORM 20-F

* * * * *
GENERAL INSTRUCTIONS
* * * * *
B. General Rules and Regulations That Apply to this Form.

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* * * * *

(e) Where the Form is being used as an annual report filed under Section 13(a) or 15(d) of the Exchange Act, provide the certification required by Rule 13a-14 (17 CFR 240.13a-14) or Rule 15d-14 (17 CFR 240.15d-14) exactly as specified in this form.

* * * * *

PART II

* * * * *

Item 15. Controls and Procedures.

(a) Where the Form is being used as an annual report filed under Section 13(a) or 15(d) of the Exchange Act, disclose the conclusions of the registrant's principal executive officer or officers and principal financial officer or officers, or persons performing similar functions, about the effectiveness of the registrant's disclosure controls and procedures (as defined in §§240.13a-15(c) and 240.15d-15(c)) based on their evaluation the controls and procedures as of a date within 90 days prior to the filing date of the report.

(b) Where the Form is being used as an annual report filed under Section 13(a) or 15(d) of the Exchange Act, disclose whether or not there were significant changes in the registrant's internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

* * * * *

SIGNATURES

* * * * *

CERTIFICATIONS*

I, [identify the certifying individual], certify that:

1. I have reviewed this annual report on Form 20-F of [identify registrant];

2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;

3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of

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operations and cash flows of the registrant as of, and for, the periods presented in this annual report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:

a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;

b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the "Evaluation Date"); and

c) presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):

a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this annual report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: ....

____
[Signature]
[Title]

* Provide a separate certification for each principal executive officer and principal financial officer of the registrant. See Rules 13a-14 and 15d-14. The required certification must be in the exact form set forth above.

* * * * *

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21. By amending Form 40-F (referenced in §249.240f) by adding a new paragraph (6) to General Instruction B and by adding a "Certifications" section after the "Signatures" section to read as follows:

Note: The text of Form 40-F does not, and this amendment will not, appear in the Code of Federal Regulations.

FORM 40-F

* * * * *

GENERAL INSTRUCTIONS

* * * * *

B. Information To Be Filed on this Form.

* * * * *

(6)Where the Form is being used as an annual report filed under Section 13(a) or 15(d) of the Exchange Act:

(a) Provide the certification required by Rule 13a-14 (17 CFR 240.13a-14) or Rule 15d-14 (17 CFR 240.15d-14) exactly as specified in this form.

(b) Disclose the conclusions of the registrant's principal executive officer or officers and principal financial officer or officers, or persons performing similar functions, about the effectiveness of the registrant's disclosure controls and procedures (as defined in §§240.13a-15(c) and 240.15d-15(c)) based on their evaluation the controls and procedures as of a date within 90 days prior to the filing date of the report.

(c) Disclose in the report whether or not there were significant changes in the registrant's internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

* * * * *

SIGNATURES

* * * * *

CERTIFICATIONS*

I, [identify the certifying individual], certify that:

1. I have reviewed this annual report on Form 40-F of [identify registrant];

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2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;

3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:

a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;

b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the "Evaluation Date"); and

c) presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (and persons performing the equivalent function):

a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this annual report whether there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: ....

____

[Signature]
[Title]

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* Provide a separate certification for each principal executive officer and principal financial officer of the registrant. See Rules 13a-14 and 15d-14. The required certification must be in the exact form set forth above.

PART 270 - RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940

22. The authority citation for part 270 is amended by adding the following citation in numerical order to read as follows:

Authority: 15 U.S.C. 80a-1, et seq., 80a-34(d), 80a-37, 80a-39, unless otherwise noted;

* * * * *

Section 270.30a-2 is also issued under 15 U.S.C. 78m, 78o(d), and 80a-29, and secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745.

* * * * *

23. By adding § 270.30a-2 to read as follows:

§ 270.30a-2 Certification of disclosure in annual and semi-annual reports.

(a) Each report, including transition reports, filed on Form N-SAR (referenced in §§249.330 and 274.101) by a registered management investment company or unit investment trust must include a certification containing the information set forth in paragraph (b) of this section in the form specified in the report, except that a report of a unit investment trust or small business investment company on Form N-SAR may omit paragraph (b)(3) of this section. Each principal executive officer or officers and principal financial officer or officers of the investment company, or persons performing similar functions, at the time of filing of the report must sign the certification.

(b) The certification included in each report specified in paragraph (a) of this section must be in the form specified in the report and consist of a statement of the certifying officer that:

(1) He or she has reviewed the report being filed;

(2) Based on his or her knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by the report;

(3) Based on his or her knowledge, the financial information included in the report, and the financial statements on which the financial information is based, fairly present in all material respects the financial condition, results of operations, changes in net assets, and cash flows (if the financial statements are required to include a statement of cash flows) of the investment company as of, and for, the periods presented in the report;

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(4) He or she and the other certifying officers are responsible for establishing and maintaining disclosure controls and procedures (as such term is defined in paragraph (c) of this section) for the investment company and have:

(i) Designed such disclosure controls and procedures to ensure that material information relating to the investment company, including its consolidated subsidiaries, is made known to them by others within those entities, particularly during the period in which the periodic reports are being prepared;

(ii) Evaluated the effectiveness of the investment company's disclosure controls and procedures as of a date within 90 days prior to the filing date of the report (the "Evaluation Date"); and

(iii) Presented in the report their conclusions about the effectiveness of the disclosure controls and procedures based on their evaluation as of the Evaluation Date;

(5) He or she and the other certifying officers have disclosed, based on their most recent evaluation, to the investment company's auditors and the audit committee of the board of directors (or persons fulfilling the equivalent function):

(i) All significant deficiencies in the design or operation of internal controls which could adversely affect the investment company's ability to record, process, summarize, and report financial data and have identified for the investment company's auditors any material weaknesses in internal controls; and

(ii) Any fraud, whether or not material, that involves management or other employees who have a significant role in the investment company's internal controls; and

(6) He or she and the other certifying officers have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

(c) For purposes of this section, the term "disclosure controls and procedures" means controls and other procedures of an investment company that are designed to ensure that information required to be disclosed by the investment company in the reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized, and reported, within the time periods specified in the Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an investment company in the reports that it files or submits under the Securities Exchange Act of 1934 is accumulated and communicated to the investment company's management, including its principal executive officer or officers and principal financial officer or officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

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(d) A person required to provide the certification specified in paragraph (a) of this section may not have the certification signed on his or her behalf pursuant to a power of attorney or other form of confirming authority.

24. Section 270.30b1-3 is amended by adding a sentence at the end of the section to read as follows:

§270.30b1-3 Transition reports.

* * * A report filed pursuant to this section must include the certification required by §270.30a-2.

PART 249 - FORMS, SECURITIES EXCHANGE ACT OF 1934

PART 274 - FORMS PRESCRIBED UNDER THE INVESTMENT COMPANY ACT OF 1940

25. The authority citation for Part 274 is revised to read as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 78c(b), 78l, 78m, 78n, 78o(d), 80a-8, 80a-24, 80a-26, and 80a-29, and secs. 3(a) and 302, Pub. L. No. 107-204, 116 Stat. 745, unless otherwise noted.

26. By amending Form N-SAR (referenced in §§ 249.330 and 274.101) by:

a. Revising the reference "132" in item 6 to read "133";

b. Adding item 133;

c. Revising the reference "132" in the fifth paragraph of General Instruction A to read "133";

d. Revising General Instructions D and G, and the Instructions to sub-items 77Q3 and 102P3;

e. Adding an Instruction to item 133; and

f. Revising the reference "132" in the Instructions to the Signature Page to read "133."

These additions and revisions read as follows:

Note: The text of Form N-SAR does not, and these amendments will not, appear in the Code of Federal Regulations.

FORM N-SAR

* * * * *

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133. Include the certifications required by rule 30a-2 under the Investment Company Act (17 CFR 270.30a-2).

* * * * *

GENERAL INSTRUCTIONS

* * * * *

D. Preparation of Report

(1) No item of the form except items 77 and 102 shall be answered by incorporating any information by reference. No exhibits or supplemental information are required or permitted, except in response to these items and item 133.

* * * * *

G. Submitting an Amendment to Form N-SAR on Paper or Electronically

* * * * *

(5) In an exhibit to the amendment, each principal executive officer and principal financial officer must provide the certification required by Item 133, instruction (a) for sub-item 77Q3, and instruction (a) for sub-item 102P3. A registrant that is a unit investment trust or a small business investment company may omit paragraph 3 of the certification required by instruction 77Q3(a)(iii).

* * * * *

INSTRUCTIONS TO SPECIFIC ITEMS

* * * * *

SUB-ITEM 77Q3:

Subject to Rule 201.24 of the General Rules of Practice regarding incorporation by reference, the rules applicable to electronic submission of filings, and General Instruction F of this form, the following exhibits shall be filed as part of this form, if not previously filed:

(a) If the form is filed under Section 13(a) or 15(d) of the 1934 Act, include the following information:

(i) Disclose the conclusions of the registrant's principal executive officer or officers and principal financial officer or officers, or persons performing similar functions, about the effectiveness of the registrant's disclosure controls and procedures (as defined in rule 30a-2(c) under the Act (17 CFR 270.30a-2(c)) based on their evaluation of these controls and procedures as of a date within 90 days of the filing date of the report that includes the disclosure required by this paragraph.

(ii) Disclose whether or not there were significant changes in the registrant's internal controls or in other factors that could significantly affect these controls subsequent to the date of their

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evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

(iii) Include the certification of each principal executive officer and principal financial officer required by Rule 30a-2 under the Act (17 CFR 270.30a-2). Provide a separate certification for each principal executive officer and principal financial officer, or person performing similar functions, in the exact form set forth below:

CERTIFICATIONS

I, [identify the certifying individual], certify that:

1. I have reviewed this report on Form N-SAR of [identify registrant];

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial information included in this report, and the financial statements on which the financial information is based, fairly present in all material respects the financial condition, results of operations, changes in net assets, and cash flows (if the financial statements are required to include a statement of cash flows) of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in rule 30a-2(c) under the Investment Company Act) for the registrant and have:

a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this report (the "Evaluation Date"); and

c) presented in this report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize, and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

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b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: _______________

____
[Signature]
[Title]

(b) Furnish any other information required to be included as an exhibit pursuant to such rules and regulations as the Commission may prescribe.

* * * * *

SUB-ITEM 102P3

See instructions for sub-item 77Q3. The registrant may omit paragraph 3 of the certification required by instruction (a)(iii).

* * * * *
ITEM 133

Include the exhibit required by instruction (a) for sub-item 77Q3. The registrant may omit paragraph 3 of the certification required by instruction (a)(iii).

By the Commission.

Margaret H. McFarland
Deputy Secretary

August 28, 2002

Endnotes

1 We do not edit personal identifying information, such as names or electronic mail addresses, from electronic submissions. You should submit only information that you wish to make available publicly.

2 17 CFR 228.307.

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3 17 CFR 228.10 *et seq*.

4 17 CFR 229.307.

5 17 CFR 229.10 *et seq*.

6 17 CFR 240.13a-14.

7 17 CFR 240.13a-15.

8 17 CFR 240.15d-14.

9 17 CFR 240.15d-15.

10 15 U.S.C. §78a *et seq*.

11 17 CFR 270.30a-2.

12 15 U.S.C. §80a-1 *et seq*.

13 17 CFR 240.12b-15.

14 17 CFR 240.13a-10.

15 17 CFR 240.15d-10.

16 17 CFR 249.308a.

17 17 CFR 249.308b.

18 17 CFR 249.310.

19 17 CFR 249.310b.

20 17 CFR 249.220f.

21 17 CFR 249.240f.

22 17 CFR 270.30b1-3.

23 17 CFR 232.302.

24 17 CFR 249.330; 17 CFR 274.101.

25 Pub. L. 107-204, 116 Stat. 745 (2002).

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26 See Release No. 34-46079 (June 14, 2002) [67 FR 41877] (the "June Proposals").

27 See Release No. 34-46300 (Aug. 2, 2002) [67 FR 51508] notifying interested parties of the rules that we are required to adopt pursuant to Section 302 of the Act and highlighting some of the major differences between those rules and the June Proposals.

28 The commenters included 56 individual and institutional investors, 21 companies and company associations, one domestic governmental agency, one foreign governmental agency and 23 members of the accounting and legal communities. These comment letters and a summary of comments are available for public inspection and copying in our Public Reference Room, 450 Fifth Street, NW, Washington, DC 20549, in File No. S7-21-02. Public comments submitted electronically and the summary of comments are available on our website <http://www.sec.gov>.

29 See, for example, the Letter dated June 13, 2002 of Robert E. Jones, the Letter dated June 24, 2002 of Dan Jamieson and the Letter dated July 5, 2002 of T. Jeffrey Mangin.

30 See, for example, the Letter dated August 9, 2002 of the American Society of Corporate Securities and the Letter dated August 14, 2002 of the National Association of Real Estate Investment Trusts.

31 Separately, Section 404 of the Act directs the Commission to prescribe rules for issuers to state in their annual reports required by Section 13(a) or 15(d) of the Exchange Act the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting.

32 See proposed Exchange Act Rules 13a-15 and 15d-15.

33 See Section IV below for a discussion of registered investment companies. Registered investment companies generally are required to file periodic reports under Section 13(a) or 15(d) of the Exchange Act on Form N-SAR and, therefore, would provide the certification required by Section 302 of the Act. However, because Section 302 of the Act only applies to issuers that file periodic reports under Section 13(a) or 15(d) of the Exchange Act, the rules we are adopting today will not apply to registered investment companies that do not file periodic reports under either Section 13(a) or 15(d).

34 15 U.S.C.§§78m(a) or 78o(d). Section 13(a) of the Exchange Act requires every issuer of a security registered pursuant to Section 12 of the Exchange Act [15 U.S.C. §78l] to file with the Commission such annual reports and such quarterly reports as the Commission may prescribe. Section 15(d) of the Exchange Act requires each issuer that has filed a registration statement that has become effective pursuant to the Securities Act of 1933 [15 U.S.C.§77a *et seq*.] to file such supplementary and periodic information, documents and reports as may be required pursuant to Section 13 in respect of a security registered pursuant to Section 12. The duty of an issuer to file under Section 15(d) is automatically suspended for any fiscal year, other than a fiscal year in which its registration statement becomes effective or is required to be updated pursuant to Section 10(a)(3) of the Securities Act [15 U.S.C. §77j(a)(3)], if an issuer's securities are held of record by less than 300 persons. See Exchange Act Rule 12h-3(c) [17 CFR 240.12h-3(c)].

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35 As permitted under our rules, a registrant may satisfy its disclosure obligations under Part III of Forms 10-K and 10-KSB by incorporating the required information by reference from its definitive proxy or information statement, if that statement involves the election of directors and is filed not later than 120 days after the end of the fiscal year covered by the annual report. See General Instruction G(3) to Form 10-K and General Instruction E(3) to Form 10-KSB. For purposes of this provision, the certification in the annual report on Form 10-K or 10-KSB would be considered to cover the Part III information in a registrant's proxy or information statement as and when filed.

36 See American Institute of Certified Public Accountants ("AICPA") Codification of Statements on Auditing Standards, AU §319.

37 These reports include quarterly reports on Form 10-Q or 10-QSB, annual reports on Form 10-K, 10-KSB, 20-F or 40-F, current reports, definitive proxy materials filed under Section 14(a) of the Exchange Act [15 U.S.C. §78n(a)], definitive information statements filed under Section 14(c) of the Exchange Act [15 U.S.C. §78n(c)] and amendments to any of these reports or documents.

38 See new Exchange Act Rules 13a-14(c) and 15d-14(c).

39 See Section 302(a) of the Act.

40 The new rules achieve the objective of Section 302(b) of the Act, which states that nothing in the provision is to be interpreted or applied in any way to allow any issuer to lessen the legal force of the certification requirement by an issuer that has reincorporated or engaged in any other transaction resulting in the transfer of the corporate domicile or offices of the issuer from inside of the United States to outside of the United States, because they are applicable to all issuers without regard to their jurisdiction of incorporation or domicile.

41 For purposes of the Exchange Act, a "foreign private issuer" is any foreign issuer (other than a foreign government) except an issuer meeting the following conditions: (1) more than 50% of the issuer's outstanding voting securities are directly or indirectly held of record by residents of the U.S.; and (2) the majority of the executive officers or directors are U.S. citizens or residents; or more than 50% of the assets of the issuer are located in the U.S.; or the business of the issuer is administered principally in the U.S. See Exchange Act Rule 3b-4(c) [17 CFR 240.3b-4(c)]. We sought comment on whether to apply a certification requirement to foreign private issuers in the June Proposals.

42 The new rules do not apply to foreign private issuers that furnish materials to the Commission pursuant to Exchange Act Rule 12g3-2(b) [17 CFR 240.12g3-2(b)].

43 See Section 3(b)(4) of the Act.

44 Asset-backed issuers also sometimes voluntarily file Exchange Act reports in order to comply with provisions in the indenture or pooling and servicing agreements.

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45 See, for example, Release No. 34-16520 (Jan. 23, 1980) (order granting application pursuant to Section 12(h) of the Exchange Act [15 U.S.C. §78*l*(h)] of Home Savings and Loan Association); Release No. 34-14446 (Feb. 6, 1978) (order granting application pursuant to Section 12(h) of the Exchange Act of Bank of America National Trust and Savings Association); Division of Corporation Finance no-action letters to *Key Bank USA, N.A.* (May 9, 1997) and *Bay View Securitization Corp.* (Jan. 15, 1998).

46 See Section 302(a) of the Act.

47 The certification requirement does not apply to annual reports on Form 11-K [17 CFR 239.311].

48 See amended Exchange Act Rules 12b-15, 13a-10 and 15d-10. In the case of the amendment on or after the compliance date of the new rules of a quarterly or annual report filed prior to August 29, 2002, the certification requirement will apply.

49 17 CFR 249.306.

50 A foreign private issuer must furnish under cover of Form 6-K material information that it makes public or is required to make public under its home country laws or the rules of its home country stock exchange or that it distributes to security holders. While foreign private issuers may submit interim financial information under cover of Form 6-K, they do so pursuant to their home country requirements and not because of a Commission requirement to submit updated financial information for specified periods and according to specified standards. Therefore, we do not believe that a Form 6-K constitutes a "periodic" report analogous to a quarterly report on Form 10-Q or 10-QSB for which certification is required.

51 See new Exchange Act Rules 13a-15 and 15d-15.

52 See General Instruction D to Form 20-F.

53 17 CFR 249.210 and 249.210b.

54 See Exchange Act Rules 10b-5(b) [17 CFR 230.10b-5(b)] and 12b-20 [17 CFR 240.12b-20.]. See also *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988); *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. (1976).

55 Presenting financial information in conformity with generally accepted accounting principles may not necessarily satisfy obligations under the antifraud provisions of the federal securities laws. See *United States v. Simon*, 425 F.2d 796 (2d Cir. 1969). See also *In re Caterpillar, Inc.*, Release No. 34-30532 (Mar. 31, 1992); *Edison Schools, Inc.*, Release No. 34-45925 (May 14, 2002).

56 See Exchange Act Rule 12b-20 and the case and proceedings referenced in n. 55 above. In addition, both International Accounting Standard IAS 1, ¶14 and 15 and AICPA, Codification of

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Statements on Auditing Standards, AU §411.04 speak to the essential elements that must be considered, within the framework of generally accepted accounting principles, in evaluating whether an issuer's financial statements fairly present its financial condition and results of operations. These statements, without being limited by reference to generally accepted accounting principles, provide guidance as to what elements should be considered in determining whether an issuer's financial information, taken as a whole, provides a fair presentation of its financial condition and results of operations. These elements include, without limitation, whether the accounting principles selected are appropriate in the circumstances and whether the disclosure is informative and reasonably reflects the underlying transactions and events.

57 See, for example, *In re Caterpillar, Inc.*, Release No. 34-30532 (Mar. 31, 1992); Exchange Act Rule 12b-20.

58 See new Exchange Act Rules 13a-14(c) and 15d-14(c).

59 15 U.S.C. §78m(b). See also AICPA Professional Standards AU Section 319.06 ("Internal controls is a process - effected by an entity's board of directors, management and other personnel - designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (a) reliability of financial reporting, (b) effectiveness and efficiency of operations and (c) compliance with applicable laws and regulations.").

60 Officers and employees of an issuer who have an interest in, and the expertise to serve on, the committee could include the principal accounting officer (or the controller), the general counsel or other senior legal official with responsibility for disclosure matters who reports to the general counsel, the principal risk management officer, the chief investor relations officer (or an officer with equivalent responsibilities) and such other officers or employees, including individuals associated with the issuer's business units, as the issuer deems appropriate.

61 The rules called for under Section 404 of the Act will be the subject of separate Commission rulemaking. See n. 75 below.

62 See Section V below.

63 To further emphasize the importance of the required certification, a principal executive officer or principal financial officer is not permitted to have the certification signed on his or her behalf pursuant to a power of attorney or other form of confirming authority. See new Exchange Act Rules 13a-14(d) and 15d-14(d).

64 See Exchange Act Rule 12b-11(d) [17 CFR 240.12b-11(d)].

65 17 CFR 232.302.

66 See Sections 13(a) and 18 of the Exchange Act [15 U.S.C. §§78m(a) and 78r].

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67 See, for example, *Howard v. Everex Systems, Inc.* 228 F.3d 1057 (9th Cir. 2000) (a corporate officer who signs a Commission filing containing representations "makes" the statement in the filing and can be liable as a primary violator of Section 10(b) of the Exchange Act).

68 See Sections 20, 21, 21C and 21D of the Exchange Act [15 U.S.C. §78t, 78u, 78u-3 and 78u-4].

69 15 U.S.C. §78j(b).

70 A false certification also may have liability consequences under Sections 11 and 12(a)(2) of the Securities Act [15 U.S.C. §§77k and 77*l*(a)(2)] where a quarterly or annual report is incorporated by reference into a registration statement on Form S-3 [17 CFR 239.13] or F-3 [17 CFR 239.33] or into a prospectus filed pursuant to Securities Act Rule 424(b) [17 CFR 230.424(b)].

71 See Section 13(b)(2) of the Exchange Act [15 U.S.C. §78m(b)(2)] and Rules 13b2-1 and 13b2-2 [17 CFR 240.13b2-1 and 240.13b2-2].

72 17 CFR 210.1-01 *et seq*.

73 For example, for some businesses, an assessment and evaluation of operational and regulatory risks may be necessary.

74 Accordingly, a company that failed to maintain adequate procedures, review them and otherwise comply with the rule could be subject to Commission action for violating Section 13(a) of the Exchange Act even where the failure did not lead to flawed disclosure.

75 We note that Section 404 of the Act directs us to prescribe rules requiring each annual report filed under Section 13(a) or 15(d) of the Exchange Act to contain an internal control report, which shall: (1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting: and (2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting. These rules will be the subject of a separate rulemaking project.

76 17 CFR 249.330; 17 CFR 274.101; Item 133 and Instructions to Items 77Q3, 102P3 and 133 of Form N-SAR.

77 See n. 34 above. Because Section 302 of the Sarbanes-Oxley Act only applies to companies that file periodic reports under Section 13(a) or 15(d) of the Exchange Act, the rules we are adopting today will not apply to registered investment companies that do not file periodic reports under Section 13(a) or 15(d).

78 15 U.S.C. §80a-30(a) and (b)(1).

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79 General Instruction A to Form N-SAR. See Release No. IC-14299 (Jan. 4, 1985) [50 FR 1442] (release adopting Form N-SAR).

80 Investment Company Act Rule 30b1-1 [17 CFR 270.30b1-1]; General Instruction C to Form N-SAR.

81 Investment Company Act Rule 30a-1 [17 CFR 270.30a-1]; General Instruction C to Form N-SAR. A unit investment trust is "an investment company which (A) is organized under a trust indenture, contract of custodianship or agency, or similar instrument, (B) does not have a board of directors, and (C) issues only redeemable securities, each of which represents an undivided interest in a unit of specified securities; but does not include a voting trust." Section 4(2) of the Investment Company Act [15 U.S.C. §80a-4(2)].

82 See Items 72 and 74 of Form N-SAR and the Instructions to those items.

83 In the case of a master-feeder fund, the report of the master fund on Form N-SAR would be expected to include a certification based upon the financial statements of the master fund included in the report to shareholders of the feeder fund.

84 The certification must be filed as an exhibit to the report on Form N-SAR. The EDGAR document type must be EX-99.77Q3 CERT for an Exhibit filed in response to the instructions to sub-item 77Q3, EX-99.102P3 CERT for an Exhibit filed in response to the instructions to sub-item 102P3 and EX-99.133 CERT for an Exhibit filed in response to the instructions to item 133 of this form.

85 New Exchange Act Rule 13a-15 applies to every issuer that has a class of securities registered pursuant to Section 12 of the Exchange Act. New Exchange Act Rule 15d-15 applies to every issuer that is required to file reports pursuant to Section 15(d) of the Exchange Act.

86 New Investment Company Act Rule 30a-2(c) incorporates the definition of "disclosure controls and procedures" contained in new Exchange Act Rules 13a-14(c) and 15d-14(c). We recognize that, in the case of a series fund or family of investment companies, the disclosure controls and procedures for each fund in the series or family may be the same. Therefore, for purposes of new Investment Company Act Rule 30a-2(b)(4)(ii) and (iii), a single evaluation of the effectiveness of the disclosure controls and procedures for the series or family could be used in multiple certifications for the funds in the series or family, as long as the evaluation has been performed within 90 days of the date of the report on Form N-SAR.

87 Instructions (a)(i) and (ii) to sub-item 77Q3 of Form N-SAR.

88 See Items 111 to 132 of Form N-SAR.

89 Signing officers could include, for example, the officers of the depositor required to sign a registration statement on Form N-4 [17 CFR 239.17b; 17 CFR 274.11c] or N-6 [17 CFR 239.17c; 17 CFR 274.11d], or the officers of the depositor, trustee or custodian required to sign a registration statement on Form N-8B-2 [17 CFR 274.12].

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90 *Cf*. Investment Company Act Rule 30e-2 [17 CFR 270.30e-2] (requiring registered unit investment trusts substantially all of the assets of which consist of securities issued by a management investment company to transmit to their shareholders semi-annually a report containing all of the applicable information and financial statements or their equivalent required to be included in reports of the management investment company for the same fiscal period).

91 Instruction to item 133 of Form N-SAR.

92 Business development companies are a category of closed-end investment company that are not required to register under the Investment Company Act. See 15 U.S.C. 80a-2(a)(48) (defining business development companies). A face-amount certificate company is an investment company that engages or proposes to engage in the business of issuing certain face amount certificates. See 15 U.S.C. 80a-4(1). See Release No. IC-14080 (Aug. 6, 1984) [49 FR 32370, 32372] (business development companies and face-amount certificate companies are required to file reports on other forms prescribed under the Exchange Act rather than Form N-SAR).

93 44 U.S.C. §3501 *et seq*.

94 44 U.S.C. §3507(d) and 5 CFR 1320.11.

95 The burden hour and cost estimates for these collections of information are as follows: with respect to Form 10-K (OMB Control No. 3235-0063) an increase in annual reporting and recordkeeping burden hours and cost of 35,190 hours and $3,519,000, respectively; with respect to Form 10-KSB (OMB Control No. 3235-0420) an increase in annual reporting and recordkeeping burden hours and cost of 14,209 hours and $1,421,000, respectively; with respect to Form 10-Q (OMB Control No. 3235-0070) an increase in annual reporting and recordkeeping burden hours and cost of 100,298 hours and $10,030,000, respectively; and respectively; with respect to Form 10-QSB (OMB Control No. 3235-0416) an increase in annual reporting and recordkeeping burden hours and cost of 43,530 hours and $4,353,000, respectively.

96 See the Letter dated August 2, 2000 of Bernard E. Klein.

97 44 U.S.C. §3507(j) and 5 CFR 1320.13.

98 References to new Exchange Act Rule 13a-14 in this section also refer to new Exchange Act Rule 15d-14.

99 References to new Exchange Act Rule 13a-15 in this section also refer to new Exchange Act Rule 15d-15.

100 We have based our estimates of the effects that the new rules and amendments to existing rules and forms will have on these information collections primarily on our review of actual filings of these forms and the forms' requirements.

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101 This estimate is based on 1,200 foreign private issuers that file annual reports on Form 20-F and 100 Canadian issuers that file annual reports on Form 40-F.

102 This estimate is based on 3,650 registered management investment companies and 800 registered unit investment trusts that file reports under Section 13(a) or 15(d) of the Exchange Act.

103 This estimate is based on consultations with several law firms and other persons who regularly assist registrants in preparing and filing quarterly and annual reports with the Commission.

104 This estimate is based on the current annual burden per filing for each foreign private issuer. The estimate of 4,500 hours is calculated by 1,200 foreign private issuers x one filing per year x five burden hours x .75).

105 This estimate is based on the current annual burden per filing for each Canadian issuer. The estimate of 475 hours is calculated by 100 Canadian issuers x one filing per year x five burden hours x .75 + 100 hours to reflect an adjustment in the distribution of burden hours and associated costs). The estimate has then been increased by 100 hours due to an adjustment to reflect a revised burden hour/cost allocation (75%/25%) for the report.

106 This estimate is based on the current annual burden per filing for each investment company. With regard to Form N-SAR, the current estimated average burden hours per response for registered management investment companies and registered small business investment companies is 14.75 hours and the current estimated average burden hours per response for registered unit investment trusts is six hours. The estimated average burden hours per response, if new Investment Company Act Rule 30a-2 is adopted, for Form N-SAR would increase the average burden hours per response by five hours per filing that is required to be certified. We estimate that 50 registered management investment companies are not subject to Section 13(a) or 15(d) of the Exchange Act and hence would not be required to include the certification. Therefore, the estimate of 154,450 hours is calculated by: (3,650 registered management investment companies x two filings per year x 19.75 burden hours) + (50 registered management investment companies not subject to Section 13(a) or 15(d) of the Exchange Act x two filings per year x 14.75 burden hours) + (800 registered unit investment trusts x one filing per year x 11 burden hours).

107 The increase in burden hours is attributed to an increase of 400 registered management investment companies and 67 registered unit investment trusts that are required to file reports pursuant to the Exchange Act from the previous number of these issuers calculated for the current annual burden, and the certification requirement required by the new rule.

108 The estimate of 100,298 hours is calculated by 26,746 quarterly reports x five burden hours x .75.

109 The estimate of 43,350 hours is calculated by 11,608 quarterly reports x five burden hours x .75.

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110 The estimate of 35,190 hours is calculated by 9,384 annual reports x five burden hours x .75.

111 The estimate of 14,209 hours is calculated by 3,789 annual reports x five burden hours x .75.

112 This estimate is based on the current annual burden per filing for each foreign private issuer. The estimate of $450,000 is calculated by 1,200 foreign private issuers x one filing per year x five burden hours x .25 x $300.00).

113 This estimate is based on the current annual burden per filing for each foreign private issuer. The estimate of $26,500 is calculated by 100 foreign private issuers x one filing per year x five burden hours x .25 x $300.00). The estimate has then been reduced by $11,000 due to an adjustment to reflect a revised burden hour/cost allocation (75%/25%) for the report.

114 The estimate of $10,030,000 is calculated by 26,746 quarterly reports x five burden hours x .25 x $300.00.

115 The estimate of $4,353,000 is calculated by 11,608 quarterly reports x five burden hours x .25 x $300.00.

116 The estimate of $3,519,000 is calculated by 9,384 annual reports x five burden hours x .25 x $300.00.

117 The estimate of $1,421,000 is calculated by 3,789 annual reports x five burden hours x .25 x $300.00.

118 See the amendment to Rule 302(b) of Regulation S-T [17 CFR 232.302(b)].

119 5 U.S.C. §603.

120 The Initial Regulatory Flexibility Analysis ("IRFA") prepared in connection with the June Proposals also involved proposed rules under the Exchange Act that would have required an issuer's principal executive officer and principal financial officer to certify the information contained in their quarterly and annual reports That proposal has been superseded by the statutory mandate of Section 302 of the Act. The Act's directive to adopt rules for all issuers makes no distinction based on the size of the issuer. We, therefore, do not analyze the new rules adopted under the Exchange Act requiring certifications by an issuer's principal executive and financial officers.

121 17 CFR 240.0-10(a).

122 A similar definition is provided under Securities Act Rule 157 [17 CFR 230.157].

123 This estimate is based on filings with the Commission.

124 See the June Proposals at Section V.

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125 See the Letter dated August19, 2002 of the Office of the Chief Counsel for Advocacy of the U.S. Small Business Administration.

126 See Section V above.

127 15 U.S.C. §78m(b)(2)(B).

128 15 U.S.C. §78w(a)(2).

129 15 U.S.C. §78c(f).

130 15 U.S.C. §80a-2(c).

131 See 5 U.S.C. §553(b).

132 *Id*. The Commission previously published notice and sought comment on a certification proposal that was somewhat similar to, but different in several material respects, from the new rules we are adopting today to implement Section 302 of the Sarbanes-Oxley Act. We did not propose rules that would apply to investment companies or foreign private issuers (although we sought comment on the latter).

133 See Section 302 (a) and (c) of the Act.

134 See 5 U.S.C. §553(d).

135 *Id*.

136 This finding also satisfies the requirements of 5 U.S.C. §808(2), allowing the rules to become immediately, effective notwithstanding the requirements of 5 U.S.C. §801 (if agency finds that notice and public comment procedure are "impractical, unnecessary, or contrary to the public interest," a rule "shall take effect at such time as the Federal agency promulgating the rule determines").

http://www.sec.gov/rules/final/33-8124.htm

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Summary of NASDAQ Corporate Governance Proposals

The NASDAQ Stock Market, Inc. (NASDAQ®) Board of Directors has approved a comprehensive package of corporate governance reforms to enhance investor confidence. NASDAQ is in the process of submitting rule filings with the U.S. Securities and Exchange Commission to effectuate these changes.[1] NASDAQ proposes that changes requiring a company to modify the composition of its board of directors be effective immediately following a company's first annual meeting that is at least 120 days after SEC approval of the changes.

Following is a summary of the proposals:

Stock Options

- Require shareholder approval for the adoption of all stock option plans and for any material modification of such plans. An exemption would permit inducement grants to new employees if such grants are approved by an independent compensation committee or a majority of the company's independent directors. Exemptions will also be available for certain tax-qualified plans (e.g., employee stock ownership plans) and for the assumption of pre-existing grants in connection with an acquisition or merger. Existing option plans will be unaffected under this proposal, unless there is a material modification made to the plan.

Loans to Officers and Directors

- Prohibit loans to officers and directors through the adoption of a NASDAQ rule that mirrors the Sarbanes-Oxley Act of 2002 (the "Act").

Increase Board Independence

- Require a majority of independent directors on the board.
- Require regularly convened executive sessions of the independent directors.
- Require that a company's audit committee or a comparable body of the board of directors review and approve all related-party transactions.
- Prohibit an independent director from receiving any payments (including political contributions) in excess of $60,000 other than for board service and extend such prohibition to the receipt of payments by a non-employee family member of the director. An audit committee member may not receive any compensation except for board or committee service, in accordance with the Act.
- Expand to cover not-for-profits the current rule prohibiting a director from being considered independent if the company makes payments to an entity where the director is an executive officer and such payments exceed the greater of $200,000 or five percent of either the company's or the entity's gross revenues

[1] The NASD has also approved most of these proposals. The remainder will be submitted for NASD approval shortly.

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- Prohibit former partners or employees of the outside auditors who worked on a company's audit engagement from being deemed independent.

- Apply a three-year "cooling off" period to directors who are not independent due to: (1) interlocking compensation committees; (2) the receipt by the director or a family member of the director of any payments in excess of $60,000 other than for board service; or (3) having worked on the company's audit engagement.

Heightened Standards of Independence for Audit Committee Members

- Prohibit audit committee members from receiving any payment other than payment for board or committee service, consistent with Section 301 of the Act.

- Prohibit directors from serving on the audit committee in the event they are deemed an affiliated person of the issuer or any subsidiary, consistent with Section 301 of the Act. In this regard, prohibit audit committee members from owning or controlling 20% or more of the issuer's voting securities, or such lower number as may be established by the SEC in rulemaking under Section 301 of the Act. Audit committee members will also be required to meet the NASDAQ independence definition set forth in Rule 4200(a)(14).

Strengthen the role of independent directors in compensation and nomination decisions

- Require independent director approval of director nominations, either by an independent nominating committee or by a majority of the independent directors. A single non-independent director would be permitted to serve on an independent nominating committee: (1) if the individual is an officer who owns or controls more than 20% of the issuer's voting securities, or (2) pursuant to an "exceptional and limited circumstances" exception.[2]

- Require independent director approval of CEO compensation, either by an independent compensation committee or by a majority of the independent directors meeting in executive session. Require independent director approval of other executive officer compensation, either by an independent compensation committee or by a majority of the independent directors in a meeting at which the CEO may be present. A single non-

  independent director, who is not an officer, would be permitted to serve, for two years, on the independent compensation committee pursuant to an "exceptional and limited circumstances" exception.[3]

[2] An "exceptional and limited circumstances" exception is available for an individual who is not an officer or current employee or a family member of such a person. Additionally, such an exception may only be implemented following a determination by the board that the individual's service on the committee is in the best interests of the company and its shareholders. The issuer is also required to disclose the use of such an exception in the next annual proxy statement, as well as the nature of the individual's relationship to the company and the basis for the board's determination.

[3] An "exceptional and limited circumstances" exception is available for an individual who is not an officer or current employee or a family member of such a person. Additionally, such an exception may only be implemented following a determination by the board that the individual's service on the committee is in the best interests of the company and its shareholders. Finally, the issuer is required to disclose the use of such an exception in the next annual proxy statement, as well as the nature of the individual's relationship to the company and the basis for the board's determination.

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Controlled Company Exception

- "Controlled" companies are exempt from the requirements for a majority independent board, executive sessions of the independent directors, and independent compensation and nominating committees. A controlled company is a company of which more than 50% of the voting power is held by an individual, group or another company. A controlled company relying upon this exemption must disclose in its annual meeting proxy that it is a controlled company and the basis for that determination. Such companies, however, remain subject to each of the audit committee requirements.

Empower Audit Committees and Harmonize Listing Standards with the Act

- Require that audit committees have the sole authority to appoint, determine funding for, and oversee the outside auditors, as set forth in Section 301 of the Act.

- Require that audit committees approve, in advance, the provision by the auditor of all permissible non-audit services, as set forth in Section 202 of the Act.

- Require that audit committees have the authority to engage and determine funding for independent counsel and other advisors, as set forth in Section 301 of the Act.

- Require that the audit committee establish procedures for the receipt, retention and treatment of complaints received by the issuer and ensure that such complaints are treated confidentially and anonymously, as set forth in Section 301 of the Act.

- Require that in selecting the financial expert necessary for compliance with the NASDAQ audit committee composition requirements, issuers consider whether a person has, through education and experience as a public accountant or auditor or a principal financial officer, comptroller or principal accounting officer of an issuer or from a position involving the performance of similar functions, sufficient financial expertise in the accounting and auditing areas specified in the Act.

- Require that all audit committee members be able to read and understand financial statements at the time of their appointment rather than "within a reasonable period of time" thereafter.

- Limit the time that a non-independent director may serve on the audit committee pursuant to the "exceptional and limited circumstances" exception set forth in Rule 4350(d)(2)(B) to two years and prohibit that person from serving as the chair of the audit committee. Those directors not satisfying the audit committee independence requirements of the Act are not eligible for this exception.

- Eliminate exceptions for the audit committee requirements for Small Business issuers.

Mandate Director Continuing Education

- Continuing education for all directors will be required, pursuant to rules to be developed by the NASDAQ Listing and Hearing Review Council and approved by the Board.

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Accelerated Disclosure of Insider Transactions

- NASDAQ is continuing to explore a requirement for accelerated disclosure of insider transactions that would harmonize with, and reinforce, the provisions of the Act.

Provide Transparency With Respect to Non-U.S. Companies

- Require that non-U.S. issuers disclose any exemptions to NASDAQ's corporate governance requirements, permissible under the Act or rules promulgated by the SEC thereunder, at the time the exemption is received and on an annual basis thereafter, as well as any alternative measures taken in lieu of the waived requirements.

- Require that non-U.S. issuers file with the SEC and NASDAQ all interim reports filed in their home country, and, at a minimum, file with the SEC and NASDAQ a semi-annual report, including a statement of operations and an interim balance sheet prepared in accordance with the requirements of the home country marketplace. An English translation of any such reports will be required.

Conform and Clarify the Applicability of Certain Quantitative Listing Standards to Non-U.S. Companies

- Require that non-U.S. issuers satisfy the SmallCap initial and continued listing requirements for bid price and market value of publicly held shares that are currently applicable to domestic issuers, subject to an 18-month phase-in period.

- Require that the underlying shares of SmallCap issuers with listed ADRs satisfy the same publicly held shares and shareholder requirements that are applicable to domestic issuers.

Codes of Conduct

- Require all companies to have a code of conduct addressing, at a minimum, conflicts of interests and compliance with applicable laws, rules and regulations, with an appropriate compliance mechanism and disclosure of any waivers to executive and directors. Waivers can only be granted by the independent directors. The code of conduct must be publicly available.

Regulation FD

- Harmonize the NASDAQ rule on the disclosure of material information with SEC Regulation FD so that issuers may use Regulation FD compliant methods such as conference calls, press conferences and web casts, so long as the public is provided adequate notice (generally by press release) and granted access.

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Final Rule: Acceleration of Periodic Report Filing Dates and Disclosure Concerning Website Access to Reports

Securities and Exchange Commission

17 CFR PARTS 210, 229, 240 and 249

[RELEASE NOS. 33-8128; 34-46464; FR-63; File No. S7-08-02]
RIN 3235-AI33

Acceleration of Periodic Report Filing Dates and Disclosure Concerning Website Access to Reports

Agency: Securities and Exchange Commission

Action: Final rules

Summary: We are adopting amendments to our rules and forms to accelerate the filing of quarterly and annual reports under the Securities Exchange Act of 1934 by domestic reporting companies that have a public float of at least $75 million, that have been subject to the Exchange Act's reporting requirements for at least 12 calendar months and that previously have filed at least one annual report. The changes for these accelerated filers will be phased-in over three years. The annual report deadline will remain 90 days for year one and change from 90 days to 75 days for year two and from 75 days to 60 days for year three and thereafter. The quarterly report deadline will remain 45 days for year one and change from 45 days to 40 days for year two and from 40 days to 35 days for year three and thereafter. The phase-in period will begin for accelerated filers with fiscal years ending on or after December 15, 2002. We also are adopting amendments to require accelerated filers to disclose in their annual reports where investors can obtain access to their filings, including whether the company provides access to its Forms 10-K, 10-Q and 8-K reports on its Internet website, free of charge, as soon as reasonably practicable after those reports are electronically filed with or furnished to the Commission.

Dates: *Effective Date:* sixty days after publication in the *Federal Register*.
Compliance Dates: The phase-in period for accelerated deadlines of quarterly and annual reports will begin for reports filed by companies that meet the definition of "accelerated filer" as of the end of their first fiscal year ending on or after December 15, 2002. These accelerated filers must comply with the new disclosure requirements concerning website access to reports for their annual reports on Form 10-K to be filed for fiscal years ending on or after December 15, 2002. Registrants voluntarily may comply with the new filing deadlines and disclosure requirement before the compliance dates.

For Further Information Contact: Jeffrey J. Minton, Special Counsel, or Elizabeth M. Murphy, Chief, Office of Rulemaking, at (202) 942-2910, Division of Corporation Finance, U.S. Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0312.

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Supplementary Information: We are adopting amendments to Rules 3-01,1 3-092 and 3-123 of Regulation S-X4 and Item 1015 of Regulation S-K6 under the Securities Act of 1933 ("Securities Act"),7 Forms 10-Q8 and 10-K9 under the Securities Exchange Act of 1934 ("Exchange Act")10 and Exchange Act Rules 12b-2,11 13a-1012 and 15d-10.13

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I. Background and Overview of Rule Amendments

A. The Exchange Act Reporting System

The Exchange Act requires public companies to make information publicly available to investors on an ongoing basis to aid in their investment and voting decisions.14 Issuers that have been subject to the reporting requirements for a certain period of time also can incorporate information from their Exchange Act reports into their registration statements under the Securities Act. Investors purchasing securities in public offerings therefore also rely on Exchange Act disclosure.

The Commission's rules under the Exchange Act now require disclosure at quarterly and annual intervals, with specified significant events reported on a more current basis.15 Specifically, a domestic issuer subject to the Exchange Act must, among other obligations, file the following reports:16

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* An annual report on Form 10-K (or Form 10-KSB in the case of a small business issuer[17]) no later than 90 calendar days after the end of its fiscal year;[18]

* Quarterly reports on Form 10-Q (or Form 10-QSB in the case of a small business issuer) no later than 45 calendar days after the end of the first three quarters of its fiscal year;[19] and

* Current reports on Form 8-K for a number of specified events generally within five or 15 days after their occurrence.[20]

In addition, a company may be required to file transition reports on Form 10-K or 10-KSB or Form 10-Q or 10-QSB when it changes its fiscal year.[21]

B. Proposing Release

In April 2002, we published for comment proposals to shorten the filing deadlines of quarterly and annual reports for many companies as a step in modernizing the periodic reporting system and improving the usefulness of periodic reports to investors.[22] The annual and quarterly report deadlines were last changed 32 years ago.[23] We proposed accelerating the deadline for annual reports from 90 days to 60 days after the end of the company's fiscal year and accelerating the deadline for quarterly reports from 45 days to 30 days after the end of the company's first three fiscal quarters. These proposals would have applied to companies that met the definition of an "accelerated filer" as of the end of their first fiscal year ending after October 31, 2002. We proposed the definition of an accelerated filer to include companies that had a public float[24] of at least $75 million, that had been reporting for at least 12 months and that previously had filed at least one annual report.

We also proposed to require a company subject to these accelerated filing deadlines to disclose in its annual report on Form 10-K where investors can obtain timely access to company filings, including whether the company provides access to its Forms 10-K, 10-Q and 8-K reports on its Internet website, free of charge, as soon as reasonably practicable after, and in any event on the same day as, these reports are electronically filed with or furnished to the Commission.[25] Under the proposals, a company that did not provide website access in this manner would have been required to disclose why it did not do so and where else investors could access these filings electronically immediately upon filing. The company also would be required to disclose its website address, if it has one.

We received responses to our proposals from 305 commenters.[26] 302 commented on the acceleration of periodic report deadlines. Generally, these commenters fell into two groups. The first group (20 commenters) represented primarily investors, institutional investors and other users of company reports who supported the proposals and our objective to provide investors with more timely access to company filings. The second group (282 commenters) represented primarily companies, business associations, law firms and accounting firms who opposed the extent of acceleration and length of transition period proposed because, in their view, preparing reports in the proposed timeframes would be too burdensome and could result in less accurate filings. However, many offered alternatives with longer transition periods or filing deadlines or alternative measures to limit the number of accelerated filers. Most of the 141 commenters

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expressing a view on the proposals concerning website access supported them, although some suggested refinements.

C. Final Rule Amendments

We have considered the commenters' views and have modified the proposed amendments to reflect these comments. A summary of the final rules follows:

1. Phase-In of Accelerated Deadlines

Commenters representing investors, investor groups and other users of financial information favored receiving reports within a shortened timeframe. Most of the commenters who objected to the proposals believed that the proposals were too aggressive in terms of the extent of acceleration and the speed with which we expected companies to begin complying with accelerated deadlines. These commenters offered alternatives to reduce the potential costs and burden to registrants and a possible inadvertent negative impact on disclosure quality. Also, while comments were mixed, the majority of commenters addressing the issue believed it would be more difficult to accelerate filing of the quarterly report than the annual report.

As we stated in our Proposing Release, in establishing the appropriate timeframes for filing periodic reports, we must balance the market's need for information with the time companies need to prepare that information without undue burden. Accordingly, in response to comments, we are phasing-in accelerated deadlines over a three year period, with no change in deadlines for the first year and a less extensive ultimate acceleration of the quarterly report deadline. For companies that meet our revised definition of accelerated filer as of the end of their first fiscal year ending on or after December 15, 2002, the annual report deadline will remain 90 days for year one and will then be reduced 15 days per year over two years to 60 days. The quarterly report deadline for these filers will remain 45 days for year one and will then be reduced five days per year over two years to 35 days. We also are making conforming amendments to transition reports filed by accelerated filers. These changes are summarized in the following table:

For Fiscal Years Ending On or After	Form 10-K Deadline	Form 10-Q Deadline
December 15, 2002	90 days after fiscal year end	45 days after fiscal quarter end
December 15, 2003	75 days after fiscal year end	45 days after fiscal quarter end
December 15, 2004	60 days after fiscal year end	40 days after fiscal quarter end
December 15, 2005	60 days after fiscal year end	35 days after fiscal quarter end

2. Definition of Accelerated Filer

Comments were mixed on the proposed definition of accelerated filer. Several commenters believed all public companies should be subject to the same filing deadlines, regardless of a company's size or experience in preparing filings. Other commenters agreed with the notion of excluding smaller companies that may not have the necessary resources and infrastructure to report on an accelerated basis. Comments also were somewhat mixed on the proposed use of

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public float as a method to differentiate between companies. Several commenters thought the $75 million public float threshold was too low.

After evaluating the comments, we are adopting the proposals substantially as proposed with some minor clarifications. Under the final rules, accelerated deadlines will apply to a company after it first meets the following conditions as of the end of it fiscal year:

* Its common equity public float was $75 million or more as of the last business day of its most recently completed second fiscal quarter;

* The company has been subject to the reporting requirements of Section 13(a) or 15(d) of the Exchange Act for a period of at least 12 calendar months;

* The company has previously filed at least one annual report pursuant to Section 13(a) or 15(d) of the Exchange Act; and

* The company is not eligible to use Forms 10-KSB and 10-QSB.

While we agree that there would be benefits from accelerating deadlines for all companies, we must balance the market's need for information with the ability of companies to prepare that information without undue burden. We are adopting the reporting history requirements and the $75 million public float threshold substantially as proposed, although we changed the determination date for the public float requirement to give companies more time to prepare for accelerated reporting. We believe that a public float test serves as a reasonable measure of size and market interest. A one-year reporting history requirement and a $75 million threshold excludes nearly half of all publicly traded companies from the category of accelerated filers. These requirements are based primarily on the current eligibility requirements for short-form registration and "shelf registration."27 Further, we believe the adoption of a three-year phase-in period for accelerating deadlines and a less extensive acceleration of the quarterly report deadline militates against the need to raise the threshold.

3. Conforming Amendments for Other Commission Filings

In the Proposing Release, we requested comment on several possible conforming revisions to other Commission rules as a result of the proposals. Based on the responses we received, we are making several conforming amendments. We are adopting amendments to Regulation S-X to conform the timeliness requirements for the inclusion of financial information in other Commission filings, such as Securities Act and Exchange Act registration statements and proxy statements and information statements under Section 14 of the Exchange Act.28 Under the conforming amendments, financial information included in these documents still will be required to be at least as current as financial information filed under the Exchange Act. However, in response to the concerns of commenters, separate financial statements of subsidiaries not consolidated and 50% or less owned persons required by Rule 3-09 of Regulation S-X will not be accelerated for inclusion in a company's annual report on Form 10-K if the subsidiary or 50% or less owned person is not an accelerated filer. Companies will be able to file these financial statements by amendment within the existing time periods.29 We also are adopting as proposed

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conforming amendments to maintain an extra 30 days for companies to file schedules required by Article 12 of Regulation S-X30 as an amendment to their annual report on Form 10-K, if needed.

As proposed, we are not shortening the period of time companies have to file their definitive proxy or information statements to allow the incorporation by reference of information required by Part III of Form 10-K. We also are not making conforming revisions to the financial statement filing requirements in Rule 3-05 of Regulation S-X31 and Item 7 of Form 8-K for financial statements of businesses acquired.

4. Disclosure Concerning Website Access to Company Reports

The vast majority of commenters-representing investors, investor groups, companies and professional associations-supported the proposals that would require disclosure concerning website access to company reports. Accordingly, we are adopting the disclosure requirement substantially as proposed with minor modifications. Since the Proposing Release, we have arranged for real-time access to companies' electronically filed periodic reports through our Internet website.32 Elimination of the 24-hour delay in accessing EDGAR reports on our website substantially facilitates provision by companies of free, real-time website access to their reports by hyperlinking to our website. We also have eliminated two of the proposed disclosure elements to minimize the amount of disclosure required.

As adopted, the amendments require accelerated filers to disclose the following in their annual reports on Form 10-K beginning with reports for fiscal years ending on or after December 15, 2002:

* The company's website address, if it has one;

* Whether the company makes available free of charge on or through its website, if it has one, its annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports as soon as reasonably practicable after such material is electronically filed with or furnished to the Commission;

* If the company does not make its filings available in this manner, the reasons it does not do so (including, where applicable, that it does not have an Internet website); and

* If the company does not make its filings available in this manner, whether the company voluntarily will provide electronic or paper copies of its filings free of charge upon request.

II. Discussion of Amendments

A. Reporting Deadlines for Annual and Quarterly Reports

1. Proposed Rules

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The proposed rules would have shortened the filing due date of annual reports from 90 days to 60 days after the end of a company's fiscal year and the filing due date of quarterly reports on Form 10-Q from 45 days to 30 days after the end of a company's first three fiscal quarters for companies that met our proposed definition of "accelerated filer."33 We proposed similar conforming amendments for transition reports filed on Forms 10-K and 10-Q by an accelerated filer when it changes its fiscal year.

As discussed in the Proposing Release, we believe that periodic reports contain valuable information for investors. While quarterly and annual reports at present generally reflect historical information, a lengthy delay before that information becomes available makes the information less valuable to investors. While the specific disclosure required in periodic reports has evolved over the past 30 years, and the integrated disclosure system has placed added emphasis on Exchange Act reporting, the basic structure and timeframes that were established in 1970 remain in place today.

The more extensive information in periodic reports is evaluated by investors and particularly analysts and institutional investors as a baseline for the incremental disclosures made by a company. These reports also contain more detailed information that is essential to conduct comparative analyses, as this information is often not contained in earnings releases or other incremental disclosures. Moreover, the information in Exchange Act reports, due to its required nature and the liability to which it is subject, provides a verification function against other statements made by the company in press releases and other public announcements. Investors and other users of the reports can judge previous informal statements by the company against the more extensive and mandated disclosure provided in the reports that have been reviewed by independent public accountants and other advisors.34 Accelerating the availability of this information will enable this verification to occur at an earlier point in time. Accelerating the availability of these reports also may increase the relevance of the reports, as the timeliness of information has considerable value to investors and the markets.

In addition, many public companies issue press releases to announce quarterly and annual results well before they file their reports with us. These earnings announcements reflect the importance of financial information and investors' demand for it at the earliest possible time. Assuming that companies are collecting and evaluating information before they issue these announcements, the availability of this information also suggests that much of the process involved in preparing the financial information contained in periodic reports is substantially complete. However, these earnings announcements themselves are generally less complete in their disclosure than quarterly or annual reports, and they can emphasize information that is less prominent in quarterly or annual reports.35 Investors often must wait for the periodic reports to receive financial statements and the accompanying notes prepared in accordance with generally accepted accounting principles, management's discussion and analysis, or MD&A, and other vitally important financial disclosures. These additional disclosures increase transparency for investors.

In establishing the appropriate timeframes for filing periodic reports, however, we must balance the market's need for information with the time companies need to prepare that information without undue burden. Significant technological advances over the last three decades have both increased the market's demand for more timely corporate disclosure and the ability of companies

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to capture, process and disseminate this information. However, we acknowledge that, while the deadlines for filing periodic reports have not changed in over 30 years, the disclosure requirements have changed and some companies, particularly those with widespread operations, face additional complexities in today's environment. Not all companies, particularly small and unseasoned companies, may have the resources and infrastructure in place to prepare their reports on a shorter timeframe without undue burden or expense. Our amendments must speed the flow of information to investors without sacrificing accuracy or completeness or imposing undue burden and expense on registrants.

2. Comments on the Proposal

We received responses from 302 commenters on the proposals to accelerate periodic report deadlines. Generally, these commenters fell into two groups. The first group (20 commenters) represented primarily investors, institutional investors and financial analysts who supported the proposals and our objective to provide investors with more timely access to company filings. The second group (282 commenters) represented primarily companies, business associations, law firms and accounting firms who opposed the extent of acceleration and transition period proposed because, in their view, preparing reports in the proposed timeframes would be too burdensome and could result in less accurate filings. Most of these commenters believed that any incremental benefit from the speed and extent of acceleration proposed was insufficient to warrant the added burdens on registrants and the risk of diminished disclosure quality, although these commenters generally did not analyze the benefits from the perspective of users of the reports.

Many commenters representing investors, users of financial information and several companies believed that shortening deadlines will improve the delivery and flow of reliable information to investors and capital markets and assist in the efficient operation of the markets.36 These commenters emphasized the importance of the extensive information in periodic reports and investors' demand for it at the earliest possible time.37 Several other companies, accounting firms and professional associations agreed in concept that shortening due dates would improve the flow of information, but believed the due dates should reflect concerns about the quality of information to be filed.38 A few companies, law firms and business organizations, however, believed that existing deadlines and market practices are sufficient to satisfy investors' needs.39 These commenters did not think a significant benefit would result from shortening deadlines, but also generally did not attempt to address the question of possible benefits from the perspective of users of the reports.

While some companies commented that they could or already comply with the proposal without undue burden,40 the group that objected to the proposal raised several common concerns over the extent of acceleration and transition period proposed. The most common concern was that the proposed deadlines would negatively affect the quality and accuracy of reports.41 According to one professional association, two-thirds of its survey respondents expected a reduction in the precision of reported information under the original proposals.42 Many commenters thought the proposals were contrary to other initiatives that the Commission has undertaken to increase the quantity and quality of company disclosure. Many believed that focusing on and improving accuracy and quality should be the objective, not speed.

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Another common concern was that the proposed deadlines would impair the ability of management, external auditors, boards of directors and especially audit committees to scrutinize and review filings properly and give appropriate consideration to the form, substance and priority of disclosures, especially MD&A disclosures and financial statement footnotes.43 These commenters feared that disclosures could be reduced or become more boilerplate if companies have less time to prepare and review them. These commenters believed that accelerating deadlines in the manner proposed would also undermine the governance and review mechanisms that have been put in place to ensure quality. We have separately proposed and the Sarbanes-Oxley Act of 2002 establishes new requirements to ensure that procedures are in place to ensure that a company is able to collect, process and disclose the information required in its periodic reports and for senior officers to certify the accuracy of those reports.44

A third concern was that advances in technology over the past 30 years have been largely offset by increases in accounting and disclosure requirements.45 Business operations have also become increasingly global and complex, further complicating report preparation. These commenters argued that technological advances that have allowed companies to generate earnings results quickly in an earnings release do not address the additional analysis necessary to prepare periodic reports. Processes and systems would need to be changed to report on an accelerated basis.

Commenters objecting to the original proposals also were concerned that companies would face an increased burden in preparing reports, particularly with respect to increased costs and audit fees. While a few commenters believed that the original proposals would not have a significant adverse effect on the cost of preparing reports,46 most who addressed the subject mentioned that the original proposals would result in increased costs.47 Many commenters outlined their process of preparing reports to demonstrate the difficulties of accelerating the process.48 Several commenters provided detailed timelines. The particular steps and timing varied depending on the individual company, and not all companies appear to be at the same level of technological sophistication and staffing for preparing reports. Two professional associations noted that there are no current best practices for preparing reports.49 As a result, the few cost estimates received varied widely, and many commenters were unable to provide estimates. One company believed it was not possible to put a dollar value on such costs, as it depends on the quality and flexibility of each registrant's present systems, processes and staff.50 According to one professional association that surveyed its members, 52% of its survey respondents reported that they expected costs to increase in order to comply with the original proposals.51 Forty-five percent of respondents indicated they would have to hire additional staff, and 27% of respondents indicated they would have to buy or develop additional systems. Other commenters were concerned that the original proposals would result in increased audit fees, particularly for companies with a calendar fiscal year-end, given a compression in the amount of time available for auditors to complete their work for these companies.

Objecting commenters mentioned additional concerns over the original proposals, such as an increased need to use estimates to prepare reports52 or an increased risk of amendments or restatements because of rushed preparation.53 Several commenters were especially concerned about accelerating deadlines now given recent events with Arthur Andersen LLP.54 While

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comments were mixed, many commenters said that while most audit and review work is substantially complete before the earnings release or the proposed deadlines, the process of preparing reports, including the financial statements and footnotes, is not.55 However, other commenters noted that the audit and review process is far from complete by the time a company issues an earnings release and little, if any, assurance can be ascribed to the publicly disclosed results.56 While some commenters prepare their reports concurrently with the earnings release, most described the process as a series of sequential steps where the company first closes its financial books, then prepares and releases its earnings release and then turns its attention to the periodic reports. Some companies would need to revise their internal processes to prepare their reports on a more concurrent basis with the earnings release. Several companies expressed concern that the proposals would be difficult for companies that operate on a decentralized basis with many subsidiaries and operations to consolidate, especially when the subsidiaries and operations are located worldwide or in emerging markets.57

Slightly less than half of those objecting to the proposals (129 commenters) did not think any acceleration of deadlines was warranted.58 However, slightly more than half of those objecting (153 commenters) objected because they believed the Commission was too aggressive in its proposal.59 Many of these commenters generally supported the Commission's objective to provide investors with more timely access to company information and offered alternatives to reduce the potential costs and burden to registrants and any negative impact on disclosure quality. These alternatives fell roughly into three categories:

* A more gradual phase-in or transition period than that proposed (*e.g.*, reducing deadlines by a set number of days per year over several years or delaying the effective date of accelerated filing deadlines).60

* Accelerating deadlines less extensively (*e.g.*, 75 days for the annual report and 35 days for the quarterly report) or accelerating only the annual report deadline.61 In this regard, while comments were mixed, the majority of commenters addressing the issue believed it would be more difficult to accelerate the quarterly report than the annual report.62

* Linking the deadline for filing reports to a company's public announcement of earnings (*e.g.*, the earlier of the existing deadlines or some period of time after a company's issuance of an earnings release).63

In addition to the comments received on the Proposing Release, earlier this year we hosted an investor summit in Washington, DC.64 The summit offered individual investors nationwide an opportunity to ask questions and offer comments about our regulatory agenda. Most participants at the investor summit mentioned their support for our proposals to accelerate the delivery of periodic reports to investors.65

As mentioned in the Proposing Release, we also hosted roundtable discussions in New York, Washington, DC, and Chicago earlier this year at which investor relations professionals, corporate executives, academics and experienced legal counsel discussed financial disclosure and auditor oversight.66 Several participants at these roundtables indicated that reporting within the proposed shortened deadlines was feasible.67 Some participants, however, referred to the

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comment letters on our 1998 request for comment on accelerating deadlines,68 and were concerned about the ability of companies, and smaller companies in particular, to report in a shorter timeframe.69 They thought that accelerating deadlines could cause the quality of reports to diminish.70 One participant was concerned that shortened deadlines may present more problems for quarterly reports than for annual reports.71

3. Final Rules

After careful consideration of the comments received, we are adopting a phased-in approach of accelerated deadlines, with no change in deadlines for the first year and a less extensive ultimate acceleration of the deadline for quarterly reports. Specifically, we are phasing-in accelerated deadlines for accelerated filers according to the following schedule:

For Fiscal Years Ending On or After	**Form 10-K Deadline**	**Form 10-Q Deadline**
December 15, 2002	90 days after fiscal year end	45 days after fiscal quarter end
December 15, 2003	75 days after fiscal year end	45 days after fiscal quarter end
December 15, 2004	60 days after fiscal year end	40 days after fiscal quarter end
December 15, 2005	60 days after fiscal year end	35 days after fiscal quarter end<

We also are accelerating the due dates for transition reports by accelerated filers on Form 10-K and 10-Q on the same schedule. These conforming changes will ensure that the deadlines for transition reports remain similar to the deadlines for periodic reports.72 We also are making technical corrections to the codification of financial reporting policies to reflect our amendments.

According to the amendments, if a company with a calendar year fiscal year-end determines it is an accelerated filer as of December 31, 2002 (its first fiscal year ending on or after December 15, 2002), its annual report on Form 10-K for that fiscal year will continue to have a 90 day filing deadline and will be due by March 31, 2003.73 Each of the Form 10-Q reports for the first three quarters of its 2003 fiscal year will continue to have a 45-day deadline. For example, the Form 10-Q for the company's first fiscal quarter ending March 31, 2003 will continue to be due by May 15, 2003. The Form 10-K for the fiscal year ending December 31, 2003 will have a 75-day deadline and will be due by March 15, 2004. Each of the Form 10-Q reports for the first three quarters in the 2004 fiscal year will have a 40-day deadline. For example, the Form 10-Q for the company's first fiscal quarter ending March 31, 2004 will be due by May 10, 2004. The Form 10-K for the fiscal year ending December 31, 2004 will have a 60-day deadline and will be due by March 1, 2005. Each of the Form 10-Q reports for the first three quarters in the 2005 fiscal year will have a 35-day deadline. For example, the Form 10-Q for the company's first fiscal quarter ending March 31, 2005 will be due by May 5, 2005. All subsequent reports on Form 10-K and 10-Q by the accelerated filer will be subject to a 60 and 35-day deadline, respectively.

In establishing this schedule for accelerated deadlines, we agree with the suggestions of many commenters that appropriate focus should be directed toward report quality.74 We also agree with investors and other users of financial information that timeliness of information is important. Increased quality and timeliness, with an appropriate balance between the two, assures that investors receive the full and reliable data they deserve at the speed in which they desire it. A phased-in approach of accelerated deadlines allows a greater transition period for

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companies to adjust their procedures and to develop efficiencies to ensure that the quality and accuracy of reported information will not be sacrificed. Under a phased-in approach, companies will have additional time to plan for and adjust their reporting schedules and processes to ensure that the necessary reviews will not be compromised. Given the recent enactment of the Sarbanes-Oxley Act of 2002, a phased-in approach also allows companies to adjust to significant new changes and requirements in the reporting system. At the same time, a phased-in approach allows investors to begin to experience the benefits of an accelerated flow of information. A phased-in approach also will provide the Commission with an opportunity to understand how each incremental change affects the disclosure process.

A phased-in approach helps to alleviate the immediate impact of any costs and burdens that may be imposed on certain registrants. While several commenters indicated that they could report on an accelerated timeframe today, several major business associations that surveyed their members reported that adjustment to accelerated deadlines would be easier with a longer phase-in period.75 A longer transition may even help reduce costs as companies will have additional time to develop best practices, long-term processes and efficiencies to prepare reports, as opposed to having to take rushed and possibly inefficient measures to meet a more sudden acceleration.76 Also, a longer transition period helps to smooth out any possible impact on the availability of third party advisors used by companies to prepare their reports.

A less extensive acceleration of the quarterly report deadline also will alleviate some of the burdens mentioned by commenters. There will be more time than proposed to gather the necessary data and complete the necessary reviews by company officials, the board of directors and outside advisors. One professional association commented that 80% of its survey respondents reported they could more easily meet a 35-day deadline than a 30-day deadline.77 Further, we believe that by imposing a 40-day deadline before finally reducing it to 35 days, we are striking an adequate compromise between the benefits of reducing deadlines with the potential inconvenience, difficulty and cost that may be incurred by some companies.

We considered, but rejected, the alternative of tying the due date of reports to a company's announcement of earnings. Not all companies issue earnings releases or issue them on an accelerated basis. As a result, linking deadlines to earnings releases may not result in more accelerated reporting of information. We also were concerned that linking report deadlines to earnings announcements could delay earnings announcements, as companies would know that the announcement would trigger the deadline to file reports. While market demand for earnings information could negate this risk, an approach linking deadlines to earnings announcements could have the effect of penalizing companies for early releases of information while rewarding companies that delay their earnings with extended time to file their reports.

Even with a phase-in period, accelerating filing deadlines may create the risk that more companies will file their reports late or need a filing extension. Moreover, if a company is late filing its reports, it will lose availability for short-form registration for at least one year from the date of the late filing. Being late also could render Securities Act Rule 144 temporarily unavailable for security holders' resales of restricted and control securities, and make new filings on Form S-8 temporarily unavailable for resales of employee benefit plan securities.78 We considered the suggestions of some commenters to extend the filing extension periods in

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Exchange Act Rule 12b-25 as an additional method to alleviate any transition difficulties to shortened deadlines.[79] However, we think a lengthy phase-in period adequately addresses these concerns. A less dramatic acceleration of deadlines over a set schedule each year will provide companies with advance notice of the changes they will be expected to make and will smooth out some of the possible difficulties raised by commenters. Rule 12b-25 in its existing form still will provide companies that face extenuating circumstances the ability to gain a filing extension of five calendar days for quarterly reports and fifteen calendar days for annual reports.

While our proposals did not directly address the contents of earnings releases, many commenters supported additional efforts by the Commission in this area. Several recommended that earnings or other standardized earnings information be filed with the Commission, such as on Form 8-K.[80] Others thought the Commission should consider issuing or promoting minimum requirements or guidelines for the contents of earnings releases, such as a GAAP reconciliation.[81] While we will continue to explore ways to improve earnings releases, and the Sarbanes-Oxley Act of 2002 requires us to take steps in this area, we believe these are separate initiatives from the need to accelerate periodic report deadlines.[82] We recognize that the information in periodic reports is more extensive than that contained in earnings releases, and that it would be difficult to eliminate any gap between the earnings release and the filing of the report. As mentioned above, however, we believe periodic reports contain valuable information for investors, and comments received from the users of this information uniformly indicated their desire to receive the reports at the earliest time that is consistent with receiving quality information.[83]

B. Definition of "Accelerated Filer"

1. Proposed Rules

We proposed to accelerate the due dates for annual and quarterly reports only for companies with a common equity public float of $75 million or more, that have been reporting for at least 12 calendar months and that have filed at least one annual report. The public float and reporting history requirements are designed to include the companies that are least likely to find such a change overly burdensome and where investor interest in accelerated filing is likely to be highest. Other companies would continue to file under existing deadlines, including small business issuers that file on Forms 10-KSB and 10-QSB, foreign governments, foreign private issuers that elect to use Form 20-F and companies that do not have a common equity public float. Under the proposed rules, a company would determine its public float for purposes of determining whether it would become an accelerated filer as of a date no more than 60 and no less than 30 days before the end of its fiscal year. In addition, as proposed, a company would become an accelerated filer at any time during the year if it met the public float test on a previous determination date and subsequently met the reporting requirements during the year.

2. Comments on the Proposal

Comments were mixed on the proposed definition of accelerated filer. Several commenters believed that all public companies should be required to adhere to the same filing deadlines, regardless of a company's size or experience in preparing filings.[84] These commenters thought it

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would be confusing to investors and companies to have differing filing deadlines. They also believed that investors in companies with a public float of less than $75 million should expect the same timely access to prompt disclosure as investors in larger companies. They argued that such prompt disclosure may be even more important for smaller companies. Several commenters also thought that while large firms may have more resources, they tend to have more complex and geographically widespread operations, numerous consolidated entities and segments and complicated financial transactions.85

Other commenters agreed with the notion of excluding smaller companies.86 Smaller companies may have operations that are just as complicated as large companies. More importantly, accelerated reporting may be particularly burdensome for smaller companies because they may not have the necessary resources or infrastructure to report on an accelerated basis. Many of these issuers have small staffs and limited technological resources, so the imposition of accelerated deadlines may have a disproportionate impact on these companies. In addition, auditors may be more likely to postpone their reviews of smaller companies' financial statements until they have completed their work for larger clients. There also may not be sufficient market interest in these companies to justify the costs and burdens needed to accelerate a smaller company's reporting processes.87

Comments also were somewhat mixed on the use of public float as a method to differentiate between companies.88 Several commenters questioned the use of public float as a measure indicative of a company's ability to file sooner. According to these commenters, smaller companies with limited operations and personnel could easily develop a significant public float. These commenters offered several alternative measures, including revenues, assets or some measure of trading volume. Other commenters thought the proposed $75 million public float threshold was too low.89 These commenters recommended a number of alternative thresholds, ranging from $150 million to $10 billion. Several other commenters thought the proposed public float measurement date occurred too late in the fiscal year to give companies sufficient time to modify their systems and prepare for accelerated reporting.90

In the Proposing Release, we also requested comment on whether the deadline for annual reports of foreign private issuers on Form 20-F should be shortened. Comments were mixed on this request. Some commenters did not think there was a reason to not also shorten deadlines for foreign filers.91 Others thought that the issues involving foreign issuers are sufficiently different as to warrant a separate study and rule proposal.92 A few others thought the deadlines for foreign issuers should not be accelerated at all.93

3. Final Rules

After evaluating the comments on this aspect of the proposal, we are adopting the amendments substantially as proposed with some minor clarifications. Under the final rules, accelerated deadlines will apply to a company after it first meets the following conditions as of the end of its fiscal year:

* Its common equity public float was $75 million or more as of the last business day of its most recently completed second fiscal quarter;

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* The company has been subject to the reporting requirements of Section 13(a) or 15(d) of the Exchange Act for a period of at least 12 calendar months;

* The company has previously filed at least one annual report pursuant to Section 13(a) or 15(d) of the Exchange Act; and

* The company is not eligible to use Forms 10-KSB and 10-QSB.

The public float and reporting history aspects of this definition are being adopted substantially as proposed. These requirements are based primarily on the current eligibility requirements for registration of primary offerings for cash on Form S-3.94 These companies can take advantage of short-form registration, including the resultant benefits of incorporation by reference and quick access to the capital markets through "shelf registration." Shortening the periodic reporting deadline for these companies, coupled with our conforming revisions to the financial statement timeliness requirements discussed below, promises that investors will receive information about these companies sooner. This enhances the timeliness of information received for primary purchasers in these offerings in addition to secondary market purchasers. These changes also ensure that investors receive consistent financial information regardless of the particular registration form a company uses. In identifying companies that will be subject to this new requirement, we also thought it would be appropriate to use a pre-existing threshold to reduce regulatory complexity.

While we agree that investors in smaller companies value the timeliness of corporate disclosures, we must balance the market's need for information with the ability of companies to prepare that information without undue burden. The possible detrimental effects of accelerating the reporting process for companies least able to bear the burden of these changes may outweigh the potential advantages of acceleration if the quality of information suffers. We do not think that having two sets of reporting deadlines will be confusing. Some registrants, such as foreign private issuers, are already subject to different deadlines. We believe it is more important that companies of the same relative size, including the most actively followed companies, are subject to shortened deadlines. We agree that larger companies may have more complex operations, but they also are more likely than smaller companies to have the infrastructure and resources to report on an accelerated timeframe.

We believe that a public float test serves as a reasonable measure of company size and market interest. While several commenters urged raising the proposed threshold, we believe a longer phase-in period for accelerating deadlines and a less extensive acceleration of the quarterly report deadline militates against the need to raise the threshold. The definition of accelerated filer we are adopting today with a $75 million public float threshold excludes nearly half of all publicly traded companies, as well as all companies eligible for our small business issuer reporting system, all foreign private issuers that file on Form 20-F and all companies that do not have a common equity public float.95

A company that does not fall within the "accelerated filer" definition as of its first fiscal year ending on or after December 15, 2002 will have to re-evaluate its status at the end of each fiscal

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year. To address concerns raised by commenters, a company will determine its public float by looking back at the last business day of its most recently completed second fiscal quarter. This allows companies to know further in advance whether they will become an accelerated filer at the end of their fiscal year and allow them to begin making the appropriate preparations.

As explained in the new definition of "accelerated filer," the determination of whether a non-accelerated filer becomes an accelerated filer as of the end of its fiscal year governs the annual report to be filed for that fiscal year, the quarterly reports to be filed for the subsequent fiscal year and annual and quarterly reports to be filed thereafter. Under the final rules, a company would not need to determine whether it would become an accelerated filer other than at the end of its fiscal year. We believe this provides increased notice to a company for planning purposes. It also lessens any potential confusion to investors by a sudden change in deadlines.

For example, if a calendar year-end company meets the public float requirement, but has not filed its first annual report as of December 31, 2002, it does not become an accelerated filer and remains subject to existing deadlines for its 2002 annual report and its 2003 quarterly reports. However, if on December 31, 2003, the company meets the public float test as of the last business day of its second fiscal quarter ending June 30, 2003 and meets the other requirements of the accelerated filer definition, the company becomes an accelerated filer subject to the accelerated deadlines for its 2003 annual report, 2004 quarterly reports and all periodic reports thereafter.

As proposed, once a company becomes an accelerated filer, it remains an accelerated filer subject to shortened deadlines unless and until it subsequently becomes eligible to use Forms 10-KSB and 10-QSB for its annual and quarterly reports.96 In that case, the issuer ceases to be an accelerated filer unless and until it again meets the accelerated filer criteria. A few commenters thought that the use of different standards for entering and exiting accelerated filer status would be confusing and potentially unfair compared to companies that never had their public float exceed $75 million, especially for companies that cross the threshold for a certain period of time and then fall back below the threshold but do not otherwise meet the criteria to become a small business issuer.97 However, it is our view that, once a company meets the accelerated filer threshold, it is reasonable to minimize a company's fluctuation in and out of accelerated filer status while still allowing the company to exit if it becomes so small for so long that it becomes eligible to file its reports as a small business issuer. Accordingly, we are adopting the provisions to exit accelerated filer status as proposed.

Currently, companies are required to disclose on the cover page of their annual report on Form 10-K their public float as of a specified date within 60 days before filing. To assist investors and the Commission in evaluating whether a company is subject to accelerated deadlines, we are revising this requirement. We are requiring every company, regardless of whether it is an accelerated filer, to disclose its public float as computed on the last business day of the company's most recently completed second fiscal quarter. We recognize that this will reduce the currency of this disclosure, but we believe such a change will simplify the burdens companies face by requiring them to calculate only one public float amount. Also, to clarify further a company's filing status, we are requiring each company to check a box on the cover of its quarterly and annual reports to indicate whether it is an accelerated filer.

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We are not adopting changes today to the deadline for annual reports by foreign private issuers on Form 20-F. As we mentioned in the Proposing Release, we are continuing to consider this issue and Exchange Act filing requirements generally for foreign issuers. We recognize that with the adoption of today's amendments, the discrepancy between the filing deadlines for larger seasoned U.S. issuers and those for foreign private issuers will increase. We will consider the comments received in our continuing review of the issue.

C. Conforming Amendments

In the Proposing Release, we requested comment on several possible conforming revisions to other Commission rules as a result of the proposals. Our decisions on these requests are discussed in this section.

1. Timeliness Requirements in Other Commission Filings

We mentioned in the Proposing Release that we were considering making conforming revisions to accelerate the timeliness requirements in Regulation S-X for the inclusion of financial statements by accelerated filers in other Commission filings, such as Securities Act and Exchange Act registration statements and proxy and information statements under Section 14 of the Exchange Act. We requested comment on whether these changes should be made. Most of the commenters that responded to this request suggested we should make conforming changes if we change the periodic report deadlines.[98] We agree.

When the Commission made extensive revisions to its rules, forms and regulations in 1980 to further the integrated disclosure system, it adopted amendments regarding the inclusion of financial information in registration statements and proxy statements that parallel the requirements for financial data in Exchange Act periodic reports.[99] Parallel requirements facilitate the integrated reporting system by simplifying existing rules. They also improve overall disclosure as investors are assured consistent requirements as to the timeliness of information regardless of the document received. If conforming amendments are not made to keep these requirements parallel, a filing could conceivably be filed under the Securities Act with financial information less current than that filed under the Exchange Act. Accordingly, to facilitate uniform requirements, we are adopting amendments to Regulation S-X to conform the timeliness requirements. Under the conforming amendments we are adopting today, financial statements included in a registration statement or proxy statement still will be required to be at least as current as any financial statements filed under the Exchange Act.

We recognize that in making these conforming changes, for some short period of time, accelerated filers may be prevented from going to market.[100] However, it is our view that, when a company is an accelerated filer and is attempting to raise capital in the marketplace after audited financial information would be required to be filed under the Exchange Act, it is reasonable to delay registration until such financial statements become available. We believe this change is in the best interest of the investing public and will not create any additional burden on the large majority of accelerated filers because the required financial information already will be

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required to have been filed. Also, as in the past, we will consider waivers to the rules where unusual circumstances dictate the need for them.101

a. Filings Within 90 Days of Year-End

Currently, a reporting issuer is not required to include audited financial statements for its most recent fiscal year until the 90th day after the end of the fiscal year if it satisfies three conditions:

* The company has filed all required Exchange Act reports;

* The company reasonably, and in good faith, expects income, after taxes but before extraordinary items and a cumulative effect of a change in accounting principle, for its most recent fiscal year; and

* For at least one of the two immediately preceding fiscal years, the company has reported income, after taxes but before extraordinary items and cumulative effect of a change in accounting principle.

Unless all three conditions are met, registration statements filed or declared effective or proxy statements mailed after the 45th day following the fiscal year end must include audited financial statements for the most recent fiscal year end.102

We are shortening the 90-day deadline to conform to the phase-in periods for accelerated filers to keep this requirement parallel to the requirement to file an annual report under the Exchange Act. In year one of the phase-in period, the deadline will remain at 90 days. In year two of the phase-in period, the deadline will be reduced to 75 days. For year three and subsequent years, the deadline will be reduced to 60 days.

One commenter suggested we eliminate the distinctions among registrants that meet the conditions in Rule 3-01(c) of Regulation S-X.103 We are not changing the 45-day deadline for companies that do not meet the three required conditions. This deadline was not previously linked to an Exchange Act reporting requirement, and we continue to think that this shorter deadline is sufficient. This deadline will continue to require audited financial information more current than that required by the Exchange Act reporting requirements for companies that have not reported, and do not expect to report, income.

b. Filings After 134 Days of Year-End

The existing rules require interim financial information in registration statements filed by registrants after 134 days subsequent to the end of the registrant's fiscal year-the period after audited financial statements for the most recently completed fiscal year are already required to be filed by most registrants on Form 10-K or 10-KSB and on or after the date most registrants are required to have filed interim financial statements for the first quarter on Form 10-Q or 10-QSB. Under the conforming amendments, in year one of the phase-in period, the period will remain at 134 days for accelerated filers. In year two of the phase-in period, the period will be reduced from 134 to 129 days for accelerated filers. When a registration statement is filed or is to be

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declared effective during this period, updated financial statements will now be required as of an interim date within 130 days of the date of filing. For year three and subsequent years, the period will be reduced to 124 days for accelerated filers. Registration statements filed or to be declared effective during this period will be required to include updated financial statements as of an interim date within 125 days of the date of filing. Here again, the amended rules parallel the requirements for filing interim information under the Exchange Act.

c. Age at Effective Date of Filing

Under the existing rules, where financial statements in a filing are as of a date 135 days or more before the date the filing is expected to become effective, or proposed mailing date in the case of a proxy statement, the financial statements must be updated with a balance sheet as of an interim date within 135 days and with statements of income and cash flows on a comparative basis for the interim period between the end of the most recent fiscal year and the date of the interim balance sheet provided.104 Two exceptions exist under the current rule. First, where the registrant meets the conditions in Rule 3-01 of Regulation S-X and the anticipated effective date or proposed mailing date in the case of a proxy statement falls after 45 days but within 90 days of the end of the fiscal year, the filing need not be updated with financial statements more current than as of the end of the third fiscal quarter of the most recently completed fiscal year provided audited financial statements for such fiscal year are not available. Second, where the registrant does not meet the prescribed conditions referred to above and the anticipated effective date or proposed mailing date falls after 45 days but within 90 day of the end of the fiscal year, the filing must include audited financial statements for the most recent fiscal year. Both exceptions are consistent with the rules governing financial statements as of the date of filing.

The conforming amendments revise the updating rule to parallel the requirements for filing financial information under the Exchange Act. In year one of the phase-in period, the general updating period will remain at 135 days for accelerated filers. In year two of the phase-in period, the general updating period will be reduced from 135 days to 130 days for accelerated filers. For year three and subsequent years, the period will be reduced to 125 days. For each of the exceptions, the 90 day period will remain at 90 days for year one and then be reduced to 75 days in year two and 60 days in year three and subsequent years for accelerated filers. We will maintain the two existing exceptions in the rule.105

d. Unconsolidated Subsidiaries and 50% or Less Owned Persons

Several commenters did not think that the due date in Rule 3-09 of Regulation S-X regarding the inclusion of financial statements of significant equity investees, joint ventures and subsidiaries not consolidated should be accelerated to conform to that of the investor registrant.106 Accelerating the filing of these financial statements could require a company that does not meet the definition of an accelerated filer to file its financial statements before it would otherwise be required to do so solely because of a minority ownership stake by the investor registrant. In addition, the investor registrant may have difficulty in obtaining these financial statements from these non-wholly owned entities in the appropriate timeframe. This may lead a registrant to either sell its investment, not for business reasons, but in order to remain timely and current in its

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filing requirements, or cause the investor registrant to be not timely, which could have a number of adverse effects, including the loss of short-form registration.

As part of our conforming amendments, we are amending Rule 3-09 of Regulation S-X to address these concerns. Separate financial statements of subsidiaries not consolidated and 50% or less owned persons required by Rule 3-09 of Regulation S-X will not be accelerated for inclusion in a company's annual report on Form 10-K if the subsidiary or 50% or less owned person is not an accelerated filer. In that instance, the financial statements of the subsidiary or 50% or less owned person can be filed by amendment within the existing time periods. In addition, we are making conforming amendments to still provide companies with additional time to file the required financial statements if the fiscal years of the investor registrant and the subsidiary or 50% or less owned person differ.

2. Time Allowed to Incorporate Form 10-K Information From Definitive Proxy or Information Statements

In the Proposing Release, we did not propose to make a conforming change to the 120-day period companies have to file their definitive proxy or information statements involving the election of directors to allow the incorporation by reference of the information required by Part III of Form 10-K.107 We requested comment on whether this period should be shortened. While two commenters supported accelerating the filing of definitive proxy or information statements to ensure that investors have timely information,108 the majority of commenters that responded to our request objected to a conforming change.109 The objecting commenters thought that a shortened deadline would be overly burdensome. We see no significant reason to shorten the deadline at this time.

Some commenters were concerned that a reduction of the filing deadline for Form 10-K without a corresponding change in the deadline for incorporating the Part III information by reference from the proxy statement would interfere with the ability of some companies to file new short-form registration statements for securities offerings during the period between the Form 10-K filing date and the filing of the proxy statement.110 This is because these issuers would be required to include the Part III information in the registration statement, either directly or through incorporation by reference from another document, before the proxy statement is filed. As the ability to incorporate the Part III information from the proxy statement is voluntary and is designed for the benefit of registrants, we do not believe this concern warrants either a change to the deadline to incorporate Part III information from the proxy statement or the Form 10-K deadline. Companies will retain the flexibility to choose the alternative that best suits their individual circumstances.

3. Form 10-K Schedules Required by Article 12 of Regulation S-X

We did propose to make a conforming change to the date by which all schedules required by Article 12 of Regulation S-X may be filed as an amendment to the annual report. We proposed to change this date from 120 calendar days to 90 calendar days for accelerated filers to maintain a 30-day period after the due date of the report to file the amendment. We requested comment on this change.

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The majority of commenters responding to this request supported this change.111 Several commenters supported eliminating any delay and requiring these schedules to be filed with the Form 10-K.112 However, we understand that in some instances additional time may be necessary to prepare these schedules. As a result, we are adopting conforming amendments to maintain a 30-day period after the due date of the report to file the schedules.

4. Financial Statement Filing Requirements in Rule 3-05 of Regulation S-X and Item 7 of Form 8-K

In the Proposing Release, we requested comment on whether we should make conforming revisions to the financial statement filing requirements in Item 7 of Form 8-K and Rule 3-05113 of Regulation S-X for financial statements of businesses acquired. The commenters who responded to this request uniformly objected to such a change.114 Many of these commenters believed that the ability to obtain audited financial statements of a significant acquired business generally is unrelated to any circumstances of the acquirer that cause it to be an accelerated filer for purposes of its own financial statements. We see no significant reason to shorten the deadline at this time, and therefore we are not adopting conforming amendments to these provisions.

D. Website Access to Information

1. Proposed Rules

We proposed to require accelerated filers to provide additional disclosure in their annual reports of where investors can obtain access to company filings. This would have included disclosure regarding the availability of information from the Commission, the company's website address and whether the company makes available free of charge on its website, if it has one, its annual, quarterly and current reports, and all amendments to those reports, as soon as reasonably practicable after, and in any event on the same day as, such material is electronically filed with or furnished to the Commission. If a company chose not to make its filings available on its website in this manner, the proposals would have required it to disclose why it does not do so and where else the public can access these filings immediately upon filing and whether there is a fee for such access. Companies also would have to disclose whether they voluntarily will provide electronic or paper copies of its filings upon request.

Widespread access to timely corporate information promotes the efficient functioning of the secondary markets by enabling investors to make informed investment and voting decisions. Further, ready access to Exchange Act information is critical to short-form registration of securities offerings by seasoned issuers under the Securities Act.115 This form of registration allows certain information about the company conducting the offering to be incorporated by reference from the company's Exchange Act reports without, in many instances, separate delivery of those reports. One rationale for this method of registration is that the information in the company's Exchange Act reports already has been adequately disseminated and evaluated by the marketplace.

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The development of the Internet has revolutionized information production, availability, and dissemination.116 The increased availability of information has helped to promote transparency, liquidity and efficiency in our capital markets. One of the key benefits of the Internet is that companies can make information available to many investors and the financial markets quickly and in a cost-effective manner. Online access to Internet information also helps to democratize the capital markets by enabling many small investors to access corporate information.117

We have taken a number of steps to encourage the dissemination of information electronically via the Internet. For 18 years, we have been continually improving and modernizing electronic access to companies' Exchange Act reports through our EDGAR system, including by providing Internet access to these reports.118 We now provide electronic access to the public on a real-time basis through our Internet website.119

Without regard to EDGAR, an efficient and economical method for companies to make information available about themselves to many investors is through their Internet websites. In addition to other existing sources of company information, such as our website, a company's website is often an obvious place for investors to find information about a company. A company also may use different formats and other approaches to making information available in ways it believes are useful to investors. Most companies, realizing the benefits of this technology for information dissemination, already provide access to their Commission filings through their websites. A study by our Office of Economic Analysis revealed that approximately 83% of companies with a public float of at least $75 million provide some form of access to their Commission filings through their websites, either via a hyperlink with a third-party service providing real-time access to the filings (45%), by posting the filings directly on their websites (29%) or via a hyperlink to our EDGAR database (15%).

Modernizing the disclosure system under the federal securities laws involves recognizing the importance of the Internet in fostering prompt and more widespread dissemination of information.120 We believe company disclosure should be more readily available to investors on a timely basis in a variety of locations to facilitate investor access to that information. We believe it is important for companies to make investors aware of the different sources that provide access to company information. We applaud those that already provide access to their Commission filings through their websites, and encourage every reporting company to do so.

2. Comments on the Proposal

We received responses from 141 commenters on the proposals for disclosure concerning access to company filings. The vast majority of commenters representing investors, investor groups, companies and professional associations were supportive of the proposals. Sixty commenters supported the requirement as proposed and concurred with our objective to provide

investors with information on where they can access company reports.121 These commenters believed the proposal would aid in encouraging companies to make information available in a variety of locations and hence make corporate information more widely accessible and disseminated. One professional association mentioned that almost 90% of companies in its survey expected to accomplish the objectives of the proposal with ease.122 The commenter also

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referred to other studies demonstrating that corporate websites are a significant source of information to investors and the media.

Forty commenters concurred with our objective but offered modifications to the proposal, such as recommending that we allow additional time for companies to post the reports on their websites and suggesting that a permanent statement regarding availability of the company's filings on a web page referring to EDGAR or a standing hyperlink to EDGAR should suffice.123 Twenty other commenters offered similar suggestions to modify the proposal.124 Some of the commenters requested interpretive clarifications for complying with the proposals.125

Twenty-one commenters questioned the utility of the proposal, especially considering the existence of the Commission's EDGAR website and the Commission's recent announcement that its website now provides real-time access to filings.126 Some of these commenters thought the proposal unnecessarily duplicated the Commission's EDGAR system.127 One commenter did not agree that a variety of electronic sources provides any more widespread access to information than a single source.128 Ten companies suggested that the desired improvement the Commission seeks in instant accessibility of information could be best accomplished by modernizing the EDGAR system, including by making filings immediately available to the public on its website, which we have now done.129

3. Final Rules

After evaluating the comments received, we are adopting the proposals with minor revisions. These amendments require accelerated filers to disclose in their annual reports on Form 10-K the following:130

* The company's website address, if it has one;

* Whether the company makes available free of charge on or through its website, if it has one, its annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports as soon as reasonably practicable after such material is electronically filed with or furnished to the Commission;

* If the company does not make its filings available in this manner, the reasons it does not do so (including, where applicable, that it does not have an Internet website);131 and

* If the company does not make its filings available in this manner, whether the company voluntarily will provide electronic or paper copies of its filings free of charge upon request.

Accelerated filers must begin complying with the new disclosure requirement starting with their annual reports on Form 10-K to be filed for fiscal years ending on or after December 15, 2002.

In response to comment, we have eliminated the proposed requirement that registrants disclose that filings are available on our website and in our public reference room as unnecessary. We have also eliminated the proposed disclosure relating to where else the public can access

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company filings immediately upon filing if the company does not provide real-time website access as real-time access to filings is now available through our website.

We understand that companies provide website access to their Exchange Act reports in a variety of ways, including by establishing a hyperlink to its Exchange Act reports via a third-party service in lieu of maintaining the reports themselves.132 For purposes of the disclosure element for website access to reports, hyperlinking to a third-party service is acceptable so long as the reports are made available in the appropriate time frame and access to the reports is free of charge to the user. To clarify that hyperlinking to a third party website is acceptable, we have slightly modified the proposed language to specify that a company can provide access on or through its website. A company should hyperlink directly to its reports (or to a list of its reports) instead of just to the home page or general search page of the third-party service.133 We note that many companies already provide this level of specificity in their hyperlinks as a matter of best practice.

As we now provide real-time access to Exchange Act reports through our website, hyperlinking directly to a company's reports (or to a list of its reports) on our EDGAR website will allow a company to state that it provides website access to its reports as soon as reasonably practicable after those reports are filed. This will help to decrease further any incremental burdens or costs caused by the new requirement. Despite the availability of these reports through our website, we concluded that disclosure regarding company website access is still desirable as one of our objectives is to encourage the availability of information in a variety of locations and foster best practices for making that information broadly accessible. Hyperlinking through EDGAR will now allow a company to state in all cases that it provides website access as soon as reasonably practicable.134

In reference to comments concerned about technical and other obstacles that might lead to violating the "same day" requirement, we have eliminated that requirement. However, we interpret the "as soon as reasonably practicable" standard to mean that the report would be available, barring unforeseen circumstances, on the same day as filing. We could revisit this requirement if posting on the same day does not generally occur.

Whether a company provides access to its Exchange Act reports either directly or through a third-party service, we recognize that some companies display the reports in electronic formats (for example, PDF) other than the official electronic format used to transmit the filing to our EDGAR system. In fact, we encourage companies to do so if alternative formats enhance readability and accessibility of the reports, so long as all of the information in the reports remains retrievable. However, the use of a particular medium to access the reports should not be so burdensome that the intended recipients cannot effectively access the information provided.135

The website access contemplated by the amendments includes access to all exhibits and supplemental schedules electronically filed with the reports or amendments. Information incorporated by reference is not required to be separately posted, although we encourage companies to do so if it will aid investor access to the information.

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While the amendments do not cover how long a company's report must be made available on or through its website, we encourage companies to provide ongoing website access to their reports. At a minimum, we suggest companies provide website access to their previous reports for at least a 12 month period. It would be desirable for companies to provide access to their previous reports on an appropriately archived portion of their website over an even longer timeframe. Finally, we encourage companies to provide website access to all of their filings with the Commission, including their filings under the proxy rules and their Securities Act filings.

Regarding the requirement that a company disclose its website address in its annual report on Form 10-K, some commenters were concerned as to whether including the website address in the filing constitutes incorporation by reference of any website information into the filing.136 If a company is complying with this disclosure item in its annual report on Form 10-K, the inclusion of the company's website address will not, by itself, include or incorporate by reference the information on the site into the company's Commission filing, unless the company otherwise acts to incorporate the information by reference.137

We understand that a company may have multiple websites that it uses for various purposes, such as investor relations, product information and business-to-business activities. We interpret the requirement to disclose the company's website address to mean the website the company normally uses for its investor relations functions.

The revisions we adopt today create new disclosure obligations that are designed to create duties only under Sections 13(a) and 15(d) of the Exchange Act. The new disclosure is not an antifraud rule, and it is not designed to create new duties under the antifraud provisions of the federal securities laws or in private rights of action or to alter any existing liability provisions. The new disclosure also does not separately create or otherwise affect a company's duty to update its prior statements.

As proposed, we are initially limiting the amendments to accelerated filers. Commenters were nearly unanimous in thinking that we should extend the amendments to all filers, including smaller issuers and foreign issuers.138 According to these commenters, the utility of information about report access is likely to be just as great or even greater for these issuers compared to the minimal incremental cost that may be associated with the proposals. We will continue to study this issue and consider extending the requirement to all reporting companies after evaluating our initial experience with the requirement by accelerated filers.

III. Paperwork Reduction Act

The amendments contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA").139 We published a notice requesting comment on the collection of information requirements in the Proposing Release, and we submitted these requirements to the Office of Management and Budget ("OMB") for review.140 Subsequently, OMB approved the proposed information collection requirements.

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The titles for the collection of information are "Form 10-K" and "Form 10-Q." An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

Form 10-K (OMB Control No. 3235-0063) prescribes information that a registrant must disclose annually to the market about its business. Preparing and filing an annual report on Form 10-K is a collection of information.

Form 10-Q (OMB Control No. 3235-0070) prescribes information that a registrant must disclose quarterly to the market about its business. Preparing and filing a quarterly report on Form 10-Q is a collection of information.

We currently estimate that Form 10-K results in a total annual compliance burden of 12,105,360 hours and an annual cost of $1,210,536,000. The burden was calculated by multiplying the estimated number of respondents filing Form 10-K annually (9,384) by the estimated average number of hours each entity spends completing the form (1,720 hours). We estimate that 75% of the burden is carried by the respondent internally (9,384 x 1,720 x 0.75 = 12,105,360), and we estimate that 25% of the burden is carried by outside advisors retained by the respondent at an average cost of $300 per hour (9,384 x 1,720 x 0.25 x $300 = $1,210,536,000).141 The portion of the burden carried by outside advisors is reflected as a cost.

We currently estimate that Form 10-Q results in a total annual compliance burden of 2,728,092 hours and an annual cost of $272,809,200. The burden was calculated by multiplying the estimated number of reports on Form 10-Q filed annually (26,746) by the estimated average number of hours each entity spends completing the form (136 hours). We estimate that 75% of the burden is prepared by the respondent (26,746 x 136 x 0.75 = 2,728,092). We estimate that 25% of the burden is prepared by outside advisors retained by the respondent at an average cost of $300 per hour (26,746 x 136 x 0.25 x $300 = $272,809,200). This portion of the burden is reflected as a cost.

A. Summary of Amendments

The amendments will accelerate the filing deadlines of quarterly reports on Form 10-Q and annual reports on Form 10-K by companies subject to specified public float and reporting history requirements. The amendments also require those companies to disclose in their annual reports on Form 10-K where investors can obtain access to company filings, including whether the company provides access to its Exchange Act reports free of charge on its Internet website as soon as reasonably practicable after those reports are electronically filed with or furnished to the Commission. If a company does not provide website access in this manner, it must also disclose the reasons it does not do so. We also require companies to disclose their website address if they have one. We believe that the revisions will promote direct, uniform and more widespread dissemination of timely information to investors and the markets and further the purposes of short-form registration under the Securities Act.

B. Summary of Comment Letters and Revisions to Proposals

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We requested comment on the PRA analysis contained in the Proposing Release. We received responses from two companies addressing the Commission's overall estimates for preparing reports.142 Both commenters questioned our original estimate of the allocation of the burden between the company (25% of the burden) and outside professionals retained by the company (75% of the burden). Both believed the estimate for the amount of work prepared in-house should be much higher.143 Subsequent to the Proposing Release, we have changed our estimates of the allocation of the burden between the company and outside advisors to 75% for in-house work and 25% for outside advisors.144 We recognize that not all companies may utilize in-house resources to the extent mentioned by the commenters, but we believe the new allocation more accurately reflects current practice for annual and quarterly reports.

One of the commenters believed the Commission's estimate of the average number of hours each entity spends completing Form 10-Q (136 hours) is too low.145 The commenter also believed that the Commission's estimate of the average number of hours each entity spends completing the Form 10-K (1,720 hours) was more accurate. We have not concluded that our estimates should be changed as a result of this comment, although we will continue to monitor registrant response to our burden hour estimates.

In addition to the concerns raised by commenters, we have made several modifications to the proposals, although the modifications do not affect our estimate of the incremental burden of the amendments. The amendments will change the calculation date for determining the disclosure of a company's common equity public float that appears on the cover page of its Form 10-K. In addition, companies will be required to check a box on their Form 10-K and 10-Q indicating whether they are an accelerated filer. We believe these changes are minimal and do not affect the total amount of burden hours for preparing the forms.

In addition, we have made several changes to the proposal for disclosure concerning access to company reports in response to comments on the substance of the proposal and to avoid unnecessarily lengthening reports. These changes include revising or eliminating some of the proposed disclosure elements. We do not believe these changes will significantly change our previous estimates of the burden on registrants from this new disclosure item.

C. Revisions to Reporting and Cost Burden Estimates

We estimate that approximately 59% of Form 10-K and Form 10-Q respondents, or 5,494 respondents, will satisfy our proposed definition of accelerated filer, and thus will be subject to accelerated deadlines and the requirement to make the enhanced disclosure in their Form 10-K regarding website access to their Exchange Act reports.146

For our amendments regarding filing deadlines, the amount of information required to be included in Exchange Act reports will remain the same. Accordingly, solely for purposes of the Paperwork Reduction Act, our estimate is that the amount of time necessary to prepare the reports, and hence, the total amount of burden hours, will not change.

As proposed, we estimate that the preparation of the required disclosure regarding information access in a respondent's Form 10-K will add 0.50 burden hours to each annual report on Form

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10-K. Thus, we estimate this aspect of the amendments will add an additional 2,747 burden hours to the current Form 10-K (0.50 hours x 5,494 respondents). We estimate that 75% of the burden is carried by the respondent (0.50 x 5,494 x 0.75 = 2,060).147 We estimate that 25% of the burden is prepared by outside advisors retained by the respondent at an average cost of $300 per hour (0.50 x 5,494 x 0.25 x $300 = $206,025). This portion of the burden is reflected as a cost.

As a result, we estimate the total annual compliance burden for Form 10-K after our revisions to be 12,107,420 hours and an annual cost of $1,210,742,025, an increase of 2,060 hours and $206,025 in cost. Compliance with the disclosure requirement will be mandatory. There will be no mandatory retention period for the information disclosed, and responses to the disclosure requirements will not be kept confidential. We do not believe that the imposition of this disclosure requirement will alter significantly the number of respondents that file on Form 10-K.

IV. Cost-Benefit Analysis

The amendments are part of our initiative to modernize and improve the regulatory system for periodic disclosure under the Exchange Act. We are sensitive to the costs and benefits that result from our rules. In this section, we examine the benefits and costs of our amendments.

The rule and form changes will enhance the timeliness and availability of disclosure to investors in two ways:

* Shorten the due dates of quarterly and annual reports (and transition reports) for domestic reporting companies that meet certain public float and reporting history requirements;148 and

* Require companies to disclose in their annual reports on Form 10-K where investors can obtain access to company filings, including whether companies provide access to their Exchange Act reports on their Internet websites.

A. Acceleration of Quarterly and Annual Report Due Dates

1. Benefits

The due dates for quarterly and annual reports by domestic issuers have not changed in over 30 years, despite enormous advances in information technology and productivity. We believe that periodic reports contain valuable information for investors. Shortening the due dates for quarterly, annual and transition reports will provide many benefits. Most importantly, it will accelerate the delivery of information to investors and the capital markets, enabling them to make more informed investment and valuation decisions more quickly.149 This helps the capital markets function more efficiently, which implies more efficient valuation and pricing. While quarterly and annual reports at present generally reflect historical information, a lengthy delay before that information becomes available makes the information less valuable to investors.

The more extensive information in periodic reports is evaluated by investors and particularly analysts and institutional investors as a baseline for the incremental disclosures made by a

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company. These reports also contain more detailed information that is essential to conduct comparative analyses, as this information is often not contained in earnings releases or other incremental disclosures. Moreover, the information in Exchange Act reports, due to its required nature and the liability to which it is subject, provides a verification function against other statements made by the company in press releases and other public announcements. Investors and other users of the reports can judge previous informal statements by the company against the more extensive and mandated disclosure provided in the reports that have been reviewed by independent public accountants and other advisors. Accelerating the availability of this information will enable this verification to occur at an earlier point in time. Accelerating the availability of these reports also may increase the relevance of these reports, as the timeliness of information has considerable value to investors and the markets. Moreover, seasoned issuers incorporate information from their Exchange Act reports in their Securities Act registration statements. Hence, investors buying in these public offerings, particularly in on-going shelf offerings, also may benefit from more timely disclosure.

Many companies now routinely release quarterly and annual results well before they file their formal reports with us. These earnings announcements reflect the importance of financial information and investors' demand for it at the earliest possible time. Assuming that companies are collecting and evaluating information before they issue these announcements, the availability of this information also suggests that much of the process involved in preparing the financial information contained in periodic reports is substantially complete. However, these earnings announcements are generally less complete in their disclosure than quarterly or annual reports, and they can emphasize information that is less prominent in quarterly or annual reports. Investors often must wait for the periodic reports to receive financial statements and the accompanying notes prepared in accordance with generally accepted accounting principles, MD&A and other vitally important financial disclosures. These additional disclosures increase transparency for investors.

We also are making conforming amendments to accelerate the timeliness requirements in Regulation S-X for the inclusion of financial statements by accelerated filers in other Commission filings, such as Securities Act and Exchange Act registration statements and proxy and information statements under Section 14 of the Exchange Act. When the Commission made extensive revisions to its rules, forms and regulations in 1980 to further the integrated disclosure system, it adopted amendments regarding the inclusion of financial information in registration statements and proxy statements that parallel the requirements for financial data in Exchange Act periodic reports. Parallel requirements facilitate the integrated reporting system by simplifying existing rules. They also improve overall disclosure as investors are assured consistent requirements as to the timeliness of information regardless of the document received. If conforming amendments are not made to keep these requirements parallel, a filing could conceivably be made under the Securities Act with financial information less current than that filed under the Exchange Act. Accordingly, to facilitate uniform requirements, we are adopting amendments to Regulation S-X to conform the timeliness requirements. Under the conforming amendments we are adopting today, financial statements included in a registration statement or proxy statement still will be required to be at least as current as any financial statements filed under the Exchange Act.

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Many commenters representing investors, users of financial information and several companies concurred with our assessment of the benefits of the proposals. These commenters believed that shortening deadlines will improve the delivery and flow of reliable information to investors and capital markets and assist in the efficient operation of the markets. These commenters emphasized the importance of the extensive information in periodic reports and investors' demand for it at the earliest possible time. Several other companies, accounting firms and professional associations agreed in concept that shortening due dates would improve the flow of information, but believed the due dates should reflect concerns about the quality of information to be filed.

A small minority of companies, law firms and business organizations, however, believed that existing deadlines and market practices are sufficient to satisfy investors' needs and believed we over-emphasized the importance of periodic reports. These commenters did not think a significant benefit would result from shortening deadlines, but also generally did not attempt to address the question of possible benefits from the perspective of users of the reports. While we recognize that investors and the markets rely on information from a variety of sources in formulating their investment decisions, we agree with the near unanimous view of commenters representing the users of reports that the financial and other information in periodic reports is important to them, and that accelerating the delivery of the reports will provide benefits to investors and the markets.

2. Costs

The amendments will increase costs to some affected reporting companies, although companies may, and some already do, report within the new deadlines voluntarily. Specifically, the amendments may increase the costs of preparing reports because although companies already must prepare the reports, some may have to delay other projects or use additional resources, including in-house personnel, outside legal counsel and outside auditors to prepare the information in a shorter timeframe. Some companies may need to make additional capital investments, such as in additional information systems, to prepare their reports in a shorter timeframe.

While a few commenters believed that the original proposals would not have a significant adverse effect on the cost of preparing reports, most who addressed the subject mentioned that the original proposals would result in some increased costs. Many outlined their process of preparing reports to demonstrate the difficulties of accelerating the process. The particular steps and timing varied depending on the individual company, and not all companies appear to be at the same level of technological sophistication and staffing for preparing reports. Two professional associations noted that there are no current best practices for preparing reports.150 As a result, the few cost estimates received varied widely, and many commenters were unable to provide estimates. One company believed it was not possible to put a dollar value on such costs, as it depends on the quality and flexibility of each registrant's present systems, processes and staff.151 According to one professional association that surveyed its members, 52% of its survey respondents reported that they expected costs to increase in order to comply with the original proposals.152 Forty-five percent of respondents indicated they would have to hire additional staff, and 27% of respondents indicated they would have to buy or develop additional systems.

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Other commenters were concerned that accelerating deadlines would result in increased audit fees, particularly for companies with a calendar fiscal year-end, given a compression in the amount of time available for auditors to complete their work for these companies.

The amendments may have indirect effects as well. While some companies commented that they could or already comply with the proposal without undue burden, the group that objected to the proposal raised several common concerns over the extent of acceleration and transition period proposed. The most common concern was that the proposed deadlines would negatively affect the quality and accuracy of reports. According to one professional association, two-thirds of its survey respondents expected a reduction in the precision of reported information under the original proposals.153 We are not changing the liability standards for reports, nor are we decreasing the amount of information required. Investors and the capital markets may suffer if quality or accuracy diminished, causing the markets to function less efficiently and investment decisions to be impaired.

Another common concern was that the proposed deadlines would impair the ability of management, external auditors, boards of directors and especially audit committees to scrutinize and review filings properly and give appropriate consideration to the form, substance and priority of disclosures, especially MD&A disclosures and financial statement footnotes. These commenters feared that disclosures could be reduced or become more boilerplate if companies have less time to prepare and review them. The commenters believed that accelerating deadlines in the manner proposed would also undermine the governance and review mechanisms that have been put in place to ensure quality. Several other commenters mentioned additional concerns over the proposals, such as an increased need to use estimates or an increased risk of amendments or restatements because of rushed preparation. Several commenters were especially concerned about accelerating deadlines now given recent events with Arthur Andersen LLP.

We have limited direct data on which to base cost estimates of the amendments. However, we reviewed cost estimates provided by respondents to a survey conducted by the American Society of Corporate Secretaries. These estimates were based on the original proposal. We attempted to determine if the survey results were related to issuer characteristics. The cost estimates did not appear to be related to market capitalization, revenues, industry or number of reporting segments of the underlying company. Based on 46 companies with over $75 million in public float that provided estimates, 17% reported that they did not expect any additional costs from the proposals. 43.4% expected initial costs to prepare for the proposals. These estimates ranged from $12,500 to $5,000,000, with a median value of $125,000. 50% expected on-going annual costs to comply with the proposals. These estimates ranged from $27,500 to $250,000, with a median value of $90,000. 11% of respondents expected both initial and on-going costs to comply with the proposals. Assuming these estimates are representative of all affected companies, we estimate that initial costs of the original proposal for all affected companies would range from $29,862,500 to $11,945,000,000, with a median value of $298,625,000.154 Aggregate on-going, annual costs of the original proposal for all affected companies would range from $75,524,500 to $686,750,000, with a median value of $247,230,000.

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These estimates may overstate the actual costs from the amendments we are adopting today, however, as we are making several accommodations to address commenters' concerns and to ease compliance, including:

* A gradual phase-in of the new deadlines over three years, with no change in deadlines for the first year;

* A less extensive ultimate acceleration of quarterly reports than proposed;

* Revisions to the definition of accelerated filer to give companies more advance notice and time to prepare for accelerated deadlines; and

* Conforming amendments that allow certain financial statements of subsidiaries to be filed by later amendment if the subsidiary is not an accelerated filer.

A phased-in approach helps to alleviate the immediate impact of any costs and burdens that may be imposed on certain registrants. While several commenters indicated that they could report on an accelerated timeframe today, several major business associations that surveyed their members reported that adjustment to accelerated deadlines would be easier with a phase-in period.155 A longer transition may even help reduce costs as companies will have additional time to develop best practices, long-term processes and efficiencies to prepare reports, as opposed to having to take rushed and possibly inefficient measures to meet a more sudden acceleration. Also, a longer transition period helps to smooth out any possible impact on the availability of third party advisors used by companies to prepare their reports.

A less extensive acceleration of the quarterly report deadline also will alleviate some of the burdens mentioned by commenters. There will be more time than proposed to gather the necessary data and complete the necessary reviews by company officials, the board of directors and outside advisors. One professional association commented that 80% of its survey respondents reported they could more easily meet a 35-day deadline than a 30-day deadline.156 Further, we believe that by imposing a 40-day deadline before finally reducing it to 35 days, we are striking an adequate compromise between the benefits of reducing deadlines with the potential inconvenience, difficulty and cost that may be incurred by some companies.

Regarding our conforming changes to the timeliness requirements in other Commission filings, we recognize that for some short period of time, accelerated filers may be prevented from going to market. However, it is our view that, when a company is an accelerated filer and is attempting to raise capital in the marketplace after audited financial information would be required to be filed under the Exchange Act, it is reasonable to delay registration until such financial statements become available. We believe this change is in the best interest of the investing public and will not create any additional burden on the large majority of accelerated filers because the required financial information already will be required to have been filed. Also, as in the past, we will consider waivers to the rules where unusual circumstances dictate the need for them.

We considered several regulatory alternatives in formulating the final amendments. We considered, but rejected, the alternative of tying the due date of reports to a company's

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announcement of earnings. Not all companies issue earnings releases or issue them on an accelerated basis. As a result, linking deadlines to earnings releases may not result in more accelerated reporting of information. We also were concerned that linking report deadlines to earnings announcements could delay earnings announcements, as companies would know that the announcement would trigger the deadline to file reports. While market demand for earnings information could negate this risk, an approach linking deadlines to earnings announcements could have the effect of penalizing companies for early releases of information while rewarding companies that delay their earnings with extended time to file their reports.

Even with a phase-in period, accelerating filing deadlines may create the risk that more companies will file their reports late or need a filing extension. Moreover, if a company is late filing its reports, it will lose availability for short-form registration for at least one year from the date of the late filing. Being late also could render Securities Act Rule 144 temporarily unavailable for security holders' resales of restricted and control securities, and make new filings on Form S-8 temporarily unavailable for resales of employee benefit plan securities. We considered the suggestions of some commenters to extend the filing extension periods in Exchange Act Rule 12b-25 as an additional method to alleviate any transition difficulties to shortened deadlines. However, we think a lengthy phase-in period adequately addresses these concerns. A less dramatic acceleration of deadlines over a set schedule each year will provide companies with advance notice of the changes they will be expected to make and will smooth out some of the possible difficulties raised by commenters. Rule 12b-25 in its existing form still will provide companies that face extenuating circumstances the ability to gain a filing extension.

While our proposals did not directly address the contents of earnings releases, many commenters supported additional efforts by the Commission in this area. Several recommended that earnings or other standardized earnings information be filed with the Commission, such as on Form 8-K. Others thought the Commission should consider issuing or promoting minimum requirements or guidelines for the contents of earnings releases, such as a GAAP reconciliation. While we will continue to explore ways to improve earnings releases, and the Sarbanes-Oxley Act of 2002 requires us to take steps in this area, we believe these are separate initiatives from the need to accelerate periodic report deadlines. As mentioned above, we believe periodic reports contain valuable information for investors, and comments received from the users of this information uniformly indicated their desire to receive the reports at the earliest time that is consistent with receiving quality information.

We also considered shorter and longer phase-in periods and deadlines. While several commenters indicated they could report on an accelerated timeframe today, several major business associations that surveyed their members reported that adjustment to accelerated deadlines would be easier with a phase-in period. Also, while comments were mixed, the majority of commenters addressing the issue believed it would be more difficult to accelerate the quarterly report than the annual report. Accordingly, the quarterly deadline will only be reduced to a 35-day deadline at the end of the phase-in period, which is five days longer than originally proposed. We think any concerns over possible confusion over changing deadlines during the phase-in period will be temporary and justified by the benefits of giving companies additional time to adjust their reporting schedules.

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We considered shortening filing deadlines for all companies. Comments were mixed over excluding smaller issuers. Although we believe investors in less large or unseasoned companies may want and benefit from more timely disclosures just as much as investors in larger, listed companies, we are concerned that this may impose undue burden and expense on these companies. Smaller companies are likely to be more sensitive to any increased costs in preparing their reports. These entities may not have the infrastructure and resources available or necessary to prepare their reports on a shorter timeframe. Accordingly, we are only shortening the filing deadlines for companies with a minimum public float or reporting history as proposed. Of course, smaller companies may file their reports earlier voluntarily.

Comments also were mixed on the proposed $75 million public float threshold. We considered several different thresholds for shortening deadlines, including thresholds based on revenue, measures of trading volume and listing status. However, based on our past experience, we believe the public float test currently used in Form S-3 is consistent with our purposes. We believe that a public float test serves as a reasonable measure of company size and market interest. While several commenters urged raising the threshold, we believe a longer phase-in period and a less extensive acceleration of the quarterly report deadline militates against the need to raise the threshold. The definition of accelerated filer we are adopting today excludes nearly half of all publicly traded companies, as well as all companies eligible for our small business issuer reporting system, all foreign private issuers that file on Form 20-F and all companies that do not have a common equity public float. Selecting a $75 million public float threshold also is consistent with our conforming amendments to the timeliness requirements for other Commission filings. By using the same threshold as in Form S-3, investors are assured of receiving the most up-to-date information regardless of the particular registration form a company chooses.

B. Website Access to Information

1. Benefits

Widespread access to timely company information promotes the efficient functioning of the capital markets. Also, ready access to Exchange Act information is critical to short-form registration of securities offerings. Many aspects of our disclosure system were adopted well before the revolutions in information technology brought about by the Internet. In modernizing and improving our disclosure system, we recognize the benefits of the Internet in promoting more widespread dissemination of information. An efficient and cost effective method for companies to make information available about themselves is through their Internet website. In addition to other existing sources of company information, such as our website, a company's website is one obvious place for many investors to find information about a company. A company also may use different formats and other approaches to making information available in ways it believes are useful to investors. We believe company disclosure should be more readily available to investors on a timely basis in a variety of locations to facilitate investor access to that information. We believe it is important for investors to know of additional sources where they can access company information.

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Providing this disclosure and encouraging companies to post their Exchange Act reports on their websites will provide many benefits, and the vast majority of commenters concurred and were supportive of the proposals. The amendments protect investors by alerting them to sources where they can obtain direct and easy access to the information they should have to make informed investment and valuation decisions. The amendments will help promote consistent, direct, timely and more widespread access of information to investors and the markets, and further the proper functioning of the integrated disclosure and short-form registration system. An efficiently functioning registration system facilitates capital formation. Not all reporting companies now make their Exchange Act filings available through their websites, and not all the ones that do make information available provide access in real-time. The amendments encourage uniform best practices to aid in an investor's search for timely information, thereby potentially reducing the costs to gather such information.

2. Costs

The amendments may increase the costs to some affected companies, although we seek to minimize those costs. Companies will be required to include minimal additional disclosure in their annual report on Form 10-K. We estimate this will result in a total cost of $463,525 for all affected companies.157 The disclosure requirement only will apply to companies that meet specified public float and reporting history requirements, which will help to minimize the impact on companies potentially less able to bear additional costs. The amendments also will not require a company to provide website access, although we encourage all companies to do so. Commenters were nearly unanimous in their belief that the proposal would result in no or minimal additional costs and would not be unduly burdensome to implement, particularly since it is limited only to accelerated filers.158 One professional association mentioned that the majority of its survey respondents expected that the proposal would incur no additional costs.159 Another professional association mentioned that almost 90% of companies in its survey expected to accomplish the objectives of the proposal with ease.160

Also, as we now provide real-time access to Exchange Act reports through our website, hyperlinking directly to our EDGAR website will allow a company to state that it provides website access in the required timeframe. This will help to decrease further any incremental burdens or costs caused by the amendments. Some commenters thought the proposal was duplicative of EDGAR, particularly considering that we now provide real-time Internet access to reports. Despite the availability of reports through our website, we concluded that disclosure regarding company website access is still desirable as one of our objectives is to encourage the availability of information in a variety of locations and foster best practices for making that information broadly accessible. In response to comments concerned about the technical and other obstacles that might lead to violating the proposed "same day" requirement, we have eliminated that requirement.

We considered several additional regulatory alternatives. Many companies already voluntarily provide at least some access to their filings on their websites, but not all provide access to all of their filings or in real-time. We considered requiring website access to company reports as an additional eligibility requirement for short-form registration. However, we were concerned that the potential loss of form eligibility from non-compliance with the requirement would be overly

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burdensome on companies. We are considering the suggestions by many commenters to extend the disclosure requirement to non-accelerated filers.

V. Consideration of Burden on Competition, and Promotion of Efficiency, Competition and Capital Formation

Section 23(a)(2) of the Exchange Act161 requires us, when adopting rules under the Exchange Act, to consider the impact that any new rule would have on competition. In addition, Section 23(a)(2) prohibits us from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. We have considered the amendments in light of the standards in Section 23(a)(2).

The amendments are intended to improve the timeliness and accessibility of Exchange Act reports to investors and the financial markets. We anticipate these amendments will enhance the proper functioning of the capital markets. This increases the competitiveness of companies participating in the U.S. capital markets. The amendments will affect certain companies and not others, so the impacts of the proposal may not be equally distributed. Also, if not all competitors in a given industry are subject to accelerated deadlines, information about some competitors may be disclosed ahead of other competitors (for example, the filing of material contracts).162 This could potentially give some competitors an informational advantage. If the amendments to shorten filing deadlines increased the number of companies who filed their reports late, this could reduce the number of companies eligible for short-form and delayed shelf registration. For our amendments relating to website access, companies that will be subject to accelerated deadlines may incur increased costs from providing additional disclosure that will not be incurred by companies not subject to these deadlines. However, we believe these costs are not significant.

We requested comment on any anti-competitive effects of the proposals. A few commenters suggested that the proposals to accelerate filing deadlines might have some effects on competition. For example, one law firm thought that differing reporting deadlines for accelerated and non-accelerated filers could adversely affect competition.163 Non-accelerated filers would enjoy a competitive advantage against accelerated filers who are forced to incur the incremental costs imposed by accelerated deadlines. While we recognize that the impacts of the amendments will not be equally distributed, we also must balance the market's need for information with the ability of companies to report on an accelerated timeframe without undue burden. Not all companies, particularly small and unseasoned companies, may have the resources and infrastructure in place to prepare their reports on a shorter timeframe without undue burden or expense. While any dividing line we ultimately choose could have a possible disproportionate affect at the margin, we believe separating small and large companies balances the needs of investors against the constraints facing smaller issuers. In doing so, the amendments could actually encourage competition because they are designed to avoid imposing onerous burdens and expenses on those companies that are least able to bear them. We will continue to study whether acceleration of deadlines for a broader class of issuers is appropriate.

Several other commenters believed we should not exclude foreign private issuers from our definition of accelerated filer.164 These commenters believe foreign filers should be subject to

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the same rules to create a level playing field for all companies that access the U.S. capital markets. Other commenters thought that the issues involving foreign issuers are sufficiently different as to warrant separate study and rule proposals.165 We agree with the latter group. We do recognize that with the amendments we adopt today, the discrepancy between the filing deadlines for larger seasoned U.S. issuers and those for foreign private issuers will increase. Foreign issuers are subject to similar obligations as to the information to be reported. There are some categories of information, for example executive compensation, where requirements for foreign issuers are less onerous. Foreign issuers that do not prepare their financial statements in accordance with U.S. GAAP, however, must go through the additional step of preparing a reconciliation of their financial statements to U.S. GAAP. These companies also may have additional home country reporting requirements. We are continuing to consider this issue and Exchange Act filing requirements generally for foreign issuers. However, given that a current filing lag already exists, we do not believe the relative increase in the lag created by the amendments is significant enough to warrant a delay in their adoption. To the extent any anti-competitive effect may arise from the increase in this lag, we believe any such burden would be necessary and appropriate for the protection of investors.

Section 2(b) of the Securities Act166 and Section 3(f) of the Exchange Act167 requires us, when engaging in rulemaking where we are required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation. We have considered the amendments in light of the standards in these provisions.

The amendments will enhance our reporting requirements in light of technological advances. The purpose of the amendments is to promote greater timeliness and accessibility of this information so that investors can more easily make informed investment and voting decisions. Informed investor decisions generally promote market efficiency and capital formation. As noted above, however, the proposals could have certain indirect negative effects, such as discouraging or precluding some companies near the threshold from using short-form registration, which could adversely impact their ability to raise capital.

We also are adopting conforming amendments to the timeliness requirements for the inclusion of financial statements in proxy statements, information statements and Securities Act and Exchange Act registration statements. We recognize that in making these conforming changes, for some short period of time, accelerated filers may be prevented from going to market. However, it is our view that, when a company is an accelerated filer and is attempting to raise capital in the marketplace after audited financial information would be required to be filed under the Exchange Act, it is reasonable to delay registration until such financial statements become available. We believe this change is in the best interest of the investing public and will not create any additional burden on the large majority of accelerated filers because the required financial information already will be required to have been filed. Also, as in the past, we will consider waivers to the rules where unusual circumstances dictate the need for them.

We requested comment on how the proposals would affect efficiency, competition and capital formation. Many commenters representing investors, investor organizations as well as some companies believed that shortening deadlines will improve the delivery and flow of reliable

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information to investors and capital markets and assist in the efficient operation of the markets. A larger group of commenters representing primarily companies, business associations, law firms and accounting firms objected to the extent of acceleration and transition period proposed because, in their view, preparing reports in the proposed time frame could result in less accurate filings, which could stifle efficiency. Some commenters also were concerned that the proposed deadlines may increase the number of late filings. In addition to adverse market reaction, filing late could cause companies to lose eligibility to use short-form registration statements for at least one year, which could raise the cost of capital.

In response to these concerns, we are phasing-in deadlines over a three-year period and adopting a less extensive acceleration of the quarterly report deadline. A phased-in approach of accelerated deadlines allows a greater transition period for companies to adjust their procedures and develop efficiencies to ensure that the quality and accuracy of reported information will not be sacrificed. With a less extensive acceleration of the quarterly report deadline, there will be more time than proposed to gather the necessary data and complete the necessary reviews by company officials, the board of directors and outside advisors. Also, Exchange Rule 12b-25 in its existing form still will provide companies that face extenuating circumstances the ability to gain a filing extension.

VI. Final Regulatory Flexibility Analysis

This Final Regulatory Flexibility Analysis, or FRFA, has been prepared in accordance with the Regulatory Flexibility Act.168 This FRFA relates to amendments to the rules and forms under the Securities Act and the Exchange Act to:

* Shorten the due dates of quarterly and annual reports (and transition reports) for domestic reporting companies that meet certain public float and reporting history requirements;169 and

* Require companies to disclose in their annual reports on Form 10-K where investors can obtain access to company filings, including whether companies provide access to their Exchange Act reports on their Internet websites.

A. Need for the Amendments

The amendments have two primary objectives. First, we are accelerating the disclosure of information to investors and the capital markets by shortening the due dates of quarterly and annual periodic reports and transition reports for domestic reporting companies that meet certain minimum public float and reporting history requirements. These due dates have not changed in over 30 years, despite advances in information technology and productivity and increases in the pace of and need for communications in the capital markets. Accelerating the delivery of information to the capital markets will help enhance the efficient functioning of those markets. The more extensive information in periodic reports is evaluated by investors and particularly analysts and institutional investors as a baseline for the incremental disclosures made by a company, and these reports also contain more detailed information that is essential to conduct comparative financial analyses. Many companies routinely release quarterly and annual financial results before they file their formal reports with us. However, these earnings announcements are

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generally less complete in their disclosure than periodic reports, and they can emphasize information that is less prominent than in the reports. Shortening the deadlines will shorten this information gap, thereby increasing the relevance of those reports. Investors buying in public offerings of issuers that incorporate their Exchange Act reports in their Securities Act registration statements also will benefit from more timely disclosure.

Second, we wish to encourage more direct and widespread accessibility and dissemination of timely information to investors and the capital markets in a variety of locations. Accordingly, we are requiring companies subject to the accelerated filing deadlines to disclose in their annual reports on Form 10-K where investors can obtain access to company filings, including whether the company provides access to its Exchange Act reports free of charge on its Internet website as soon as reasonably practicable after those reports are electronically filed with or furnished to the Commission. These amendments will help promote consistent, direct, timely and more widespread access of information to investors and the markets and further the proper functioning of the integrated disclosure and short-form registration system. Not all public companies currently make their filings available on their websites, and not all provide access to all of their reports or in real-time. The amendments will thus promote greater access for investors.

B. Significant Issues Raised by Public Comment

The Initial Regulatory Flexibility Analysis, or IRFA, appeared in the Proposing Release.170 We requested comment on any aspect of the IRFA, including the number of small entities that would be affected by the proposals, the nature of the impact, how to quantify the number of small entities that would be affected and how to quantify the impact of the proposals. We received no comment letters responding to that request.

C. Small Entities Subject to the Amendments

The amendments will affect certain small entities that are required to file quarterly and annual periodic reports and transition reports under the Exchange Act, but only if those small entities meet the definition of an "accelerated filer" that we are adopting today. For purposes of the Regulatory Flexibility Act, Exchange Act Rule 0-10(a)171 defines the term "small business" to be an issuer, other than an investment company, that, on the last day of its most recent fiscal year, has total assets of $5 million or less. The Securities Act defines a "small business" issuer, other than investment companies, to be an issuer that, on the last day of its most recent fiscal year, has total assets of $5 million or less and is engaged in or proposes to engage in an offering of securities of $5 million or less.172

We estimate that there are approximately 2,500 companies, other than investment companies, subject to the reporting requirements of Sections 13 or 15(d) of the Exchange Act that have assets of $5 million or less. The amendments to shorten the deadlines for annual and quarterly periodic and transition reports and the amendments regarding access to Exchange Act reports will apply to these small entities if they have a public float of $75 million or more, have been subject to the Exchange Act's reporting requirements for at least one year, have filed at least one annual report and are not eligible for our small business issuer reporting system. We have no way to determine exactly how many small entities meet these requirements, although it is likely

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that only a very small number of these entities will meet the public float requirement. In addition, small entities are not affected if they are eligible to use our small business issuer reporting system.

According to the Standard & Poors Research Insight Compustat Database, of the 711 reporting companies listed with assets of $5 million or less, 10, or 1.4%, had a market capitalization greater than $75 million.173 Assuming that this sample is representative of all small entities, the public float requirement will have the effect of almost completely excluding all small entities.

D. Projected Reporting, Recordkeeping, and Other Compliance Requirements

For reporting companies that meet the public float and reporting history requirements, we are phasing-in shortened due dates for annual reports on Form 10-K and quarterly reports on Form 10-Q over three years. The Form 10-K deadline will be reduced over three years from the current deadline of 90 days after the end of the company's fiscal year to 60 days after the end of the company's fiscal year. The Form 10-Q deadline will be reduced over three years from the current deadline of 45 days after the end of the company's first three fiscal quarters to 35 days after the end of the first three fiscal quarters. We are making similar changes to transition reports these companies must file when they change their fiscal year and the timeliness requirements for financial information that must be included in other Commission filings such as proxy statements, information statements and Securities Act and Exchange Act registration statements. We are not changing the filing deadlines for other companies, including small business issuers eligible to rely on our small business reporting system, at this time.

While the amount of information required to be included in Exchange Act reports, and hence the amount of time necessary to prepare them, will remain the same, affected companies may be required to use additional resources, including in-house personnel, in preparing their reports on a shorter timeframe. Small entities that meet the public float and reporting history requirements may incur additional costs in seeking the help of outside experts, particularly outside legal counsel and auditors, or in making any necessary technological investments to speed their reporting process.

Companies that are late in filing their reports will lose eligibility for short-form registration for at least one year, and Securities Act Rule 144 and new filings on Form S-8 will be temporarily unavailable during the period of noncompliance.174 On the margin, affected small entities that are unable, or cannot afford, to prepare their reports on a shorter timeframe may be discouraged from remaining public companies or accessing the public markets. This may adversely affect their ability to raise capital.

We also are requiring accelerated filers to disclose in their annual reports on Form 10-K where investors can obtain access to company filings, including whether the company provides access to its Exchange Act reports free of charge on its Internet website as soon as reasonably practicable after those reports are electronically filed with or furnished to the Commission. If a company does not provide such access, it must also disclose why it does not do so. In formulating these amendments, we have sought to minimize its costs, particularly on small entities. The requirement will apply only to companies that met the public float and reporting

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history requirements. Companies will not be required to establish an Internet website for purposes of this requirement if they did not otherwise have one. Also, a company can elect not to provide website access to their reports as long as it disclosed that it has elected not to do so and the reasons it has elected not to do so. Accordingly, these elements of the amendments, coupled with the fact that almost all small entities will be effectively excluded from the proposal, lead us to believe that the requirement will not have a disproportionate effect on small entities.

E. Agency Action to Minimize Effect on Small Entities

As required by the Regulatory Flexibility Act, we have considered alternatives that would accomplish our stated objectives, while minimizing any significant adverse impact on small entities. In connection with the amendments, we considered several alternatives, including:

* Establishing different compliance or reporting requirements or timetables that take into account the resources available to small entities;

* Clarifying, consolidating or simplifying compliance and reporting requirements under the rules for small entities;

* Using performance rather than design standards; and

* Exempting small entities from all or part of the requirements.

Our amendments to shorten the filing deadlines will apply only to entities that meet minimum public float and reporting history requirements, which should serve to exclude almost all small entities. As a result, different timetables will apply for almost all small entities. We strive to strike a balance between timely delivery of information to investors and giving companies enough time to prepare their reports. We considered the alternative of only shortening the filing deadlines for companies whose securities are listed on the NYSE or AMEX or quoted on Nasdaq National Market System or Small Cap Market. However, we believe investors in companies that are not as large or listed but nevertheless meet the public float or reporting history requirements may want and benefit from more timely disclosures just as much as investors in larger, listed companies. Accordingly, we rejected exempting small entities in their entirety from the coverage of the amendments.

In addition, we are not aware of how to further clarify, consolidate or simply these proposals for small entities. In this regard, we already are limiting the shortened deadlines to entities that meet minimum public float and reporting history requirements. We do not consider using performance rather than design standards to be consistent with our statutory mandate of investor protection in the present context. Because specified information in Exchange Act reports must be reported in a timely manner to be useful, design standards are necessary to achieve the objectives of the amendments. Accelerating the delivery of mandated information is one of the goals of the amendments.

Our amendments regarding disclosure of website access to company reports are designed to enhance the accessibility and dissemination of information to investors. These amendments also

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will apply only to entities that meet minimum public float and reporting history requirements, which should serve to exclude almost all small entities. We believe our amendments strike a balance between providing investor access to information and giving companies alternatives in providing this access. Different compliance or reporting requirements for affected small entities or exemptions for all affected small entities are not considered warranted at this time because it is just as important that information be adequately disseminated and easily available for affected small entities as it is for large entities, if not more so. We have made a number of changes to the proposal that we believe decrease further the impact on all issuers, including small entities. First, we have narrowed the scope of disclosure required. Second, we now provide real-time access to EDGAR filings through our website for free, which allows companies an easy and low cost method to provide real-time access if they choose to do so. The expected low costs of complying with the proposal, as well as the effect of the public float requirement in lessening the impact on small entities, also contributed to our decision not to exclude small entities in their entirety.

Companies can choose whether to provide website access and therefore the disclosure that will be necessary in their annual report on Form 10-K. This allows companies, including small entities, the flexibility to choose the alternative that best suits their individual circumstances. We believe this freedom should apply to all entities, large and small. We are not aware of ways to further clarify, consolidate or simply these proposals for small entities.

VII. Update to Codification of Financial Reporting Policies

The Commission amends the "Codification of Financial Reporting Policies" announced in Financial Reporting Release No. 1 (April 15, 1982) as follows:

1. By amending Section 102.05.(2) to read as follows:

(2) Conforming the Filing Requirements of Transition Reports to the Current Requirements for Forms 10-Q and 10-K

To conform to the current filing periods for reports on Forms 10-K and 10-Q, the filing period for transition reports on Form 10-K is 90, 75 or 60 days for accelerated filers, as applicable depending on the issuer's fiscal year specified in Rules 13a-10 and 15d-10, and 90 days for other issuers after the close of the transition period or the date of the determination to change the fiscal year, whichever is later, and for transition reports on Form 10-Q, the filing period is 45, 40 or 35 days for accelerated filers, as applicable depending on the issuer's fiscal year specified in Rules 13a-10 and 15d-10, or 45 days for other issuers after the later of these two events.

2. By amending Section 102.05. to add the following preliminary note to the "Appendix" to Section 102.05.:

<u>Preliminary Note: The following examples are applicable if the issuer is not an accelerated filer. If the issuer is an accelerated filer, substitute 75 or 60 days, as applicable depending on the issuer's fiscal year specified in Rules 13a-10 and 15d-10, for 90 days in the examples for transition reports on Form 10-K, and substitute 40 or 35 days, as applicable depending on the</u>

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issuer's fiscal year specified in Rules 13a-10 and 15d-10, for 45 days in the examples for transition reports on Form 10-Q.

3. By amending Section 302.01.a. to:

a. Replace the phrase "after 45 days but within 90 days of the end of the registrant's fiscal year" with the phrase "after 45 days but within 90, 75 or 60 days of the end of the registrant's fiscal year for accelerated filers, as applicable depending on the registrant's fiscal year (or after 45 days but within 90 days of the end of the registrant's fiscal year for other registrants)" in the second paragraph of Section 302.01.a.; and

b. Replace the phrase "after 45 days but within 90 days of the end of its fiscal year (i.e., February 16 to March 31 for calendar year companies)" with the phrase "after 45 days but within 90, 75 or 60 days of the end of its fiscal year if the registrant is an accelerated filer, as applicable depending on the company's fiscal year (i.e., February 16 to March 31, 15 or 1 for calendar year companies) (or after 45 days but within 90 days of the end of its fiscal year for other registrants (i.e., February 16 to March 31 for calendar year companies))" in the first sentence of the fourth paragraph of Section 302.01.a.

4. By amending Section 302.01.b. to:

a. Replace the phrase "134 days subsequent to the end of a registrant's fiscal year" with the phrase "134, 129 or 124 days subsequent to the end of a registrant's fiscal year if the registrant is an accelerated filer, as applicable depending on the registrant's fiscal year (or 134 days subsequent to the end of a registrant's fiscal year for other registrants)" in the first sentence of Section 302.01.b.;

b. Replace the phrase "135 days of the date of the filing" with the phrase "135, 130 or 125 days of the date of the filing if the registrant is an accelerated filer, as applicable depending on the registrant's fiscal year (or 135 days of the date of the filing for other registrants)" in the second sentence of Section 302.01.b.; and

c. Removing the words "135 day" in the footnote to the fourth sentence of Section 302.01.b.

5. By amending Section 302.01.c. to:

a. Replace the phrase "135 days or more" with the phrase "135, 130 or 125 days or more, if the registrant is an accelerated filer, as applicable depending on the registrant's fiscal year (or 135 days or more for other registrants)" in the first paragraph of Section 302.01.c.;

b. Replace the phrase "as of an interim date within 135 days" with the phrase "as of an interim date within 135, 130 or 125 days, if the registrant is an accelerated filer, as applicable depending on the registrant's fiscal year (or 135 days for other registrants)" in the first paragraph of Section 302.01.c.; and

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c. Replace the phrase "after 45 days but within 90 days of the end of the fiscal year" with the phrase "after 45 days but within 90, 75 or 60 days of the end of the fiscal year if the registrant is an accelerated filer, as applicable depending on the registrant's fiscal year (or after 45 days but within 90 days of the end of the fiscal year for other registrants)" in the second and third sentences of the second paragraph of Section 302.01.c.

The Codification is a separate publication of the Commission. It will not be published in the Federal Register or Code of Federal Regulations.

VIII. Statutory Authority and Text of Rule Amendments

The amendments contained in this document are being adopted under the authority set forth in Sections 3(b) and 19(a) of the Securities Act and Sections 12, 13, 15(d) and 23(a) of the Exchange Act.

TEXT OF RULE AMENDMENTS

List of Subjects in 17 CFR Parts 210, 229, 240 and 249

Reporting and recordkeeping requirements, Securities.

In accordance with the foregoing, Title 17, Chapter II of the Code of Federal Regulations is amended as follows.

PART 210 - FORM AND CONTENT OF AND REQUIREMENTS FOR FINANCIAL STATEMENTS, SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934, PUBLIC UTILITY HOLDING COMPANY ACT OF 1935, INVESTMENT COMPANY ACT OF 1940, INVESTMENT ADVISERS ACT OF 1940, AND ENERGY POLICY AND CONSERVATION ACT OF 1975

1. The authority citation for Part 210 continues to read as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z-2, 77z-3, 77aa(25), 77aa(26), 78c, 78j-1, 78l, 78m, 78n, 78o(d), 78q, 78u-5, 78w(a), 78ll, 78mm, 79e(b), 79j(a), 79n, 79t(a), 80a-8, 80a-20, 80a-29, 80a-30, 80a-37(a), 80b-3, 80b-11 unless otherwise noted.

2. Section 210.3-01 is amended by:

a. Removing the phrase "90 days of the end of the registrant's fiscal year" and adding, in its place, the phrase "the number of days of the end of the registrant's fiscal year specified in paragraph (i) of this section" in the introductory text of paragraph (c) and paragraph (d); and

b. Revising paragraph (e) and adding paragraph (i) to read as follows:

§ 210.3-01 Consolidated balance sheets.

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* * * * *

(e) For filings made after the number of days specified in paragraph (i) of this section, the filing shall also include a balance sheet as of an interim date within the following number of days of the date of filing:

(1) For accelerated filers (as defined in § 240.12b-2 of this chapter):

(i) 135 days for fiscal years ending on or after December 15, 2002 and before December 15, 2004;

(ii) 130 days for fiscal years ending on or after December 15, 2004 and before December 15, 2005; and

(iii) 125 days for fiscal years ending on or after December 15, 2005; and

(2) 135 days for all other registrants.

* * * * *

(i)(1) For purposes of paragraph (c) and (d) of this section, the number of days shall be:

(i) For accelerated filers (as defined in § 240.12b-2 of this chapter):

(A) 90 days for fiscal years ending on or after December 15, 2002 and before December 15, 2003;

(B) 75 days for fiscal years ending on or after December 15, 2003 and before December 15, 2004; and

(C) 60 days for fiscal years ending on or after December 15, 2004; and

(ii) 90 days for all other registrants.

(2) For purposes of paragraph (e) of this section, the number of days shall be:

(i) For accelerated filers (as defined in § 240.12b-2 of this chapter):

(A) 134 days subsequent to the end of the registrant's most recent fiscal year for fiscal years ending on or after December 15, 2002 and before December 15, 2004;

(B) 129 days subsequent to the end of the registrant's most recent fiscal year for fiscal years ending on or after December 15, 2004 and before December 15, 2005; and

(C) 124 days subsequent to the end of the registrant's most recent fiscal year for fiscal years ending on or after December 15, 2005; and

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(ii) 134 days subsequent to the end of the registrant's most recent fiscal year for all other registrants.

3. Section 210.3-09 is amended by:

a. Removing the authority citation following § 210.3-09;

b. Removing the phrase "§ 210.1-02(v)" and adding, in its place, the phrase "§ 210.1-02(w)" in the first sentence of paragraph (a); and

c. Revising the last sentence of paragraph (b) and adding paragraphs (b)(1), (b)(2), (b)(3) and (b)(4) to read as follows:

§ 210.3-09 Separate financial statements of subsidiaries not consolidated and 50 percent or less owned persons.

* * * * *

(b) * * * For purposes of a filing on Form 10-K (§ 249.310 of this chapter):

(1) If the registrant is an accelerated filer (as defined in § 240.12b-2 of this chapter) but the 50 percent or less owned person is not an accelerated filer, the required financial statements may be filed as an amendment to the report within 90 days, or within six months if the 50 percent or less owned person is a foreign business, after the end of the registrant's fiscal year.

(2) If the fiscal year of any 50 percent or less owned person ends within the registrant's number of filing days before the date of the filing, or if the fiscal year ends after the date of the filing, the required financial statements may be filed as an amendment to the report within the subsidiary's number of filing days, or within six months if the 50 percent or less owned person is a foreign business, after the end of such subsidiary's or person's fiscal year.

(3) The term registrant's number of filing days means:

(i) If the registrant is an accelerated filer:

(A) 90 days for fiscal years ending on or after December 15, 2002 and before December 15, 2003;

(B) 75 days for fiscal years ending on or after December 15, 2003 and before December 15, 2004; and

(C) 60 days for fiscal years ending on or after December 15, 2004; and

(ii) If the registrant is not an accelerated filer, 90 days.

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(4) The term subsidiary's number of filing days means:

(i) If the 50 percent or less owned person is an accelerated filer:

(A) 90 days for fiscal years ending on or after December 15, 2002 and before December 15, 2003;

(B) 75 days for fiscal years ending on or after December 15, 2003 and before December 15, 2004; and

(C) 60 days for fiscal years ending on or after December 15, 2004; and

(ii) If the 50 percent or less owned person is not an accelerated filer, 90 days.

* * * * *

4. Section 210.3-12 is amended by:

a. Removing the phrase "135 days" and adding, in its place, the phrase "the number of days specified in paragraph (g) of this section" in both instances where it appears in the first sentence of paragraph (a);

b. Removing the phrase "90 days subsequent to the end of the fiscal year" and adding, in its place, the phrase "the number of days subsequent to the end of the fiscal year specified in paragraph (g) of this section" in the first sentence of paragraph (b); and

c. Adding paragraph (g) to read as follows:

§ 210.3-12 Age of financial statements at effective date of registration statement or at mailing date of proxy statement.

* * * * *

(g)(1) For purposes of paragraph (a) of this section, the number of days shall be:

(i) For accelerated filers (as defined in § 240.12b-2 of this chapter):

(A) 135 days for fiscal years ending on or after December 15, 2002 and before December 15, 2004;

(B) 130 days for fiscal years ending on or after December 15, 2004 and before December 15, 2005; and

(C) 125 days for fiscal years ending on or after December 15, 2005; and

(ii) 135 days for all other registrants.

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(2) For purposes of paragraph (b) of this section, the number of days shall be:

(i) For accelerated filers (as defined in § 240.12b-2 of this chapter):

(A) 90 days for fiscal years ending on or after December 15, 2002 and before December 15, 2003;

(B) 75 days for fiscal years ending on or after December 15, 2003 and before December 15, 2004; and

(C) 60 days for fiscal years ending on or after December 15, 2004; and

(ii) 90 days for all other registrants.

PART 229 - STANDARD INSTRUCTIONS FOR FILING FORMS UNDER SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934 AND ENERGY POLICY AND CONSERVATION ACT OF 1975-REGULATION S-K

5. The authority citation for Part 229 continues to read, in part, as follows:

Authority: 15 U.S.C. 77e, 77f, 77g, 77h, 77j, 77k, 77s, 77z-2, 77z-3, 77aa(25), 77aa(26), 77ddd, 77eee, 77ggg, 77hhh, 77iii, 77jjj, 77nnn, 77sss, 78c, 78i, 78j, 78l, 78m, 78n, 78o, 78u-5, 78w, 78ll(d), 78mm, 79e, 79n, 79t, 80a-8, 80a-29, 80a-30, 80a-31(c), 80a-37, 80a-38(a) and 80b-11, unless otherwise noted.

* * * * *

6. Section 229.101 is amended by revising paragraph (e) to read as follows:

§ 229.101 (Item 101) Description of business.

* * * * *

(e) Available information. Disclose the information in paragraphs (e)(1), (e)(2) and (e)(3) of this section in any registration statement you file under the Securities Act (15 U.S.C. 77a et seq.), and disclose the information in paragraphs (e)(3) and (e)(4) of this section if you are an accelerated filer (as defined in § 240.12b-2 of this chapter) filing an annual report on Form 10-K (§ 249.310 of this chapter):

(1) Whether you file reports with the Securities and Exchange Commission. If you are a reporting company, identify the reports and other information you file with the SEC.

(2) That the public may read and copy any materials you file with the SEC at the SEC's Public Reference Room at 450 Fifth Street, NW, Washington, DC 20549. State that the public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-

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SEC-0330. If you are an electronic filer, state that the SEC maintains an Internet site that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC and state the address of that site (http://www.sec.gov).

(3) You are encouraged to give your Internet address, if available, except that if you are an accelerated filer filing your annual report on Form 10-K, you must disclose your Internet address, if you have one.

(4)(i) Whether you make available free of charge on or through your Internet website, if you have one, your annual report on Form 10-K, quarterly reports on Form 10-Q (§ 249.308a of this chapter), current reports on Form 8-K (§ 249.308 of this chapter), and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act (15 U.S.C. 78m(a) or 78o(d)) as soon as reasonably practicable after you electronically file such material with, or furnish it to, the SEC;

(ii) If you do not make your filings available in this manner, the reasons you do not do so (including, where applicable, that you do not have an Internet website); and

(iii) If you do not make your filings available in this manner, whether you voluntarily will provide electronic or paper copies of your filings free of charge upon request.

* * * * *

PART 240 - GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

7. The authority citation for Part 240 continues to read, in part, as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 79q, 79t, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4 and 80b-11, unless otherwise noted.

* * * * *

8. Section 240.12b-2 is amended by adding the definition of "Accelerated filer" before the definition of "Affiliate" to read as follows:

§ 240.12b-2 Definitions.

* * * * *

Accelerated filer. (1) The term "accelerated filer" means an issuer after it first meets the following conditions as of the end of its fiscal year:

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(i) The aggregate market value of the voting and non-voting common equity held by non-affiliates of the issuer is $75 million or more;

(ii) The issuer has been subject to the requirements of Section 13(a) or 15(d) of the Act (15 U.S.C. 78m or 78o(d)) for a period of at least twelve calendar months;

(iii) The issuer has filed at least one annual report pursuant to Section 13(a) or 15(d) of the Act; and

(iv) The issuer is not eligible to use Forms 10-KSB and 10-QSB (§ 249.310b and § 249.308b) for its annual and quarterly reports.

NOTE to paragraph (1): The aggregate market value of the issuer's outstanding voting and non-voting common equity shall be computed by use of the price at which the common equity was last sold, or the average of the bid and asked prices of such common equity, in the principal market for such common equity, as of the last business day of the issuer's most recently completed second fiscal quarter.

(2) Entering and Exiting Accelerated Filer Status. (i) The determination for whether a non-accelerated filer becomes an accelerated filer as of the end of the issuer's fiscal year governs the annual report to be filed for that fiscal year, the quarterly and annual reports to be filed for the subsequent fiscal year and all annual and quarterly reports to be filed thereafter while the issuer remains an accelerated filer.

(ii) Once an issuer becomes an accelerated filer, it will remain an accelerated filer unless the issuer becomes eligible to use Forms 10-KSB and 10-QSB for its annual and quarterly reports. In that case, the issuer will not become an accelerated filer again unless it subsequently meets the conditions in paragraph (1) of this definition.

* * * * *

9. Section 240.13a-10 is amended by:

a. Removing the phrase "90 days" and adding, in its place, the phrase "the number of days specified in paragraph (j) of this section" in the first sentence of paragraph (b) and the second sentence of paragraph (f);

b. Removing the phrase "45 days" and adding, in its place, the phrase "the number of days specified in paragraph (j) of this section" in the first sentence of paragraph (c), the second sentence of paragraph (e)(2), and the third sentence of paragraph (f); and

c. Adding paragraph (j) before the Note to read as follows:

§ 240.13a-10 Transition reports.

* * * * *

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(j)(1) For transition reports to be filed on the form appropriate for annual reports of the issuer, the number of days shall be:

(i) For accelerated filers (as defined in § 240.12b-2):

(A) 90 days for fiscal years ending on or after December 15, 2002 and before December 15, 2003;

(B) 75 days for fiscal years ending on or after December 15, 2003 and before December 15, 2004; and

(C) 60 days for fiscal years ending on or after December 15, 2004; and

(ii) 90 days for all other issuers; and

(2) For transition reports to be filed on Form 10-Q or Form 10-QSB (§ 249.308a or § 249.308b of this chapter), the number of days shall be:

(i) For accelerated filers (as defined in § 240.12b-2):

(A) 45 days for fiscal years ending on or after December 15, 2002 and before December 15, 2004;

(B) 40 days for fiscal years ending on or after December 15, 2004 and before December 15, 2005; and

(C) 35 days for fiscal years ending on or after December 15, 2005; and

(ii) 45 days for all other issuers.

* * * * *

10. Section 240.15d-10 is amended by:

a. Removing the phrase "90 days" and adding, in its place, the phrase "the number of days specified in paragraph (j) of this section" in the first sentence of paragraph (b) and the second sentence of paragraph (f);

b. Removing the phrase "45 days" and adding, in its place, the phrase "the number of days specified in paragraph (j) of this section" in the first sentence of paragraph (c), the second sentence of paragraph (e)(2), and the third sentence of paragraph (f); and

c. Adding paragraph (j) before the Note to read as follows:

§ 240.15d-10 Transition reports.

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* * * * *

(j)(1) For transition reports to be filed on the form appropriate for annual reports of the issuer, the number of days shall be:

(i) For accelerated filers (as defined in § 240.12b-2):

(A) 90 days for fiscal years ending on or after December 15, 2002 and before December 15, 2003;

(B) 75 days for fiscal years ending on or after December 15, 2003 and before December 15, 2004; and

(C) 60 days for fiscal years ending on or after December 15, 2004; and

(ii) 90 days for all other issuers; and

(2) For transition reports to be filed on Form 10-Q or Form 10-QSB (§ 249.308a or § 249.308b of this chapter), the number of days shall be:

(i) For accelerated filers (as defined in § 240.12b-2):

(A) 45 days for fiscal years ending on or after December 15, 2002 and before December 15, 2004;

(B) 40 days for fiscal years ending on or after December 15, 2004 and before December 15, 2005; and

(C) 35 days for fiscal years ending on or after December 15, 2005; and

(ii) 45 days for all other issuers.

* * * * *

PART 249 - FORMS, SECURITIES EXCHANGE ACT OF 1934

11. The authority citation for Part 249 continues to read, in part, as follows:

<u>Authority: 15 U.S.C. 78a, et seq., unless otherwise noted.</u>

* * * * *

12. Section 249.308a is revised to read as follows:

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§ 249.308a Form 10-Q, for quarterly and transition reports under sections 13 or 15(d) of the Securities Exchange Act of 1934.

(a) Form 10-Q shall be used for quarterly reports under Section 13 or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)), required to be filed pursuant to § 240.13a-13 or § 240.15d-13 of this chapter. A quarterly report on this form pursuant to § 240.13a-13 or § 240.15d-13 of this chapter shall be filed within the following period after the end of the first three fiscal quarters of each fiscal year, but no quarterly report need be filed for the fourth quarter of any fiscal year:

(1) For accelerated filers (as defined in § 240.12b-2 of this chapter):

(i) 45 days after the end of the fiscal quarter for fiscal years ending on or after December 15, 2002 and before December 15, 2004;

(ii) 40 days after the end of the fiscal quarter for fiscal years ending on or after December 15, 2004 and before December 15, 2005; and

(iii) 35 days after the end of the fiscal quarter for fiscal years ending on or after December 15, 2005; and

(2) 45 days after the end of the fiscal quarter for all other registrants.

(b) Form 10-Q also shall be used for transition and quarterly reports filed pursuant to § 240.13a-10 or § 240.15d-10 of this chapter. Such transition or quarterly reports shall be filed in accordance with the requirements set forth in § 240.13a-10 or § 240.15d-10 of this chapter applicable when the registrant changes its fiscal year end.

13. Form 10-Q (referenced in § 249.308a) is amended by revising General Instruction A.1. and by adding a paragraph before the title "Applicable Only to Issuers Involved in Bankruptcy Proceedings During the Preceding Five Years:" on the cover page to read as follows:

Note: The text of Form 10-Q does not, and this amendment will not, appear in the Code of Federal Regulations.

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

GENERAL INSTRUCTIONS

A. Rule as to Use of Form 10-Q.

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1. Form 10-Q shall be used for quarterly reports under Section 13 or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)), filed pursuant to Rule 13a-13 (17 CFR 240.13a-13) or Rule 15d-13 (17 CFR 240.15d-13). A quarterly report on this form pursuant to Rule 13a-13 or Rule 15d-13 shall be filed within the following period after the end of each of the first three fiscal quarters of each fiscal year, but no report need be filed for the fourth quarter of any fiscal year:

a. For accelerated filers (as defined in 17 CFR 240.12b-2):

(i) 45 days after the end of the fiscal quarter for fiscal years ending on or after December 15, 2002 and before December 15, 2004;

(ii) 40 days after the end of the fiscal quarter for fiscal years ending on or after December 15, 2004 and before December 15, 2005; and

(iii) 35 days after the end of the fiscal quarter for fiscal years ending on or after December 15, 2005; and

b. 45 days after the end of the fiscal quarter for all other issuers.

* * * * *

FORM 10-Q

* * * * *

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes ..... No ......

APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY

PROCEEDINGS DURING THE PRECEDING FIVE YEARS:

* * * * *

14. Section 249.310 is revised to read as follows:

§ 249.310 Form 10-K, for annual and transition reports pursuant to sections 13 or 15(d) of the Securities Exchange Act of 1934.

(a) This form shall be used for annual reports pursuant to Sections 13 or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)) for which no other form is prescribed. This form also shall be used for transition reports filed pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

(b) Annual reports on this form shall be filed within the following period:

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(1) For accelerated filers (as defined in § 240.12b-2 of this chapter):

(i) 90 days after the end of the fiscal year covered by the report for fiscal years ending on or after December 15, 2002 and before December 15, 2003;

(ii) 75 days after the end of the fiscal year covered by the report for fiscal years ending on or after December 15, 2003 and before December 15, 2004; and

(iii) 60 days after the end of the fiscal year covered by the report for fiscal years ending on or after December 15, 2004; and

(2) 90 days after the end of the fiscal year covered by the report for all other registrants.

(c) Transition reports on this form shall be filed in accordance with the requirements set forth in § 240.13a-10 or § 240.15d-10 of this chapter applicable when the registrant changes its fiscal year end.

(d) Notwithstanding paragraphs (b) and (c) of this section, all schedules required by Article 12 of Regulation S-X (§§ 210.12-01 - 210.12-29 of this chapter) may, at the option of the registrant, be filed as an amendment to the report not later than 30 days after the applicable due date of the report.

15. Form 10-K (referenced in § 249.310) is amended by revising General Instruction A. and the paragraph before the "Note" on the cover page to read as follows:

Note: The text of Form 10-K does not, and this amendment will not, appear in the Code of Federal Regulations.

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

* * * * *

GENERAL INSTRUCTIONS

A. Rule as to Use of Form 10-K.

(1) This Form shall be used for annual reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)) (the "Act") for which no other form is prescribed. This Form also shall be used for transition reports filed pursuant to Section 13 or 15(d) of the Act.

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(2) Annual reports on this Form shall be filed within the following period:

(a) For accelerated filers (as defined in 17 CFR 240.12b-2):

(i) 90 days after the end of the fiscal year covered by the report for fiscal years ending on or after December 15, 2002 and before December 15, 2003;

(ii) 75 days after the end of the fiscal year covered by the report for fiscal years ending on or after December 15, 2003 and before December 15, 2004; and

(iii) 60 days after the end of the fiscal year covered by the report for fiscal years ending on or after December 15, 2004; and

(b) 90 days after the end of the fiscal year covered by the report for all other registrants.

(3) Transition reports on this Form shall be filed in accordance with the requirements set forth in Rule 13a-10 (17 CFR 240.13a-10) or Rule 15d-10 (17 CFR 240.15d-10) applicable when the registrant changes its fiscal year end.

(4) Notwithstanding paragraphs (2) and (3) of this General Instruction A., all schedules required by Article 12 of Regulation S-X (17 CFR 210.12-01 - 210.12-29) may, at the option of the registrant, be filed as an amendment to the report not later than 30 days after the applicable due date of the report.

* * * * *

FORM 10-K

* * * * *

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes ..... No ......

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the registrant's most recently completed second fiscal quarter.

* * * * *

By the Commission.

Margaret H. McFarland
Deputy Secretary

Dated: September 5, 2002

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Endnotes

1 17 CFR 210.3-01.

2 17 CFR 210.3-09.

3 17 CFR 210.3-12.

4 17 CFR 210.1-01 *et seq*.

5 17 CFR 229.101.

6 17 CFR 229.10 *et seq*.

7 15 U.S.C. 77a *et seq*.

8 17 CFR 249.308a.

9 17 CFR 249.310.

10 15 U.S.C. 78a *et seq*.

11 17 CFR 240.12b-2.

12 17 CFR 240.13a-10.

13

17 CFR 240.15d-10.

14 See Sections 13(a) and 15(d) of the Exchange Act [15 U.S.C. 78m(a) and 78o(d)]. The following types of companies are subject to the obligation to provide information to the secondary markets through reports filed with the Commission:

A company that has registered a class of equity or debt securities under Section 12(b) of the Exchange Act [15 U.S.C. 78*l*(b)] so that the securities can be listed and traded on a national securities exchange;

A company that has registered a class of equity securities under Section 12(g)(1) of the Exchange Act [15 U.S.C. 78*l*(g)(1)] and Exchange Act Rule 12g-1 [17 CFR 240.12g-1] because it had total assets of more than $10 million and the class of equity securities is held by more than 500 record holders as of the last day of the company's fiscal year (and cannot rely on an exemption from such registration);

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A company that has voluntarily registered a class of equity securities under Section 12(g) of the Exchange Act;

Under Section 15(d) of the Exchange Act, a company that has filed a registration statement under the Securities Act that became effective and has not met the thresholds for suspension of the reporting requirements; and

Under Exchange Act Rules 12g-3 and 15d-5 [17 CFR 240.12g-3 and 240.15d-5], a company that has succeeded to the obligation of another reporting company.

15 See, for example, Exchange Act Rules 13a-1, 13a-11, 13a-13, 15d-1, 15d-11 and 15d-13 [17 CFR 240.13a-1, 13a-11, 13a-13, 15d-1, 15d-11 and 15d-13]. In addition, Section 409 of the Sarbanes-Oxley Act of 2002 [Pub. L. No. 107-204, § 409, 116 Stat. 745 (2002)] added Section 13(*l*) of the Exchange Act [17 U.S.C. 78m(*l*)], which also requires disclosure on a rapid and current basis of such additional information concerning material changes in the financial condition or operations of the issuer as the Commission determines, by rule, is necessary or useful for the protection of investors and in the public interest.

16 Reporting companies that are foreign private issuers, as defined in Exchange Act Rule 3b-4(c) [17 CFR 240.3b-4(c)], are subject to different requirements for periodic reports. They are not required to file quarterly reports. They file annual reports on Form 20-F [17 CFR 249.220f]. Instead of current reporting on Form 8-K, foreign issuers provide reports on Form 6-K [17 CFR 249.306]. Certain Canadian issuers may file different reports under the Multijurisdictional Disclosure System. Foreign government issuers, as defined in Exchange Act Rule 3b-4(c), also are subject to different reporting requirements. They file annual reports on Form 18-K [17 CFR 249.318]. Foreign private issuers may elect to file the forms used by domestic reporting companies. If they do so, they are subject to the same deadlines as domestic companies.

17 The term "small business issuer" is defined in Exchange Act Rule 12b-2 as a U.S. or Canadian issuer with less than $25 million in revenues and public float that is not an investment company.

18 Form 10-K (and Form 10-KSB [17 CFR 249.310b]) provides a comprehensive overview of the reporting company on an annual basis. The form currently consists of four parts (Form 10-KSB has three parts, but the categories of required information are similar). Part I requires disclosure regarding the company's business, its properties, legal proceedings and matters submitted to a security holder vote. Part II requires disclosure regarding the market for the company's common equity, sales of unregistered securities, the use of proceeds from recent sales of securities, specified financial statements and information, management's discussion and analysis of financial condition and results of operations and quantitative and qualitative disclosure about market risk. Part III requires disclosure regarding the company's directors and executive officers, executive compensation, security ownership and certain relationships and related party transactions. Part IV requires disclosure of exhibits, financial statement schedules and a list of current reports filed on Form 8-K.

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19 Form 10-Q (and Form 10-QSB [17 CFR 249.308b]) currently consists of two parts. Part I requires disclosure of specified financial statements, management's discussion and analysis of financial condition and results of operations and quantitative and qualitative disclosure about market risk. Part II requires disclosure regarding legal proceedings, changes in securities, sales of unregistered securities, the use of proceeds from recent sales of securities, defaults on senior securities, exhibits and a list of current reports filed on Form 8-K.

20 17 CFR 249.308. These events currently include change in control of the registrant, the acquisition or disposition of a significant amount of assets, the bankruptcy or receivership of the registrant, changes in the registrant's certifying accountant, the resignation of a member of the registrant's board of directors and any other event that the registrant deems of significance to security holders. Item 7 of Form 8-K states that financial statements and related pro forma financial information required to be included on Form 8-K when a company acquires a business may be filed with the initial report or by amendment not later than 60 days after the date that the initial Form 8-K to report the acquisition must be filed. See Item 7(a)(3) of Form 8-K. On June 17, 2002, we proposed adding 11 new items that would require a company to file Form 8-K, moving two items currently required to be included in annual and quarterly reports to Form 8-K, amending several existing Form 8-K disclosure items and shortening the filing deadline for most items to two business days after the triggering event. See Release No. 33-8106 (June 17, 2002) [67 FR 42914].

21 See Exchange Act Rules 13a-10 and 15d-10.

22 See Release No. 33-8089; 34-45741 (Apr. 12, 2002) [67 FR 19896] (the "Proposing Release").

23 See Release No. 34-9000 (Oct. 21, 1970) [35 FR 16919] and Release No. 34-9004 (Oct. 28, 1970) [35 FR 17537].

24 Public float is the aggregate market value of a company's outstanding voting and non-voting common equity (*i.e.*, market capitalization) minus the value of common equity held by affiliates of the company. Public float also is one of the key determinants for eligibility for short-form registration under the Securities Act (Form S-3 [17 CFR 239.13] and Form F-3 [17 CFR 239.33]).

25 Even if a company chooses not to make its reports available on its website, investors still would be able to access information about the company through our EDGAR system. A company's posting of its reports on its website is not a substitute for filing documents with the Commission. EDGAR is an acronym for the Electronic Data Gathering, Analysis and Retrieval system.

26 The public comments we received, and a summary of the comments prepared by our staff (the "Comment Summary"), can be reviewed in our Public Reference Room at 450 Fifth Street, NW, Washington, DC 20549, in File No. S7-08-02. Public comments submitted by electronic mail and the Comment Summary also are available on our website, www.sec.gov.

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27 "Shelf registration" is the commonly used term for delayed offerings under Securities Act Rule 415 [17 CFR 230.415]. Rule 415 permits offerings to be delayed until some point determined by the registrant after effectiveness of the relevant registration statement.

28 15 U.S.C. 77n.

29 See revisions to 17 CFR 210.3-09(b).

30 17 CFR 210.12-01 *et seq*.

31 17 CFR 210.3-05.

32 See Press Release No. 2002-75 (May 30, 2002).

33 As mentioned in the Proposing Release, the Commission previously had requested comment as to whether it should shorten the due dates for quarterly and annual reports for all issuers. See Release No. 33-7606A (Nov. 13, 1998) [63 FR 67174]. Comments received on that release are available through our Public Reference Room under File No. S7-30-98.

34 In addition, the information in these reports must now be certified by the principal executive officer and principal financial officer of the company. See Sections 302 and 906 of the Sarbanes-Oxley Act of 2002 [Pub. L. No. 107-204, §§ 302 and 906, 116 Stat. 745 (2002)].

35 See Release No. 33-8039 (Dec. 4, 2001) [66 FR 63731]. In addition, Section 401(b) of the Sarbanes-Oxley Act of 2002 [Pub. L. No. 107-204, § 401(b), 116 Stat. 745 (2002)] directs the Commission to issue final rules providing that pro forma financial information included in any periodic or other report, or in any public disclosure or press or other release, shall be presented in a manner that reconciles it with the financial condition and results of operations of the issuer under generally accepted accounting principles.

36 See, for example, the Letters of the American Federal of Labor and Congress of Industrial Organizations ("AFL-CIO"); Association of Investment Management and Research ("AIMR"); AOL Time Warner Inc.; Adrienne Randle Bond; Corporate Communications Broadcast Network ("CCBN"); Council of Institutional Investors ("CII"); Comcast Corporation; CSX Corporation; Delphi Corporation; The Dow Chemical Company; EDGAR Online Inc.; Financial Executives Institute ("FEI"); IMC Global, Inc.; Maverick Capital Ltd.; McDonald's, Inc.; PepsiCo, Inc.; Pfizer Inc.; Pharmacia Corporation; SBC Communications Inc.; Scott H. Schulke; and Teachers Insurance and Annuity Association of America - College Retirement and Equities Fund ("TIAA-CREF"). In addition, one commenter provided the results of an unpublished study that argued that there is statistically reliable evidence of an investor response to periodic reports. See the Letter of Paul A. Griffin.

37 In addition, according to a web-based survey on The Motley Fool's website, 67% of the 1,391 respondents thought that faster information was important to them. See http://www.fool.com/Community/PollingAllFools/pollingallfoolsview.asp?questiondate=5%2F9%2F2002+12%3A45%3A29+PM.

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38 See, for example, the Letters of the American Electric Power; American Institute of Certified Public Accountants ("AICPA"); BDO Seidman, LLP; The Coca-Cola Company; Computer Sciences Corporation; Fidelity Management & Research Company; Investment Company Institute; J.P. Morgan Chase & Co.; KPMG LLP; PG&E Corporation; Sidley Austin Brown & Wood LLP ("Sidley"); and Toys R Us, Inc.

39 See, for example, the Letters of the American Bar Association ("ABA"); AFLAC Incorporated; the Association of the Bar of the City of New York ("NYCBA"); BioReliance Corporation; Compass Bankshares, Inc.; Commercial Federal Corporation; Emerson Electric Co.; Greenberg Traurig, P.A.; HealthSouth Corporation; Kellogg Company; Kimball International, Inc.; and SCANA Corporation.

40 See, for example, the Letters of Delphi Corporation; The Dow Chemical Company; Microsoft Corporation; Siebel Systems, Inc.; TIAA-CREF; United Technologies Corporation; and V. I. Technologies, Inc.

41 See, for example, the Letters of the ABA; American Corporate Counsel Association ("ACCA"); Association of Financial Professionals ("AFP"); American Insurance Association ("AIA"); AICPA; American Society of Corporate Secretaries ("ASCS"); Ashland Inc.; AT&T Corp.; BDO Seidman, LLP; the Business Roundtable; The Chubb Corporation; Deloitte & Touche LLP; Dell Computer Corporation; Ernst & Young LLP; Eli Lilly and Company; Financial Institutions Accounting Committee ("FIAC"); Grant Thornton LLP; Joseph A. Grundfest; H&R Block, Inc.; Halliburton Company; HealthSouth Corporation; Kellogg Company; KPMG LLP; Liberty Media Corporation; Merck & Co., Inc.; New York State Bar Association ("NYSBA"); NYCBA; Papa John's International, Inc.; PepsiCo, Inc.; PricewaterhouseCoopers LLP; Securities Industry Association ("SIA"); Ronald S. Stowell; Sullivan & Cromwell; SCANA Corporation; Shearman & Sterling; Sidley; Sotheby's Holdings, Inc.; Washington Mutual, Inc.; The Williams Companies, Inc.; and Kathryn J. Wilson.

42 See the Letter of the ASCS.

43 See, for example, the Letters of the ABA; American Counsel of Life Insurers ("ACLI"); ACCA; AFP; AICPA; ASCS; AT&T Corp.; BDO Seidman, LLP; The Bank of New York Company, Inc.; The Chubb Corporation; The Coca-Cola Company; Comcast Corporation; Deloitte & Touche LLP; Ernst & Young LLP; Eli Lilly and Company; FIAC; Grant Thornton LLP; Greenberg Traurig, P.A.; Joseph A. Grundfest; HealthSouth Corporation; KPMG LLP; Liberty Media Corporation; Simon M. Lorne; Marathon Oil Corporation; Merck & Co., Inc.; McGuireWoods LLP; NYCBA; NYSBA; Papa John's International, Inc.; PepsiCo, Inc.; PG&E Corporation; Pharmacia Corporation; PricewaterhouseCoopers LLP; Reed Smith LLP; Sullivan & Cromwell; SCANA Corporation; Shearman & Sterling; SIA; Sidley; Sotheby's Holdings, Inc.; Washington Mutual, Inc.; and The Williams Companies, Inc.

44 See Release No. 34-46079 (June 14, 2002) [67 FR 41877]; Release No. 34-46300 (Aug. 2, 2002) [67 FR 51508]; Release No. 33-8124 (Aug. 29, 2002); and Sections 302, 404 and 906 of

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the Sarbanes-Oxley Act of 2002 [Pub. L. No. 107-204, §§ 302, 404 and 906, 116 Stat. 745 (2002)].

45 See, for example, the Letters of the ABA; ACLI; ACCA; AICPA; ASCS; AT&T Corp.; BDO Seidman, LLP; The Bank of New York Company, Inc.; the Business Roundtable; The Coca-Cola Company; Comcast Corporation; Deloitte & Touche LLP; Ernst & Young LLP; Eli Lilly and Company; FIAC; Grant Thornton LLP; Greenberg Traurig, P.A.; Joseph A. Grundfest; H&R Block, Inc.; HealthSouth Corporation; Institute of Management Accountants; KPMG LLP; Liberty Media Corporation; Helen W. Melman; NYCBA; NYSBA; Papa John's International, Inc.; PepsiCo, Inc.; PG&E Corporation; PricewaterhouseCoopers LLP; Sullivan & Cromwell; SBC Communications Inc.; SIA; Sidley; The Southern Company; SunTrust Banks, Inc.; Washington Mutual, Inc.; and The Williams Companies, Inc.

46 See, for example, the Letters of the AFL-CIO; AIMR; Delphi Corporation; The Dow Chemical Company; and TIAA-CREF.

47 See, for example, the Letters of the ABA; ACLI; AFP; American Bankers Association; The Allstate Corporation; Deloitte & Touche LLP; Dollar Tree Stores, Inc.; Ernst & Young LLP; Halliburton Company; HealthSouth Corporation; KPMG LLP; National Association of Real Estate Companies ("NAREC"); National Association of Real Estate Investment Trusts ("NAREIT"); NYCBA; PricewaterhouseCoopers LLP; Southern Union Company; Ronald S. Stowell; and UnionBanCal Corporation.

48 See, for example, the Letters of the ACCA; ASCS; BioReliance Corporation; Community Health Systems, Inc.; Constellation Energy Group, Inc.; Dean Foods Company; HealthSouth Corporation; Merrill Lynch & Co., Inc.; Nucor Corporation; Technitrol, Inc.; Veritas Software Corporation; and Zygo Corporation.

49 See the Letters of the ASCS and the Business Roundtable.

50 See the Letter of American Electric Power.

51 See the Letter of the ASCS.

52 See, for example, the ABA; ACLI; AFLAC Incorporated; BioReliance Corporation; The Bank of New York Company, Inc.; ChevronTexaco Corporation; The Chubb Corporation; Crescent Real Estate Equities Company; Dean Foods Company; Deloitte & Touche LLP; Ernst & Young LLP; HealthSouth Corporation; J.C. Penney Company, Inc.; Mercury General Corporation; NAREC; NAREIT; PricewaterhouseCoopers LLP; and Washington Mutual, Inc.

53 See, for example, the Letters of the ABA; AFLAC Incorporated; Cleary, Gottlieb, Steen & Hamilton; Halliburton Company; J.C. Penney Company, Inc.; Jones & Keller, P.C.; Perkins Coie LLP; PG&E Corporation; PricewaterhouseCoopers LLP; Sidley; and UnionBanCal Corporation.

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54 See, for example, the Letters of Brown-Forman Corporation; Caremark Rx, Inc.; Deloitte & Touche LLP; Joseph A. Grundfest; KPMG LLP; Liberty Media Corporation; NYCBA; PricewaterhouseCoopers LLP; and XTO Energy, Inc.

55 See, for example, the Letters of the ACCA; ASCS; The Bank of New York Company, Inc.; Cleary, Gottlieb, Steen & Hamilton; Clifford Chance Rogers & Wells LLP; Crowe, Chizek and Company LLP; Greenberg Traurig, P.A.; Halliburton Company; J.P. Morgan Chase & Co.; Mellon Financial Corporation; PepsiCo, Inc.; Pfizer Inc.; SCANA Corporation; Shearman & Sterling; Southern Union Company; and Technitrol, Inc.

56 See, for example, the Letters of BDO Seidman, LLP; Ernst & Young LLP; The Great Atlantic and Pacific Tea Company, Inc.; HealthSouth Corporation; KPMG LLP; Merrill Lynch & Co., Inc.; PricewaterhouseCoopers LLP; The Southern Company; and SunTrust Banks, Inc. We are surprised and concerned by these assertions given the importance of these announcements to investors and markets and are considering their implications.

57 See, for example, the Letters of the ABA; AICPA; BDO Seidman, LLP; the Business Roundtable; ChevronTexaco Corporation; The Coca-Cola Company; Dean Foods Company; Deloitte & Touche LLP; Eli Lilly and Company; Grant Thornton LLP; HealthSouth Corporation; KPMG LLP; Marathon Oil Corporation; National Investor Relations Institute ("NIRI"); Perkins Coie LLP; PricewaterhouseCoopers LLP; Reed Smith LLP; Shearman & Sterling; Sidley; Southern Union Company; and Western Wireless Corporation.

58 See the Comment Summary.

59 *Id*.

60 See, for example, the Letters of Abbott Laboratories; ACLI; AICPA; AOL Time Warner Inc.; ASCS; the Business Roundtable; Cabot Corporation; Cleary, Gottlieb, Steen & Hamilton; Deloitte & Touche LLP; Ernst & Young LLP; Joseph A. Grundfest; Halliburton Company; KPMG LLP; NYSBA; Pfizer Inc.; PricewaterhouseCoopers LLP; Sullivan & Cromwell; SIA; Sidley; and The Williams Companies, Inc.

61 See, for example, the Letters of the ACCA; American Bankers Association; The Coca-Cola Company; Eli Lilly and Company; Harrah's Entertainment, Inc.; Lamar Advertising Company; Merck & Co., Inc.; Merrill Lynch & Co., Inc.; Michael McDonald; NAREC; NAREIT; NYCBA; Scholastic Inc.; Southern Union Company; Toys R Us, Inc.; TXU Corp.; UST Inc.; and Washington Mutual, Inc.

62 Compare, for example, the Letters of AFLAC Incorporated; Bank of America; Capital One Financial Corporation; CH Energy Group, Inc.; Clancy Systems International, Inc.; Constellation Energy Group, Inc.; Dollar Tree Stores, Inc.; FEI; Jefferson-Pilot Corporation; Lamar Advertising Company; Phillips Petroleum Company; The Southern Company; UnionBanCal Corporation and U.S. Bancorp with the Letters of American Electric Power; AOL Time Warner Inc.; Clifford Chance Rogers & Wells LLP; Long Aldridge & Norman LLP and United States Steel Corporation.

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63 See, for example, the Letters of the ABA; ACLI; AICPA; BDO Seidman, LLP; Comcast Corporation; Ernst & Young LLP; Grant Thornton LLP; Julia A. Harper; Hibernia Corporation; KPMG LLP; The Pepsi Bottling Group; PepsiCo, Inc.; PG&E Corporation; PricewaterhouseCoopers LLP; Stewart Information Services Corporation; UnumProvident Corporation; and Wild Oats Markets, Inc.

64 See SEC Press Release No. 2002-59 (May 1, 2002). The summit was held on May 8, 2002. Archived broadcasts of the investor summit are available to the public on our Internet website at www.sec.gov.

65 See, for example, Joseph D. Borg, Bill Mann and Damon Silvers, Remarks at the Investor Summit in Washington, DC (May 8, 2002) (archived broadcast; transcript).

66 See SEC Press Release Nos. 2002-28 (Feb. 22, 2002) and 2002-46 (Mar. 27, 2002). The New York roundtable was held on March 4, 2002. The Washington DC roundtable was held on March 6, 2002. The Chicago roundtable was held on April 4, 2002. Archived broadcasts and transcripts of the roundtables are available to the public on our Internet website.

67 See, for example, Richard Carbone and Raymond Groves, Remarks at the Financial Disclosure and Auditor Oversight Roundtable in Washington, DC (Mar. 6, 2002) (archived broadcasts; transcripts).

68 See, for example, John White, Remarks at the Financial Disclosure and Auditor Oversight Roundtable in New York, NY (Mar. 4, 2002); and James Cheek, Remarks at the Financial Disclosure and Auditor Oversight Roundtable in Washington, DC (Mar. 6, 2002) (archived broadcasts; transcripts).

69 See, for example, Edward Nusbaum, Remarks at the Financial Disclosure and Auditor Oversight Roundtable in Chicago, IL (Apr. 4, 2002) (archived broadcast; transcript).

70 See note 68 above.

71 See, for example, Phil Livingston, Remarks at the Financial Disclosure and Auditor Oversight Roundtable in Washington, DC (Mar. 6, 2002) (archived broadcasts; transcripts).

72 See, for example, Release No. 33-6823 (Mar. 13, 1989) [54 FR 10306] (Revising transition report rules to conform their filing requirements to those for periodic reports).

73 A one-time extension of time to file a particular periodic report is available under certain circumstances under Exchange Act Rule 12b-25 [17 CFR 240.12b-25].

74 For other proposals where we are specifically addressing the quality and content of information disclosed, see notes 20 and 44 above.

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75 See, for example, the Letters of the ASCS; the Business Roundtable; and FEI. These and other commenters also mentioned, and we are aware of other anecdotal reports that, many companies already are revising their systems and procedures to prepare for accelerated reporting.

76 See, for example, the Letters of the ASCS and FEI.

77 See the Letter of the ASCS. See also Letter of the Business Roundtable.

78 Securities Act Rule 144 [17 CFR 230.144] requires that for such a resale to be valid, the issuer of the securities must have made all filings required under the Exchange Act during the preceding 12 months. Form S-8 [17 CFR 239.16b] requires that an issuer be current in its reporting for the last 12 calendar months (or such shorter period that the issuer was required to file such reports and materials). If a company was late in filing its reports, the company would lose Rule 144 eligibility and eligibility to file a Form S-8 during the time that the company was not current in its reporting.

79 See, for example, the Letters of the ASCS; Cleary, Gottlieb, Steen & Hamilton; CSX Corporation; Deloitte & Touche LLP; Ernst & Young LLP; NAREIT; NYSBA; Pharmacia Corporation; PricewaterhouseCoopers LLP; and Triarc Companies, Inc.

80 See, for example, the Letters of the ABA; Deloitte & Touche LLP; FEI; Joseph A. Grundfest; Investment Company Institute; Intel Corporation; Merrill Lynch & Co., Inc.; Nucor Corporation; SCANA Corporation; SIA; The Southern Company; TIAA-CREF; and Trover Solutions, Inc.

81 See, for example, the Letters of Ernst & Young LLP; FEI, Fidelity Management & Research Company; Investment Company Institute; KPMG LLP; NAREC; NAREIT; NIRI; Papa John's International, Inc.; Shearman & Sterling; SIA; and Valmont Industries, Inc.

82 See, for example, Sections 401(b) and 409 of the Sarbanes-Oxley Act of 2002 [Pub. L. No. 107-204, §§ 401(b) and 409, 116 Stat. 745 (2002)].

83 See, for example, the Letter of Fidelity Management & Research Company.

84 See, for example, the Letters of the ABA; FEI; NYCBA; Caremark Rx, Inc.; Comcast Corporation; The Dow Chemical Company; Monsanto Company; and Troutman Sanders LLP.

85 See, for example, the Letters of the ABA; American Electric Power; Cleary, Gottlieb, Steen & Hamilton; Grant Thornton, LLP; HealthSouth Corporation; and Union Planters Corporation.

86 See, for example, the Letters of the AFL-CIO; Corning Incorporated; Crowe, Chizek and Company LLP; KPMG LLP; NAREC; NAREIT; NYSBA; and The Williams Companies, Inc.

87 See, for example, the Letters of Community Bankshares, Inc; First Capital Bank Holding Corporation; and GrandSouth Bancorporation.

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88 Compare, for example, the Letters of the AFP; KPMG LLP; and Western Wireless Corporation with the Letters of the ABA; AICPA; American Bankers Association; Arris Group, Inc.; BDO Seidman, LLP; Ernst & Young LLP; Foley, Hoag & Eliot LLP; Grant Thornton LLP; Joseph A. Grundfest; NYCBA; NYSBA; PricewaterhouseCoopers LLP; Shearman & Sterling; Southern Union Company; and United States Steel Corporation.

89 See, for example, the Letters of the AICPA; American Bankers Association; Arris Group, Inc.; Baldwin & Lyons, Inc.; Ernst & Young LLP; HealthSouth Corporation; KPMG LLP; NAREC; NYSBA; Perkins Coie LLP; Triarc Companies, Inc.; and Troutman Sanders LLP.

90 See, for example, the Letters of the ABA; AICPA; Ernst & Young LLP; KMPG LLP; and Troutman Sanders LLP.

91 See, for example, the Letters of the AIMR; Brown-Forman Corporation; Chevron Phillips Chemical Company LLP; Comcast Corporation; Deloitte & Touche LLP; The Dow Chemical Company; Markel Corporation; Maverick Capital Ltd.; and SBC Communications Inc.

92 See, for example, the Letters of the AICPA; Ernst & Young LLP; Institute of Management Accountants; KMPG LLP; and PricewaterhouseCoopers LLP.

93 See, for example, the Letters of Cleary, Gottlieb, Steen & Hamilton and NYCBA.

94 See General Instructions I.A.3 and I.B.1 of Form S-3.

95 We arrived at this estimate by dividing the number of companies in Standard & Poors Research Insight Compustat Database with a market capitalization below $75 million as of November, 2001 (4,622) by the total number of companies in the Compustat Database with a reported market capitalization for that period (9,325). It is our understanding that the data in the Compustat Database is derived principally from larger companies, so our estimate may understate the actual percentage of companies that would be excluded by the proposals. Further, this figure does not include many additional companies that would not be affected by the amendments, including foreign private issuers that file on Form 20-F and issuers that do not have a common equity public float.

96 See Item 10(a)(2) of Regulation S-B [17 CFR 228.10(a)(2)] for the conditions for entering and exiting the small business reporting system. A reporting company that is not a small business issuer must meet the definition of a small business issuer at the end of two consecutive fiscal years before it will be considered a small business issuer for purposes of Form 10-KSB and Form 10-QSB.

97 See, for example, the Letters of the ABA and NAREIT.

98 See, for example, the Letters of American Electric Power; Comcast Corporation; The Dow Chemical Company; Ernst & Young LLP; Eli Lilly and Company; and HealthSouth Corporation.

99 See Release No. 33-6234 (Sept. 2, 1980) [45 FR 63682].

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100 For example, after the phase-in period is complete, an accelerated filer would need to include updated financial statements in its registration statements up to 30 days earlier than under the current rules.

101 See, for example, Rule 3-13 of Regulation S-X [17 CFR 210.3-13].

102 If the audited financial statements for the most recently completed fiscal year are available or become available before effectiveness or mailing, they must be included in the filing.

103 See the Letter of Ernst & Young LLP.

104 See Rule 3-12 of Regulation S-X.

105 As with the existing rules, the revised updating rule also includes a general provision that if a filing is made near the end of a fiscal year and the audited financial statements for that fiscal year are not included in the original filing, the filing must be updated with those audited financial statements if they become available before the anticipated effective date, or proposed mailing date in the case of a proxy statement.

106 See, for example, the Letters of the AICPA; Corning Incorporated; Ernst & Young LLP; and KPMG LLP.

107 See General Instruction I.G.(3) of Form 10-K.

108 See the Letters of the AIMR and Maverick Capital Ltd.

109 See, for example, the Letters of American Electric Power; AFLAC Incorporated; ASCS; The Coca-Cola Company; Comcast Corporation; The Dow Chemical Company; Ernst & Young LLP; Intel Corporation; LeBoeuf, Lamb, Green & MacRae; McGuireWoods LLP; NYSBA; PepsiCo, Inc.; PricewaterhouseCoopers LLP; The Southern Company; and Technitrol, Inc.

110 See, for example, the Letters of J.P. Morgan Chase & Co. and NYCBA.

111 See, for example, the Letters of American Electric Power; ASCS; The Dow Chemical Company; Ernst & Young LLP; and United States Steel Corporation. But see the Letter of Triarc Companies, Inc.

112 See, for example, the Letters of the AIMR; Maverick Capital Ltd.; and PricewaterhouseCoopers LLP.

113 17 CFR 210.3-05.

114 See, for example, the Letters of the AICPA; ASCS; Cleary, Gottlieb, Steen & Hamilton; Deloitte & Touche LLP; Ernst & Young LLP; KPMG LLP; NYCBA; and PricewaterhouseCoopers LLP.

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115 Short-form registration is available in varying degrees for domestic issuers on Forms S-2 [17 CFR 239.12], S-3, S-4 [17 CFR 239.25] and S-8.

116 See, for example, Report to the Congress: The Impact of Recent Technological Advances on the Securities Markets, (Sept. 1997). That report, like all Commission reports issued after 1996, is available on our Internet website (http://www.sec.gov).

117 See, for example, Ianthe Jeanne Dugan, "Small Investors United by Web Find New Power," The Washington Post, May 30, 1999, at A01.

118 Numerous third-party vendors also make information filed with the Commission electronically available to investors, but many charge fees for this service.

119 See note 32 above.

120 Congress has already recognized the importance of utilizing the Internet to disseminate information. For example, Section 403(a) of the Sarbanes-Oxley Act of 2002 [Pub. L. No. 107-204, § 403(a), 116 Stat. 745 (2002)] added Section 16(a)(4) of the Exchange Act [15 U.S.C. 78p(a)(4)] requiring companies to provide Section 16(a) filings on their corporate websites. Other countries also have begun to recognize the importance of the Internet to disseminate information. For example, the listing standards for the S.T.A.R. Market segment of the Italian Exchange (Borsa Italiana) require listed companies to post their periodic reports on their websites. See Article 2.2.3, paragraph 3.e) of Regolamento Dei Mercati Organizzati E Gestiti Da Borsa Italiana S.P.A. [Rules of the Markets Organized and Managed by the Italian Exchange] (July 15, 2002).

121 See, for example, the Letters of the AFP; AIA; AIMR; The Allstate Corporation; AOL Time Warner Inc.; Armstrong World Industries, Inc.; BDO Seidman, LLP; the Business Roundtable; CCBN; CII; Jason Cook; Deloitte & Touche LLP; Delphi Corporation; Dollar Tree Stores, Inc.; The Dow Chemical Company; EDGAR Online; Eli Lilly and Company; Grant Thornton LLP; Investment Company Institute; Jefferson-Pilot Corporation; NIRI; Pharmacia Corporation; Principal Financial Group, Inc.; SunTrust Banks, Inc.; TIAA-CREF; UnionBanCal Corporation; UnumProvident Corporation; and XTO Energy Inc.

122 See the Letter of the NIRI.

123 See, for example, the Letters of the ACCA; American Electric Power; AFLAC Incorporated; Amerada Hess Corporation; the American Bankers Association; Capital One Financial Corporation; The Chubb Corporation; CIGNA Corporation; Cleary, Gottlieb, Steen & Hamilton; Dell Computer Corporation; Ernst & Young LLP; FEI; Halliburton Company; Merrill Lynch & Co., Inc.; NAREC; PepsiCo, Inc.; PG&E Corporation; and UniSource Energy Corporation.

124 See, for example, the Letters of the ABA; J.P. Morgan Chase & Co.; McDonald's, Inc.; Mellon Financial Corporation; NAREIT; PricewaterhouseCoopers LLP; and Sullivan & Cromwell.

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125 See, for example, the Letters of the ABA; Capital One Financial Corporation; and Reed Smith LLP.

126 See, for example, the Letters of American Financial Group, Inc.; Allegheny Energy, Inc.; Aztar Corporation; Caremark Rx, Inc.; Chevron Phillips Chemical Company LLP; Compass Bankshares, Inc.; Community Bankshares, Inc.; Edison Electric Institute; First Capital Bank Holding Corporation; GrandSouth Bancorporation; International Bancshares Corporation; J.C. Penney Company, Inc.; M&T Bank Corporation; Marathon Oil Corporation; MDU Resources, Inc.; Pinnacle West Capital Corporation; and Sinclair Broadcast Group, Inc.

127 See, for example, the Letters of Allegheny Energy, Inc.; Compass Bankshares, Inc.; Commercial Federal Corporation; Edison Electric Institute; and Pinnacle West Capital Corporation.

128 See the Letter of Compass Bankshares, Inc.

129 See, for example, the Letters of American Financial Group, Inc.; Caremark Rx, Inc.; Community Bankshares, Inc.; First Capital Bank Holding Corporation; GrandSouth Bancorporation; International Bancshares Corporation; J.C. Penney Company, Inc.; M&T Bank Corporation; Marathon Oil Corporation; and MDU Resources, Inc.

130 See revisions to Item 101(e) of Regulation S-K.

131 This requirement relates to the company's experience during the period covered by the report, or since the effective date of the amendments if a company has not completed a full fiscal year before its next annual report is due.

132 In Release No. 33-7856 (Apr. 28, 2000) [65 FR 25843] (the "2000 Release"), we provided interpretive guidance on the possible effects of hyperlinking to a third party website. See the 2000 Release, at n.48 and the accompanying text.

133 Companies could present the viewer with an intermediate screen stating that the visitor is leaving the company's website. Also, a disclaimer of responsibility for the accuracy of the third party service will not make the website posting ineffective for purposes of the disclosure requirement.

134 Several companies already hyperlink to our EDGAR website to provide website access to their reports. As a result of adding real-time EDGAR filing data to our website, new searches located on new webpages are now available on our website that provide access to this real-time data. For companies that currently hyperlink to our website, they will need to revise their hyperlink scripts if they have not already done so to refer to the new search pages providing real-time data. The older search pages will be eliminated in the near future.

135 See, for example, Release No. 33-7233 (Oct. 6, 1995) [60 FR 53458], at n. 24 and the accompanying text.

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136 See, for example, the Letters of the ABA; ASCS; Caremark Rx, Inc.; NYCBA; NYSBA; PricewaterhouseCoopers LLP; and Sullivan & Cromwell.

137 In the 2000 Release, we provided interpretive guidance on the effect of including a website address in other situations. See the 2000 Release, note 132 above, at n.41 and the accompanying text. We are not changing that guidance for those other situations.

138 See, for example, the Letters of the ABA; ASCS; Comcast Corporation; Deloitte & Touche LLP; The Dow Chemical Company; Institute of Management Accountants; PricewaterhouseCoopers LLP; and TIAA-CREF.

139 44 U.S.C. 3501 *et seq.*

140 Publication and submission were in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11.

141 Our allocation of the burden for Form 10-K and Form 10-Q is a departure from the Proposing Release and our past PRA submissions for Exchange Act periodic reports, for which we estimated that the company carried 25% of the burden internally and 75% of the burden was carried by outside professionals retained by the company. See also Release No. 33-3098 (May 10, 2002) [67 FR 35620]. We believe that this new allocation more accurately reflects current practice for annual and quarterly reports.

142 See the Letters of PPL Corporation and Southern Union Company.

143 One commenter believed the estimate should be 90% for in-house work and 10% for outside professionals. See the Letter of PPL Corporation. The other commenter mentioned it prepares over 95% of its reports by in-house personnel. See the Letter of Southern Union Company.

144 See note 141 above.

145 The commenter provided an estimate of 400 hours. See the Letter of PPL Corporation.

146 We arrived at this estimate by multiplying the approximate number of respondents that file on Form 10-K that do not only have a class of securities registered under Section 15(d) of the Exchange Act (and hence are less likely to have listed equity and therefore a public float) (7,384) by 74.4%, which represents the percentage of companies in Standard & Poors Research Insight Compustat Database with a market capitalization above $75 million out of the total number of companies in the Compustat Database with a market capitalization above $25 million (the upper limit for small business filers on Form 10-KSB). It is our understanding that the data in the Compustat Database is derived principally from larger companies, so our estimate may overstate the actual percentage of companies that would be affected by the proposals.

147 As discussed in note 141 above, this allocation of the burden is a departure from the Proposing Release, for which we estimated that the respondent carried 25% of the burden internally and 75% of the burden was carried by outside advisors retained by the respondent. We

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believe that this new allocation more accurately reflects current practice for annual and quarterly reports.

148 We also are making conforming amendments to the timeliness requirements for the inclusion of financial information in proxy statements, information statements and Securities Act and Exchange Act registration statements.

149 Some academic evidence shows that annual reports on Form 10-K filed through the EDGAR system provide incremental information to the market even after the firm has made an earnings announcement. See, for example, Daqing Qi, Woody Wu, and In-Mu Haw, 2000, "The Incremental Information Content of SEC 10-K Reports Filed Under the EDGAR System," *Journal of Accounting, Auditing, and Finance* 15 (Winter) : 25-45. See also the Letter of Paul A. Griffin.

150 See the Letters of the ASCS and the Business Roundtable.

151 See the Letter of American Electric Power.

152 See the Letter of the ASCS.

153 *Id*.

154 This estimate is based on our estimate of the probable number of affected reporting companies determined for purposes of the Paperwork Reduction Act (5,494).

155 See, for example, the Letters of the ASCS; the Business Roundtable; and FEI.

156 See the Letter of the ASCS. See also Letter of the Business Roundtable.

157 The estimate is based on the burden hour estimates calculated under the Paperwork Reduction Act. For purposes of the Paperwork Reduction Act, we estimate that the additional disclosure will result in 2,060 internal burden hours and $206,025 in external costs. Assuming a cost of $125/hour for in-house professional staff, the total cost for the internal burden hours would be $257,500. Hence the aggregate cost estimate is $463,525 ($257,500 + $206,025).

158 See, for example, the Letters of the ASCS; Dow Chemical Company; Hibernia Corporation; PricewaterhouseCoopers LLP; and TIAA-CREF.

159 See the Letter of the ASCS.

160 See the Letter of the NIRI.

161 15 U.S.C. 78w(a)(2).

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162 The Commission does have rules in place that allow for the non-disclosure of certain limited information filed with the Commission. See, for example, Exchange Act Rule 24b-2 [17 CFR 240.24b-2].

163 See, for example, the Letter of Troutman Sanders LLP.

164 See, for example, the Letters of Chevron Phillips Chemical Company LLP; Eastman Kodak Company; and Maverick Capital Ltd.

165 See, for example, the Letters of the AICPA; Ernst & Young LLP; Institute of Management Accountants; KPMG LLP; and PricewaterhouseCoopers LLP.

166 17 U.S.C. 77b(b).

167 15 U.S.C. 78c(f).

168 5 U.S.C. 603.

169 We also are making conforming amendments to the timeliness requirements for the inclusion of financial information in proxy statements, information statements and Securities Act and Exchange Act registration statements.

170 See the Proposing Release at Section VI.

171 17 CFR 240.0-10(a).

172 17 CFR 230.157.

173 It is our understanding that the data in the Compustat Database is derived principally from larger companies, so our estimate could understate the actual percentage of companies that would be affected by the proposals.

174 One-time extensions of due dates are available under certain circumstances under Exchange Act Rule 12b-25. Also, companies that are not timely will not meet the timeliness requirements for their proxy statements, information statements and Securities Act and Exchange Act registration statements.

http://www.sec.gov/rules/final/33-8128.htm

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American Corporate Counsel Association

Annual SEC Update

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RECENT DEVELOPMENTS IN FEDERAL SECURITIES REGULATION OF CORPORATE FINANCE

AS OF AUGUST 30, 2002

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Portions of this outline may be used for other programs.

The authors gratefully acknowledge the assistance of Mari K. Anzai, Gavin A. Beske, Moujan Malekafzali, Maeling Pan, Michael J. Scanlon, Cambria A. Smith and W. Stephen Venable, Jr. in the preparation of this outline.

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Recent Developments in Federal Securities Regulation of Corporate Finance

I. Introduction

This outline reviews recent cases, no-action letters, releases and other information promulgated by the Securities and Exchange Commission (the "SEC" or "Commission"), the Sarbanes-Oxley Act of 2002 and actions taken by the major securities exchanges, that address many recent and proposed changes to the federal securities laws, the related rules and regulations and the Commission's practices.

II. Current Issues

A. Accelerated Reporting Requirements for 10-Ks and 10-Qs

On April 12, 2002, the SEC proposed a set of rules which would accelerate filing deadlines for Forms 10-K and 10-Q.[1] The SEC's proposal was prompted, in part, by financial reporting and disclosure concerns highlighted by recent events, and by SEC Chairman Harvey L. Pitt's previously announced intention to reform the current disclosure system.[2] On August 27, 2002, the SEC approved the adoption of the proposed rules to accelerate the filing deadline for annual and quarterly reports under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), with a three-year phase-in period. Pursuant to the new rules, for many companies Form 10-Ks must be filed within 60 days of fiscal year-end and Form 10-Qs must be filed within 35 days of quarter-end.

The accelerated filing requirements will be phased in over three years, according to the following schedule:

- No change in periodic reporting deadlines will occur in the first year.

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[1] *Acceleration of Periodic Report Filing Dates and Disclosure Concerning Website Access to Reports*, Release No. 33-8089, 34-45741 (Apr. 12, 2002).

[2] *SEC to Propose New Corporate Disclosure Rules* (Feb. 13, 2002) (available at http://www.sec.gov/news/press/2002-22.txt). Alan L. Beller, the Director of the Division of Corporate Finance has also emphasized the Staff's focus on initiatives surrounding timely disclosure and the SEC's intention to propose a substantial expansion to the items triggering a filing on Form 8-K, a project also announced in the SEC's February 13, 2002 press release. *See Remarks before the Rocky Mountain Securities Conference* (May 17, 2002) (available at http://www.sec.gov/news/speech/spch563.htm).

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- Starting with their first fiscal year ending on or after December 15, 2003, companies will have 75 days to file their Form 10-K, with subsequent quarterly reports on Form 10-Q due within 40 days of quarter-end.
- For fiscal years ending on or after December 15, 2004, companies will have 60 days to file their Form 10-K. All subsequent quarterly reports on Form 10-Q will be due within 35 days of quarter-end.

Companies are subject to the accelerated reporting requirements if they:

- have a domestic public float of at least $75 million;
- have been a reporting company for 12 months; and
- have previously filed at least one report with the SEC.

Based on comments made by the SEC staff at the open meeting at which the rules were adopted, it appears that financial statements of subsidiaries that are not themselves subject to the accelerated filing requirements will not have to be included in the parent company's periodic reports on the accelerated schedule and may be filed by amendment at a later date. The accelerated filing deadlines do not apply to foreign private issuers.

Beginning with the first fiscal year ending on or after December 15, 2002, companies must disclose in their annual reports on Form 10-K whether they make their Form 10-K, 10-Q and 8-K, as well as all amendments thereto, available on their websites as soon as reasonably practicable after filing.

B. Section 16 Amendments

On August 27, 2002, the SEC approved the adoption of rule and form amendments to implement the accelerated filing deadline applicable to the reporting of transactions by Section 16 insiders (executive officers, directors and greater than 10% beneficial owners) under Section 16(a) of the Exchange Act, as amended by Section 403 of the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act").[3]

Effective August 29, 2002, Section 16 insiders must file Section 16(a) reports within two business days after executing transactions in company securities. Of significant note, transactions previously permitted to be deferred to a Form 5 pursuant to Rule 16b-3 now will be required to be reported within two business days. The SEC provided two exceptions to this rule permitting delayed reporting of transactions pursuant to Rule 10b5-1 plans and "discretionary transactions" (within the meaning of Rule 16b-3(f)) under employee benefit plans. The transaction date for these two types of transactions will be the date the plan

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[3] *Ownership Reports and Trading by Officers, Directors and Principal Security Holders*, Release No. 34-46421 (August 27, 2002).

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administrator notifies the insider of the date of execution, but not later than three days after the execution date. The deadline for delayed reporting is no more than five days, which consists of this maximum three-day notice period plus the two-day reporting period. The format of Form 4 will be modified to include a column entitled "Notice Date" where insiders taking advantage of delayed reporting will provide the date when they received notice of the transaction. These transactions previously enjoyed delayed reporting on Form 5. With the implementation of the Sarbanes-Oxley Act, Form 5 will primarily be limited to transactions such as gifts. Finally, transactions under 401(k) and 423 plans (employee stock purchase plans) will continue to be exempt from Section 16(a) reporting.

The Sarbanes-Oxley Act also requires the electronic filing of Section 16(a) reports by no later than July 30, 2003, one year after enactment of the Sarbanes-Oxley Act. At that time, companies will also be required to make the reports available on their websites.

C. New Form 8-K Disclosure Requirements

1. New Items or Events Requiring Current Reports on Form 8-K

On June 17, 2002, the Commission proposed that several new items or events be reported on Form 8-K in an effort to improve the quality, amount and timeliness of public disclosure of extraordinary corporate events.[4] In addition, the Commission proposed that Form 8-K reports be filed within two business days instead of the current five to fifteen days.[5] The SEC has proposed 11 new items to the list of events that would require a company to file a current report on Form 8-K:

(a) Entry into a Material Agreement

This 8-K item would require a company to disclose its entry into a material agreement not made in the ordinary course of business or a material amendment to a material agreement. The Commission has expressly stated that under this item, companies would be required to disclose letters of intent and other non-binding agreements and would have to file the agreement or letter as an exhibit to the Form 8-K. One of the instructions to the proposed item provides that a company must also provide disclosure if it succeeds as a party to an agreement by assumption or assignment.

(b) Termination of a Material Agreement

If a material agreement not made in the ordinary course of business to which the company is a party is terminated, the company would have to

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[4] *Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date*, Release No. 33-8106, 34-46084 (June 17, 2002).

[5] *Id.*

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disclose the termination of the agreement and other information, including a description of the material circumstances surrounding the termination and a discussion of management's analysis of the effect of the termination on the company.

(c) Termination or Reduction of a Business Relationship with a Customer

This item would require disclosure when a company becomes aware of a loss of revenues equal to 10% or more of the company's consolidated revenues during its most recent fiscal year stemming from the termination or reduction of a business relationship between the company and one of its customers. A proposed instruction to this item provides that no disclosure is necessary when the company is in negotiations or discussions with a customer, or a suspension or reduction of business occurs, unless and until an executive officer of the company is aware of the actual or potential termination or reduction.

(d) Creation of a Direct or Contingent Financial Obligation That is Material to the Registrant

This proposed item would require a company to disclose information whenever it or a third party enters into a transaction or agreement that creates any material direct or contingent financial obligation to which the company is subject. Disclosure is required whether or not the company is party to the agreement in question, but only when the agreement is definitive and unconditional or subject only to customary closing conditions.

The item would also require a company to disclose the nature and amount of the company's material direct or contingent financial obligation and a discussion of management's analysis of the effect of the direct or contingent financial obligation on the company.

(e) Events Triggering a Direct or Contingent Financial Obligation That is Material to the Registrant

This new item would require a company to disclose triggering events causing a direct or contingent financial obligation that is material to the company. This item would define a "triggering event" as an event where:

- a material direct or contingent financial obligation of the company that is unconditional or subject to no condition other than the passage of time has arisen, including as a result of an increase in an obligation, or been accelerated; or
- a party to an agreement obtains the unconditional right to cause such an obligation to arise or become accelerated, regardless of whether in either case the company is a defaulting party.

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No triggering event would be deemed to have occurred while the company is in negotiations or discussions with relevant parties regarding a triggering event or the cure of such event by waiver, amendment or similar arrangement.

(f) Exit Activities Including Material Write-Offs and Restructuring Charges

This proposed new item would require disclosure when a company's board of directors or authorized officer or officers definitively commit the company to a course of action, including a plan to terminate or exit an activity, pursuant to which the company will incur a material write-off or restructuring charge under generally accepted accounting principles.

(g) Material Impairments

This item would require disclosure when a company's board of directors or authorized officers conclude that the company is required to record a material charge for impairment to one or more of its assets under generally accepted accounting principles, including an impairment of securities or goodwill.

(h) Rating Agency Decisions

This proposed item would require a company to disclose that it has received notice from a rating agency to whom the company provides information that the agency has decided to:

- change or withdraw the credit rating assigned to, or outlook on, the company or any of its classes of debt or preferred securities or other indebtedness;
- refuse to assign a credit rating to the company, any class of its securities, or any of its indebtedness after the company has requested such a rating; or
- place the company or any class of its securities or indebtedness on "credit watch" or similar status.

The company would have to disclose its management's analysis of the effect of the change or decision on the company.

(i) Notice of Delisting or Failure to Satisfy Listing Standards; Transfer of Listing

This new item would require a company to disclose a notice from the national securities exchange or national securities association that is the principal trading market for a class of the company's common stock or other equity securities that the company or its class of its securities no longer

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satisfies the listing requirements or standards of such exchange or association, or that a class of the company's securities has been delisted.

(j) Non-Reliance on Previously Issued Financial Statements or a Related Audit Report

This item would require a company to file a Form 8-K if its audit committee, board of directors or authorized officers conclude that any of the company's previously issued financial statements should no longer be relied upon. A company would be required to disclose a notice from its current or former independent accountant that the company should take action to prevent future reliance on a previously issued report relating to any of its financial statements. Financial statements required pursuant to Regulation S-X or Regulation S-B would be covered by the new proposal.

(k) Material Events Regarding the Registrant's Employee Benefit, Retirement and Stock Ownership Plans

This item would require a company to disclose any known event that would materially limit, restrict or prohibit employee benefit, retirement or stock ownership plan participants from acquiring, disposing or converting their holdings, other than a periodic or other limitation, restriction or prohibition, based on knowledge of or access to material non-public information. This item would require a company to disclose the period or expected period of the limitation, the nature of the limitation and the circumstances surrounding, or reasons for, the limitation.

2. Movement of Disclosure Items to Form 8-K

The SEC has also proposed moving two disclosure items currently required in other Exchange Act reports to Form 8-K:

(a) Unregistered Sales of Equity Securities

This item would require a company to disclose information required by paragraphs (a) through (e) of Item 701 of Regulation S-K with respect to a company's sale of equity securities in a transaction that is not registered under the Securities Act. This disclosure is presently required in Item 2(c) of Forms 10-K and 10-KSB. The SEC proposal would move this disclosure from companies' annual and quarterly reports to Form 8-K.

(b) Material Modifications to Rights of Security Holders

This new item would require a company to disclose material modifications to the rights of holders of any class of the company's registered securities, and to describe the general effect of such amendments on the security holders of the company. The disclosure required by this item would

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be the same as is currently required by Items 2(a) and (b) of Forms 10-Q and 10-QSB.

3. Amendment of Existing Disclosure Items on Form 8-K

The SEC has also proposed the amendment of several existing Form 8-K disclosure items:

(a) Disclosure When a Director Resigns or Declines to Stand for Re-Election Due to a Disagreement or is Removed For Cause

This proposed item would be similar to Item 6 of existing Form 8-K because both items deal with the resignation of a corporate director. However, this item would add several new substantive requirements. Under the proposal, if a director has resigned or declined to stand for re-election to the board of directors since the date of the last annual meeting of shareholders because of a disagreement with the company on any matter relating to the company's operations, policies or practices that is known to an executive officer of the company, or if a director has been removed for cause from the board of directors, the company would have to disclose the situation, including the circumstances surrounding the resignation, declination to stand for re-election or removal.

(b) Disclosure When Certain Officers Resign or Are Terminated from a Position; Disclosure When a Director Resigns, is Removed or Declines to Stand for Re-Election for Any Reason Other Than as a Result of a Disagreement or For Cause

This new item would require a company to disclose when its principal executive officer, president, principal financial officer, principal accounting officer, principal operating officer or any person serving in an equivalent position resigns or is terminated. It would also require disclosure when a director resigns, is removed or declines to stand for re-election for any reason other than as a result of a disagreement or for cause which would be disclosed under the proposed item described above.

One difference between the proposed disclosure under this item and the proposed disclosure about a director's departure because of a disagreement is that with respect to the departure of an officer as the result of a disagreement with the company, the company would not be required to disclose the reasons for, or seek the officer's explanation of, the departure as it would be required if a director departed under other circumstances.

(c) Disclosure When the Company Appoints Certain New Officers or a New Director Is Elected

This proposed new item would require disclosure by a company upon the appointment of a new principal executive officer, president, principal

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financial officer, principal accounting officer, principal operating officer, or person serving an equivalent function. In addition, if a new officer is elected to the board, except by a vote of security holders at an annual meeting, this item would also require disclosure of such election. Certain information required to be disclosed under this item regarding new officers and directors can be filed by amendment under the new item after the company has determined the required information.

(d) Amendments to Articles of Incorporation or Bylaws; Change in Fiscal Year

This item would require a company to disclose any amendment to its articles of incorporation or bylaws that was not disclosed in a proxy statement or information statement filed by the company. If the amendment changed the company's fiscal year from the fiscal year used in its most recent filing with the SEC, the company would also have to disclose the form on which the report covering the transition period will be filed.

4. Shortened Filing Deadline For Form 8-K

The proposed amendments would also accelerate to two business days the current five business day deadline for disclosure about changes in a company's independent accountant and resignations of directors, and 15 calendar day deadline for other required disclosures. As a result, the proposed rules would provide a uniform filing period for all of the mandated disclosure items on Form 8-K. These deadline amendments would apply to domestic issuers that are subject to the reporting requirements of Section 13(a) and Section 15(d) of the Exchange Act.

5. Other Amendments

(a) Amendments to Rule 13a-11 and 15d-11 to Provide a Safe Harbor

This proposal would add a new paragraph to each of Rule 13a-11[6] and Rule 15d-11[7] under the Exchange Act. The new paragraphs would provide a safe harbor for a company that fails to file a required Form 8-K in a timely manner if the company satisfies all of the conditions of the safe harbor.[8] Under the proposed safe harbor, a company would not be liable under Sections 13(a) and 15(d) of the Exchange Act for such a failure to file if:

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[6] 17 CFR 240.13a-11.

[7] 17 CFR 240.15d-11.

[8] Release No. 33-8106, 34-46084 at 36.

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- on the due date for the required Form 8-K, the company maintained sufficient procedures to provide reasonable assurances that the company is able to collect, process and disclose, within the specified time period, the information required to be disclosed by Form 8-K; and
- no officer, employee or agent of the company knew, or was reckless in not knowing, that a report on Form 8-K was required to be filed and once an executive officer of the company became aware of its failure to file a required Form 8-K, the company promptly (and not later than two business days after becoming aware of its failure to file) filed a Form 8-K with the Commission containing the required information and stating the date, or approximate date, on which the report should have been filed.[9]

The obligation to disclose information on Form 8-K would not be affected by the safe harbor and thus would continue to exist for purposes of determining liability under Section 10 and Rule 10b-5 under the Exchange Act and Sections 11, 12 and 17 of the Securities Act. In addition, this safe harbor would not apply to a company's eligibility to use short form registration statements.[10]

Although compliance with the safe harbor would shield the company from liability under Section 13 and 15(d) for a late Form 8-K filing, that filing would not be considered timely unless filed within the original time period required by Form 8-K. A company that fails to file a Form 8-K in a timely manner would not be eligible to use short form registration statements. In addition, a company could not use Form S-8 and its security holders could not rely on Rule 144 since the company would not be current in its Exchange Act filings, which include Form 8-K.[11]

(b) Amendments to Rule 12b-25 and Form 12b-25 Regarding Late Filing

The SEC also proposes amendments to Rule 12b-25[12] and Form 12b-25[13] to require a company to file a Form 12b-25 if the company will not be

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[9] *Id.*

[10] *Id.*

[11] *Id.*

[12] 17 CFR 240.12b-25.

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able to file a current report on Form 8-K in a timely manner. A company would have to file the Form 12b-25 one business day after the Form 8-K is due and file the Form 8-K within two business days after the original due date. If the company makes the appropriate representations that it was not able to file in a timely manner without unreasonable effort or expense, then the report would be deemed to be filed on the prescribed due date. A company that provides proper notice on Form 12b-25 would not lose its eligibility to use short form registration statements as the result of its inability to timely file a Form 8-K unless the company also failed to file within the extended period permitted by Rule 12b-25.[14]

D. Certification of Filings with the SEC

1. Commission Order No. 4-460—Section 21(a) Certification

On June 27, 2002, the SEC issued an order requiring the Chief Executive Officer and Chief Financial Officer of the nation's 1000 largest public companies, determined by revenue, to file sworn statements with the SEC certifying the accuracy of their SEC filings.[15] The SEC's order was issued under its investigative authority under Section 21(a) of the Securities Exchange Act of 1934, and according to the Commission, is intended "to provide greater assurance to the Commission and to investors that persons have not violated, or are not currently violating, the provisions of the federal securities laws governing corporate issuers' financial reporting and accounting practices."[16] Since its initial order and announcement, the SEC has made available the form on which the company must provide its certification.[17] Furthermore, in subsequent statements, the staff has made clear that the certification is to be made exactly according to its form, with no additions or changes accepted.[18]

The following is a summary of the Commission order:

[Footnote continued from previous page]

[13] 17 CFR 249.322.

[14] Release No. 33-8106, 34-46084 at 37.

[15] *Order Requiring the Filing of Sworn Statements Pursuant to Section 21(a)(1) of the Securities Exchange Act of 1934*, File No. 4-460 (June 27, 2002).

[16] *Id.*

[17] The form is available at http://www.sec.gov/rules/other/4-460a.htm.

[18] *See, e.g.*, http://www.sec.gov/rules/other/4-460faqs.htm.

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- The order applies to 947 domestic issuers with revenues in its last full fiscal year of more than $1.2 billion.
- The certification is required to be filed by the close of business on the next due date for a covered company's Form 10-Q or Form 10-K if that due date is on or after August 14, 2002.
- Each certification must be sworn before a notary and delivered in written form to the SEC's Office of the Secretary. Each of the Chief Executive Officers and Chief Financial Officers must execute and file a separate certificate. The SEC is publishing the certifications after they are filed.[19]
- The certification applies to previous filings. It must cover the most recently filed Form 10-K and any subsequently filed Form 10-Q and Form 8-K, the proxy statement and any amendment to the foregoing filings.
- The certification is basically a Rule 10b-5 representation: that to the best knowledge of the Chief Executive Officer and Chief Financial Officer, based upon a review of the covered reports and subject to any subsequent amendment or correction:

  1) no covered report contained an untrue statement of a material fact as of the end of the period covered by such report or, in the case of a report on Form 8-K or definitive proxy materials, as of the date on which it was filed; and

  2) no covered report omitted to state a material fact necessary to make the statements in the covered report, in light of the circumstances under which they were made, not misleading as of the end of the period covered by such report or, in the case of a report on Form 8-K or definitive proxy materials, as of the date on which it was filed.
- If a company cannot make the foregoing certification, it must file a statement under oath describing the facts and circumstances that would make the foregoing certification incorrect.
- Each certification must state whether the executive providing it has reviewed the contents of the certification with the company's Audit Committee or, if the board of directors does not have an Audit Committee, the independent members of the Board.[20]

The Chair and Vice-Chair of the American Bar Association's Committee on Federal Regulation of Securities, along with a number of other members of the

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[19] The published certifications may be viewed and downloaded at http://www.sec.gov/rules/extra/ceocfo.htm.

[20] *Id.*

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Committee, do not believe that the Order is an appropriate use of the SEC's investigative powers under Section 21(a) of the Securities Exchange Act of 1934.[21] Although Section 21(a) investigations can give the SEC important information to use in order to evaluate the adoption of new rules or legislation, the Chair and Vice-Chair do not think that, outside the context of investigations of specific potential violations of federal securities laws or related rules, Section 21(a) sworn statements can be required.[22] The Chair and Vice-Chair have formed a task force of the Committee, consisting of securities law practitioners and former SEC officials, to consider the SEC's Section 21(a) authority in this context.[23]

The SEC's order, while a novel and untested use of its investigative authority, is intended to help reassure investors as to the integrity of the U.S. financial reporting system. It also reflects press reports of companies discovering accounting irregularities through routine internal audit reviews and through reviews that are being conducted by audit committees or as companies change their auditors. Therefore, while the required certification reflects only a statement of compliance with the law, company executives should consider what additional steps they may should undertake to support their certifications.

The additional steps each company takes in preparing the certification depend on the company's existing systems of internal controls and documentation. At a minimum, the certification clearly requires the Chief Executive Officer and the Chief Financial Officer to review each covered SEC filing. Executives will also want to discuss with their internal accounting and internal audit staff, their external auditors and their in-house or outside lawyers the procedures that have been followed, and issues that have arisen, in preparing the covered reports. With respect to past reports on Forms 10-K, 10-Q and 8-K, the certification will require a careful evaluation of what was known at the time of the report. Many companies subject to the order have required subordinate officers, and others involved in the preparation or review of reports covered by the CEO and CFO certifications, to give supporting assurances in writing as to their respective areas of responsibility. Finally, prior to filing the certifications, executives should review with the Audit Committee of their board of directors or, if the company does not have an Audit Committee, with the independent members of the board, the procedures that they have followed to substantiate their response to those questions or issues. Both the Chief Executive Officer and the Chief Financial Officer should participate in this discussion with the Audit Committee, because the form of certification requires each of them to provide separate statements

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[21] Letter, dated July 15, 2002, from Stanley Keller & Dixie Lynn Johnson to Harvey L. Pitt.

[22] *Id.*

[23] *Id.*

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certifying whether they personally have discussed the contents of the certification with the Audit Committee.

2. Section 906 Certification of Periodic Reports.

The Sarbanes-Oxley Act, signed into law on July 31, 2002, contains two divergent certification provisions, each requiring CEOs and CFOs of public companies to certify to certain matters in periodic reports filed with the SEC. These requirements are in addition to the certification requirements which the SEC imposed on the CEOs and CFOs of 947 large public companies pursuant to a June 27 investigative order. One of the new certification provisions, in Section 906 of the Act, was immediately effective, and thus applies to periodic reports filed by every domestic or foreign issuer on or after July 30, 2002.

a. Filings subject to the Section 906 certification requirement

Section 906 applies to each "periodic report" containing financial statements filed with the SEC on or after July 30, 2002. Thus, the certification requirement applies to each Form 10-K and Form 10-Q filed by a company subject to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 ("Exchange Act"), as well as to Forms 20-F filed by foreign issuers or any 11-K filed by an employee benefit plan. Companies that filed a Form 10-K or Form 10-Q on or after that date without a certification should promptly make the required certification. The certification is required to be made by the chief executive officer ("CEO") and the chief financial officer ("CFO"), or the persons holding equivalent positions.

Section 906 does not appear to apply to Forms 8-K or Forms 6-K since these reports are viewed as current reports and Section 906 applies only to "periodic reports" such as quarterly and annual reports. In its release adopting rules relating to certifications under Section 302 of the Sarbanes-Oxley Act, the SEC confirmed that Forms 8-K and Forms 6-K are not "periodic reports" subject to certification requirements.[24]

Many companies whose equity securities are closely held file periodic reports as a result of having issued debt securities in an offering that was registered under the Securities Act of 1933. These companies are required under Exchange Act Section 15(d) to file periodic reports covering the fiscal year in which that registration statement becomes effective. Thereafter, the companies typically continue to file periodic reports with the SEC pursuant to an undertaking in the indenture, even though Section 15(d) states that the duty

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[24] *Certification of Disclosure in Companies' Quarterly and Annual Reports*, Release No. 33-8124, 34-46427 (Aug. 29, 2002) (available at http://www.sec.gov/rules/final/33-8124.htm).

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to file such reports is "automatically suspended" as to any subsequent fiscal year if at the beginning of the fiscal year there are less than 300 holders of the debt securities.[25] Because the Act applies only to an issuer whose securities are registered under Exchange Act Section 12 or to an issuer that "is required to file reports under Section 15(d)," there is a strong argument that a company that is not required to file under Section 15(d), but which has chosen to do so, is not subject to Section 906 (or to other provisions of the Act). However, the same analysis may not apply to other aspects of the Sarbanes-Oxley Act and, in particular, to the Section 302 certification. The 906 certifications apply to "periodic reports," as opposed to Section 302, which applies to "each annual and quarterly report filed or submitted." This "filed or submitted" language under Section 302 and the fact that Section 302 applies to "each company filing periodic reports under Section 13(a) or 15(d)" may provide a hook for the SEC to require "voluntary" 15(d) filers to submit the 302 certifications, even if those voluntary filers do not have to submit 906 certifications (which are applicable to "issuers," a defined term not used in the lead in to Section 302). Because the Section 302 certifications appear in the filings, one can well imagine the SEC also taking the position that a "voluntary" Form 10-K or 10-Q must fully comply with the content and format requirements applicable to those forms.

b. What the Section 906 certification should state.

The certification should state that:

- the periodic report containing the financial statements fully complies with the requirements of Section 13(a) or 15(d) of the Exchange Act, and
- the information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer.

The Act imposes criminal penalties if the CEO or CFO certifies the statement "knowing" that the periodic report does not comport with the requirements set forth in the statement, and imposes greater penalties if the officer's act is also "willful." In light of the standard of liability imposed on the certifications under the Act, it appears to be acceptable for the certification to be preceded by language indicating that it is being made based on the

[25] An informal interpretation by the SEC Staff indicates that the provision under Section 15(d) of the Exchange Act stating that a company is not required to file reports under Section 15(d) during any year (except for the fiscal year in which the registration statement became effective) if the company has fewer than 300 security holders of record at the beginning of such fiscal year, is not conditioned upon the company filing a Form 15 to deregister pursuant to Rule 15d-6.

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officer's knowledge, since this merely would affirmatively state for the public the legal standard applicable to the certification by operation of law.[26] While it is unclear how the 906 certification requirement will be administered or enforced, any variation in the language of the certification itself or any attempt to vary the legal standard applicable to the order from the "knowledge" standard prescribed under the Act may be viewed as a non-complying certification that may invoke scrutiny from the SEC or the Department of Justice.

The Act does not require a separate certification from each of the CEO and CFO and in fact refers to the certification as being a "statement" in the singular, so it appears that they may each sign a single certification, although it should also be acceptable to provide separate statements. The Act does not require the certifications to be notarized.

c. What happens if an executive is unable to make the certification?

Because the certification can give rise to criminal liability, where an executive believes that the required statement would not be true, he or she should consult with counsel. The fact that a CEO or CFO believes he or she is unable to make the certification likely will be viewed as material information, with the result that the company would need to consider whether it should publicly disclose in the periodic report that one or both of its executives are unable to provide the certification, together with the reasons for their inability to provide the certification.

It is unclear whether there is any penalty for failing to file the certification. Section 3(b)(1) of the Act provides:

> A violation by any person of this Act ... shall be treated for all purposes in the same manner as a violation of the [Exchange Act] or the rules and regulations issued thereunder, consistent with the provisions of this Act, and any such person shall be subject to the same penalties, and to the same extent, as for a violation of that Act or such rules or regulations.

However, Section 906 is contained in a part of the Act entitled the "White-Collar Crime Penalty Enhancement Act of 2002," so it is unclear

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[26] As of August 14, based on an electronic terms search of SEC filings, approximately 25% of Section 906 certifications that have been publicly disclosed have included "knowledge" or "best of knowledge" language in the introduction to the certification. As of that date, approximately 1300 10-Q's and/or 10K's had been filed with Section 906 certifications and approximately 350 8-K's had been filed with Section 906 certifications.

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whether Section 3(b) applies to this Act-within-an-Act. It is also uncertain whether the Act provides a civil remedy for failure to file the certification.

d. How the Section 906 certification should be submitted to the SEC.

Section 906 requires each covered filing to "be accompanied by" a written statement of the CEO and CFO. In the absence of guidance from the SEC, there appear to be a number of ways to satisfy this requirement. Among the factors affecting the selection of a method for submitting the certification are considerations of investor and other public reaction and the potential (which as discussed below may be more theoretical than actual) for increased liability. It is recommended that companies choose one of the following four methods for submitting the certifications:

- attach the certification as an exhibit to the filing;
- include the certification on the signature page of the filing;
- submit the certification under an Item 9 Form 8-K that is filed at the same time as the covered periodic report; or
- transmit the certification via Edgar as correspondence transmitted with the filing.

As of August 14, 2002, most companies (approximately 75% to 80%, although the percentage appears to be declining) that have submitted the certification have attached it as an exhibit to the filing. (See for example, exhibits 99.1 and 99.2 to the Form 10-Q filed by General Electric Corporation on July 31, 2002). Either this approach or including the certification on the signature page has the benefit of making the certification readily available to investors and the press, thereby assuring the market that the company is in fact able to provide a "clean" certification. This may be particularly important to high profile companies or to companies in troubled industries (for example, energy and telecommunications companies).

Filing the certification as an exhibit to the periodic report or including it on the signature page of the report results in the certification being "filed" under the Exchange Act, thus making the certification subject to Exchange Act Section 18. Including the certification on the signature page of the report also results in it being incorporated into Securities Act registration statements that were previously filed on Form S-3, Form S-4 or Form S-8, and therefore being subject to Securities Act Section 11 liability (as discussed below).

Because Section 906 requires the certification to "accompany" a filing, as opposed to being included in the filing (the language used for the other certification provision contained in Section 302 of the Act), the Act does not on its face require the Section 906 certification to be filed with the SEC. It appears a certification included in a Form 8-K under Item 9 that is filed at the same time as the covered periodic report as satisfying the Act's requirement

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that the certification "accompany" the periodic report. Some companies are both submitting the certification as an Edgar "correspondence" file with the periodic report and publicly disclosing the form of certification submitted by the officers through an Item 9 Form 8-K, an approach we view as also satisfying the Act. This approach assures that the fact that the executives have made the certification, as well as the content of the certification, is publicly available. This is significant because the SEC may view the content of the certification as material information for purposes of Regulation FD.[27] An Item 9 Form 8-K is not deemed to be filed for purposes of the liability provision of Section 18 under the Exchange Act. Moreover, an Item 9 Form 8-K is not incorporated by reference into Securities Act registration statements and therefore is not subject to Securities Act Section 11 liability (as discussed below).

It is also believed that including the certification in a "non-public" correspondence file transmitted via Edgar at the time that the covered periodic report is filed satisfies the Act. This approach avoids the certification being "filed" under the Exchange Act and avoids it being incorporated by reference into Securities Act filings. There are several disadvantages to this approach. First, the non-public nature of the submission may draw adverse publicity to the company at a time when investors and the press are highly focused on the ability of a company's executives to certify the accuracy of SEC filings. Second, submitting the certification through an Edgar correspondence transmission may not avoid disclosure of the certification. Because of the SEC's statement on materiality in the context of certifications under its June 27 investigative order (see note 5 above), the fact that a Section 906 certification has been made, as well as the content of the certification, may be deemed to constitute material information. Therefore, a company submitting a Section 906 certification in a correspondence transmission should consider publicly disclosing the fact of the certification. This could be accomplished through a statement in an Item 9 Form 8-K filing indicating that the company's officers submitted the certification to the SEC (without including the form of certification in the Form 8-K).[28] Alternatively, a company could

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[27] In the context of certifications being made by the CEOs and CFOs of 947 large public companies pursuant to a June 27 SEC investigative order, the SEC Staff stated that it viewed the contents of those certifications as constituting material information for purposes of Regulation FD. However, the fact that a company's executives have provided a "clean" certification may cease to be viewed as material information as the certification process becomes a routine aspect of the disclosure process.

[28] Companies subject to the SEC's June certification order likely will be filing Forms 8-K to disclose the certifications submitted pursuant to the June certification order. These Forms 8-K could also address compliance with the Section 906 certification requirement.

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state in a press release that its executives have submitted an unqualified certification statement pursuant to Section 906 or could indicate that fact under Item 5 ("Other Information") of a Form 10-Q or Item 9 of a Form 8-K. Finally, even if submitted through a correspondence transmission, it is possible that the SEC may determine to make the certification public and, regardless, it is likely the certification would be obtainable through a Freedom of Information Act request.

In the future, as companies become subject to the certification requirements under Section 302 of the Act, which certifications will be included in the SEC filings, there may be less public attention on the Section 906 certification, and companies may increasingly move toward submitting them via an Edgar correspondence transmission.

e. Increased Liability as a result of Section 906

It is unclear whether a Section 906 certification will result in increased liability outside of the context of a criminal action brought by the U.S. Attorneys office under Section 906 for submitting or willfully submitting a certification on a periodic report that the executive knows does not satisfy the standard set forth in the Act.

In considering what method to use for submitting the Section 906 certification to the SEC, one consideration is whether the certification exposes the company or its CEO and CFO to increased liability. As noted above, by submitting the certification on an Item 9 Form 8-K or in an Edgar correspondence transmission, the certification is not deemed filed for purposes of Section 18, and not subject to Securities Act Section 11 liability under registration statements that incorporate by reference the covered reports. In other words, including the certification in a covered report exposes the certification to civil liability if the certification contains an untrue statement of a material fact or omits to state a material fact necessary to make it not misleading. Because the SEC has stated, in the context of certifications submitted under the SEC's June investigative order, that executive officer certifications may be deemed to involve material information, then it is possible that the existence of an inaccurate certification could be used in shareholders' litigation to bolster an allegation that a filing contains a material misstatement, even if any inaccuracy in the periodic report covered by the certification is not itself material. Filing or publicly disclosing the text of the certification may also increase the possibility that the certification will be cited in shareholders' litigation to support an allegation of scienter.

Whether Section 906 certifications lead to increased liability under the foregoing or other theories will, of course, take a number of years to determine and depend on judicial interpretations. It may be that the certifications will not result in litigation or liability at a company in circumstances where the company would not otherwise have that exposure

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due to some underlying inaccuracies in a periodic report. In addition, it is unclear whether the manner in which the certification is submitted will affect the scope of liability, since it will be expected that – whether filed or not – every public company provided the certification. Companies should therefore assess the benefits of and investor interest in a publicly filed certification against these possible, but perhaps unlikely, bases of liability.

3. Section 302 Certification of Periodic Reports.

Section 302 contains a CEO and CFO certification requirement that is more extensive than that required under Section 906. The Sarbanes-Oxley Act expressly provides that the Section 302 certification requirement is to be implemented by SEC regulations that are required to be effective not later than 30 days after enactment of the Sarbanes-Oxley Act (i.e., not later than August 29, 2002). On August 2, 2002, the SEC issued a release indicating it would issue and make final rules clarifying Section 302 certification.[29] On August 27, 2002, the SEC announced it had made the proposed rules final and they would become effective, pursuant to the Sarbanes-Oxley Act, on August 29, 2002.[30] On August 29, 2002, the SEC issued its release setting forth the new rules.[31]

- The Section 302 certification is required to be made "in" each annual or quarterly report filed by either a U.S. or foreign issuer under Section 13(a) or 15(d) of the Exchange Act. It is expected the forthcoming SEC rules will clarify how this certification is to be effected.
- The Section 302 certification expressly applies both a materiality standard and a knowledge standard to the CEO's and CFO's required statements regarding the financial statements, financial information and other information contained in the covered report. However, the certification also requires extensive representations as to the CEO's and CFO's responsibility for the issuer's internal reporting controls (both financial and non-financial), including a representation that they have evaluated the effectiveness of those controls on a quarterly basis.

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[29] *Proposed Rule: Certification of Disclosure in Companies' Quarterly and Annual Reports*, Release No. 34-46300 (August 2, 2002).

[30] *Commission Approves Rules Implementing Provisions of Sarbanes-Oxley Act, Accelerating Public Filings, and Other Measures*, (Aug. 27, 2002) (available at http://www.sec.gov/news/press/2002-128.htm).

[31] *Certification of Disclosure in Companies' Quarterly and Annual Reports*, Release No. 33-8124, 34-46427 (Aug. 29, 2002) (available at http://www.sec.gov/rules/final/33-8124.htm).

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- The text of the Section 302 certification set forth in the Sarbanes-Oxley Act is extensive. Specifically, the principal executive officer and principal financial officer must certify that:
  - The signing officer has reviewed the report.
  - Based on the officer's knowledge, the report does not contain any untrue statement of material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading.
  - Based on such officer's knowledge, the financial statements, and other information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report.
  - The signing officers:

    1) are responsible for establishing and maintaining internal controls;

    2) have designed such internal controls to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to such officers by others within those entities, particularly during the period in which the periodic reports are being prepared;

    3) have evaluated the effectiveness of the issuer's internal controls as of a date within 90 days prior to the report; and

    4) have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date.
  - The signing officers have disclosed to the issuer's auditors and the audit committee of the board of directors:

    1) all significant deficiencies in the design or operation of internal controls which could adversely affect the issuer's ability to record, process, summarize, and report financial data and have identified for the issuer's auditors any material weaknesses in internal controls; and

    2) any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls.

    3) the signing officers have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

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- Because Section 302 certification is now effective, companies should promptly begin to document their internal reporting systems so that any deficiencies in those procedures can be timely identified and corrected.

The SEC adopted new Rules 13a-14 and 15d-14 under the Exchange Act to implement Section 302 of the Sarbanes-Oxley Act. The rules, which are effective for filings made after August 29, 2002, apply to an issuer's quarterly and periodic reports under Exchange Act Section 13(a) or 15(d), including filings by foreign private issuers and registered investment companies.

The certification requirement follows the language in Section 302 of the Sarbanes-Oxley Act. While the SEC staff has indicated that the adopting release contains a gloss on the "fairly presents" language of Section 302, the SEC has not narrowed the language with a reference to "in accordance with GAAP." The staff has confirmed that Section 302 certifications will be placed below the signature block in the applicable periodic report. Although Section 302 does not apply to proxy statements, a Section 302 certification in an annual report on Form 10-K covers any disclosure in the proxy statement that is incorporated by reference into the 10-K. The staff has also confirmed that Section 302 certifications are not required with respect to Form 11-K (annual report with respect to employee stock purchase, savings and similar plans).

The SEC also adopted Rules 13a-15 and 15d-15, which will require CEO and CFO certifications to cover "disclosure controls and procedures," which extend beyond internal controls. The SEC staff indicated that the rules do not specify particular requirements for evaluating the adequacy of internal controls or disclosure controls and procedures because this will vary by company.

4. Steps should a company take in support of SEC certifications.

The steps that a company and its executives take in support of a Section 302 and 906 and Section 21(a) certification will vary from company to company, depending upon such factors as the company's business structure, geographic dispersion, and existing control and financial reporting structures. In addition, the steps that a CEO takes may depend on the extent to which the CEO has traditionally been involved in the financial, as opposed to the operational, side of the company's business. Additional steps that companies and executives should consider taking include:

- Read and review the periodic report covered by the certificate.
- Review the company's existing procedures for the preparation of financial statements and for collecting, processing and disclosing information required under the periodic report (including the historical financial information).
- Discuss the periodic report with those who contribute to its drafting and content, including:

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  - discussing with the principal drafters of the filing the significant accounting and other issues they considered in preparing the filing, including issues to be addressed in any representation letters to the outside auditors and any issues raised in past SEC comment letters;
  - discussing with other senior officers any significant operational or financial issues that are or are not proposed to be disclosed in the filing;
  - confirming with internal accounting and auditing personnel that they are comfortable with the filing;
  - discussing with the company's outside auditor their review of the financial statements included in the filing and taking part in or being briefed on the auditor's SAS 71 discussions with the company's audit committee;
  - discussing with all of the above significant developments, as well as trends, in the business during the periods to which the filing relates.
- Conduct a careful compliance check of the filing through in-house or outside disclosure counsel to confirm full compliance with the requirements of Section 13(a) or 15(d) of the Exchange Act and the rules thereunder.
- Review internal control mechanisms required by Section 302.

While not required under the Sarbanes-Oxley Act, executives may also wish to meet with the company's audit committee to discuss the filing and the procedures that were undertaken with respect to its preparation.

While an executive may wish to document the steps that he or she took in support of the certification, we do not believe it necessary to chronicle specific disclosure areas that would not otherwise be documented.

E. The Sarbanes-Oxley Act of 2002: Issues for Immediate Attention

On July 31, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002.[32] This sweeping legislation addresses a number of issues of critical importance to public companies. Among its many provisions are ones establishing new disclosure requirements applicable to companies and their CEOs and CFOs, restricting certain executive officer and director transactions and accelerating Section 16 reporting, imposing new obligations on corporate audit committees, establishing a new regulatory body to oversee public company auditors and redefining the relationship between auditors and their clients, imposing new

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[32] The complete text of the act can be found at http://financialservices.house.gov/media/pdf/H3763CR_HSE.PDF.

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rules of professional responsibility on attorneys and securities analysts, and enhancing a variety of criminal penalties and enforcement measures for securities-related offenses. In addition, the Sarbanes-Oxley Act requires the SEC to study and issue reports on a variety of topics.

Many provisions of the Sarbanes-Oxley Act are applicable to any issuer that is subject to reporting requirements under Section 13(a) or 15(d) of the Exchange Act. As a result, many of the provisions are applicable to foreign companies that are subject to the Exchange Act. The provisions also are applicable to companies that have registered debt under the Securities Act or that have voluntarily or contractually undertaken to file Exchange Act reports, even though their equity securities may not be publicly traded.

The Sarbanes-Oxley Act covers a wide variety of issues. In many cases, the Sarbanes-Oxley Act instructs the SEC (alone or in conjunction with other regulatory organizations) to adopt implementing or clarifying regulations. In addition, the Sarbanes-Oxley Act provides the SEC general authority to adopt "such rules and regulations, as may be necessary or appropriate in the public interest or for the protection of investors, and in furtherance of" the Sarbanes-Oxley Act. Thus, the Sarbanes-Oxley Act's provisions may be subject to elaboration in the future.

While all of the Sarbanes-Oxley Act's provisions require close scrutiny by public companies, a few provisions require immediate attention. Following is a summary of those provisions which companies should consider most immediately and an overview of other aspects of the Sarbanes-Oxley Act that companies should be aware of. The SEC has indicated that it will publish an interpretive release addressing a number of the issues arising under the Sarbanes-Oxley Act.

1. Section 302 and 906 Certifications

As discussed above in Section II. C., the Sarbanes-Oxley Act contains two divergent certification provisions, each requiring CEOs and CFOs of public companies to certify to certain matters in periodic reports filed with the SEC, which are currently effective.

2. Ban on Loans to Executive Officers and Directors.

Section 402 of the Sarbanes-Oxley Act amends Section 13 of the Exchange Act to prohibit most loans by an issuer (including both U.S. and foreign public companies, and subsidiaries) to its executive officers and directors that are made, modified or renewed after enactment of the Sarbanes-Oxley Act. The provision is effective immediately, subject to the SEC's general rulemaking and exemptive authority.

- Under Section 402, companies may not directly or indirectly (including through a subsidiary) extend or maintain credit, arrange for the extension of credit, or renew any extension of credit, in the form of a personal loan to or for any executive officer or director of the company.
- The primary exceptions to this prohibition are:

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  - any loan that existed on July 30, 2002, so long as it is not thereafter materially modified or renewed;
  - home improvement and manufactured home loans, consumer credit, and credit extended under credit cards, provided in each case that such loans are (i) made in the ordinary course of the issuer's consumer credit business, (ii) of a type generally made available by the issuer to the public, and (iii) made on market terms or terms no more favorable than those offered to the general public; and
  - loans made by FDIC-insured banks and thrifts that are subject to existing insider lending restrictions of the Federal Reserve Act. However, this exception does not apply to non-U.S. banks whose securities are listed in the U.S.
- Because of the new focus on lending arrangements, many common compensation arrangements will need to be examined to determine if they are deemed to involve loans. For example, split dollar life insurance policies (where premiums are paid by an employer for a policy in the name of an executive and are repaid upon maturity of the policy), cashless option exercise arrangements (where a company issues shares upon exercise of an option and the broker pays the exercise price after settlement of a simultaneous sale of the option shares) and travel advances may each be deemed to involve unlawful extensions of credit. Another interpretive issue that will arise is whether a loan that was extended to an employee before he or she became an executive officer or director must be repaid when the person is elevated to one of those positions.

3. Section 16 Filing Deadlines.

Section 403 of the Sarbanes-Oxley Act amends Section 16(a) of the Exchange Act to shorten the due date for Section 16 insiders (directors, executive officers and greater than 10% beneficial owners) to file Section 16(a) transaction reports to two (2) business days after the transaction has been executed. The amendment is effective 30 days after enactment (i.e., August 29, 2002).

- The Sarbanes-Oxley Act authorizes the SEC to provide for later than 2-day reporting in any case in which it determines that such 2-day reporting is "not feasible." In addition, the SEC continues to have exemptive authority under Exchange Act Sections 12(h) and 36(a)(1) to prescribe due dates for Section 16 reports.

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- The SEC adopted rules to implement the accelerated reporting deadline on August 27, 2002.[33]
- Initially, insiders may continue to file Section 16 reports with the SEC in paper format. However, the Sarbanes-Oxley Act requires Section 16 reports to be filed electronically as of a date not later than one year after enactment, and at that time also requires companies to post the filings on their web sites.
- These provisions appear to obviate the need for most of the insider transaction reporting provisions which the SEC had proposed to impose on companies under Form 8-K. However, the SEC may continue to pursue some aspects of its provisions, such as requiring disclosure of insiders' trading plans that are intended to claim the benefit of Exchange Act Rule 10b5-1(c).

4. Corporate Responsibility.

The Sarbanes-Oxley Act also contains the following provisions regarding corporate responsibility and corporate governance:

a. Listing Standards Applicable to Audit Committees (§ 301).

- Summary: Requires the SEC, by April 27, 2003, to require the NYSE, Nasdaq and any other national securities exchange to prohibit listing any company that does not satisfy certain audit committee requirements. Specifically, a company's audit committee must:

  1) be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm engaged by the company;

  2) be composed entirely of independent directors, with "independence" defined to prohibit the director's receipt of any consulting, advisory or other compensatory fees from the company and to prohibit other affiliations with the company, subject to SEC exemptive authority;

  3) establish procedures to receive and respond to employee and others' complaints and concerns regarding the company's accounting or auditing matters;

  4) be authorized to engage independent counsel and other advisers; and

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[33] See Section II.B.1. above.

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5) be provided by the company with appropriate funding for engaging the company's outside auditors and any other counsel or advisors.

- The SEC is given authority to mandate these listing standards by rule, but it can be expected that the NYSE and Nasdaq will be proactive in implementing them.
- The SEC is to establish procedures that provide companies an opportunity to cure any defects that would result in their being delisted under these provisions.
- Effective Date: SEC rule must be effective no later than 270 days after enactment, but both NYSE and Nasdaq have already prepared listing rules changes that will all or most of these changes. These proposed rules will likely be adopted in fall 2002.

b. Disgorgement of Certain Executive Compensation upon Financial Statement Restatements (§ 304).

- Summary: Requires that CEOs and CFOs disgorge bonuses, other incentive- or equity-based compensation and profits on sales of issuer securities where an accounting restatement is required due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws as a result of misconduct. Disgorgement is required for such compensation received or profits realized during the 12-month period following the first public issuance or filing with the SEC (whichever occurs first) of a document embodying the noncompliant report. The SEC may exempt any person from the application of this provision as it deems necessary and appropriate.
- Effective Date: Immediately upon enactment. Note that there is no deadline by which the SEC must adopt exemptions.

c. Officer and Director Bars (§§ 305, 1105).

- Summary: Section 305 changes the standard governing judicial imposition of officer and director bars in SEC actions under Section 21(d)(2) of the Exchange Act and Section 20(e) of the Securities Act from "substantial unfitness" to "unfitness."
- Section 1105 amends Section 21C of the Exchange Act and Section 8A of the Securities Act to add new provisions giving the SEC authority to bar in an administrative cease and desist proceeding an individual who has violated Section 10(b) of the Exchange Act or Section 17(a)(1) of the Securities Act (anti-fraud provisions), or rules or regulations thereunder, from acting as an officer or director of a public company if the person's conduct demonstrates unfitness to serve as an officer or director of a public company.

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- Effective Date: Immediately upon enactment.

d. Insider Trades During Pension Fund Blackout Periods (§ 306).

- Summary: Prohibits executive officers and directors from acquiring or transferring company equity securities during pension fund "blackout periods." "Blackout period" is defined to include periods of more than three business days during which trading in the security by 50% or more of the beneficiaries or participants in a company retirement plan is suspended. The Employee Retirement Security Act of 1974 ("ERISA") is also amended to add provisions relating to blackout period notice requirements for plan administrators and related matters.
- Effective Date: 180 days after enactment. Note that both the SEC and the Secretary of Labor are required to issue rules under this provision. The Secretary of Labor must issue final rules within 75 days of enactment, but no deadline is provided for SEC action.

e. Improper Influence on Audits (§ 303).

- Summary: Makes it unlawful, under rules to be issued by the SEC, for an officer or director, or any person acting under the direction of an officer or director, to "fraudulently influence, coerce, manipulate or mislead" an auditor for the purpose of rendering the financial statements being audited materially misleading. The SEC is given sole civil enforcement authority to enforce this provision (i.e., no private cause of action is authorized).
- Effective Date: SEC to propose rules within 90 days of enactment and to issue final rules within 270 days.

f. Professional Conduct Rules for Attorneys (§ 307).

- Summary: Requires the SEC to establish minimum standards of professional conduct for attorneys practicing before the SEC in representation of public companies. The standards must include a requirement that attorneys report to the chief legal counsel or CEO of the company (and, if no appropriate response, the audit committee or the entire board of directors) evidence of material violations of the securities laws, breaches of fiduciary duty, and similar violations by public companies or their agents.
- Effective Date: SEC to issue final rules within 180 days of enactment.

g. Statute of Limitations for Securities Fraud (§ 804).

- Summary: Amends 28 U.S.C. 1658 to extend the statute of limitations for private rights of action involving claims of fraud, deceit, manipulation or contrivance in contravention of a

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regulatory requirement concerning the securities laws, to the earlier of (i) 2 years after discovery of the facts constituting the violation or (ii) 5 years after such violation.

- Effective Date: Applies to proceedings commenced on or after the date of enactment.

h. Whistleblower Protection (§ 806).

- Summary: Amends Federal criminal law to prohibit public companies and their employees, contractors, subcontractors or other agents from discriminating in the terms and conditions of employment with respect to employees who:

  1) provide information or assist in investigations of securities law violations by Federal regulatory or law enforcement agencies, Congress or company personnel with supervisory or investigatory authority, or

  2) file, testify, participate in, or otherwise assist in proceedings (including private actions) filed or about to be filed (with any knowledge of the employer) involving alleged violations of the securities laws or SEC regulations or securities fraud.

- An employee may seek relief under this provision by filing, within 90 days after the date of the violation, a claim with the Department of Labor, or, if a decision is not rendered by the Secretary of Labor within 180 days, bringing an action for *de novo* review in the federal district court of jurisdiction. Potential relief includes reinstatement, back pay with interest and compensation for special damages such as attorney's fees and other litigation costs.
- Effective Date: Immediately upon enactment.

i. Retaliation Against Informants (§ 1107).

- Summary: Amends 18 U.S.C. § 1513 (retaliation against a witness, victim or informant) to provide for fines and imprisonment of up to 10 years for anyone who "knowingly, with the intent to retaliate," takes any action harmful to any person, including interference with the lawful employment or livelihood of any person, for providing to a law enforcement officer any truthful information relating to the commission or possible commission of any Federal offense.
- Effective Date: Immediately upon enactment.

5. Disclosure Requirements

The Sarbanes-Oxley Act contains disclosure provisions as summarized below:

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a. Off-Balance Sheet Transactions (§ 401(a)).

- Summary: Requires the SEC to issue rules providing that each annual and quarterly financial report filed with the SEC disclose all material off-balance sheet transactions and other relationships of the issuer with unconsolidated entities or other persons that may have a material current or future impact on the issuer's financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenues or expenses.
- Effective Date: SEC to issue final rules within 180 days of enactment.

b. Pro Forma Financial Information (§ 401(b)).

- Summary: Requires the SEC to issue rules providing that issuers who disseminate "pro forma" financial information in their filings with the SEC, press releases or other public disclosures must present such information in a manner that does not contain an untrue statement or omit to state a material fact necessary in order to make the information, in light of the circumstances under which it is presented, not misleading, and must reconcile such information with the issuer's financial condition and the results of operations under generally accepted accounting principles.
- Effective Date: SEC to issue final rules within 180 days of enactment.

c. Material Correcting Adjustments (§ 401(a)).

- Summary: Amends Section 13 of the Exchange Act to require that each financial statement containing financial statements required to be prepared in accordance with (or reconciled to) generally accepted accounting principles reflect all material correcting adjustments that have been identified by an issuer's "registered public accounting firm" (as discussed below under "Auditor and Accounting Related Provisions") in accordance with generally accepted accounting principles and SEC rules.
- Effective Date: No deadline for SEC rulemaking provided.

d. Management Assessment of Internal Accounting Controls (§ 404).

- Summary: Requires the SEC to issue rules to require that each annual report contain an internal control report that (1) states the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting, and (2) contains an assessment, as of the end of the issuer's most recent fiscal year, of the effectiveness of the internal control structure and procedures. The issuer's outside auditor is

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required to attest to and report on management's assessment in accordance with the standards for attestation engagements adopted by the new Public Company Accounting Oversight Board established under the Act (as discussed below under "Auditor and Accounting Related Provisions").

- Effective Date: SEC to issue final rules within 180 days of enactment.

e. **Codes of Ethics for Senior Financial Officers (§ 406).**

- Summary: Requires the SEC to issue rules requiring (1) each issuer to disclose in periodic reports, whether or not it has adopted a code of ethics for senior financial officers and, if not, why not, and (2) the immediate disclosure on Form 8-K and dissemination by the Internet or other electronic means of any change in, or waiver of, the company's code of ethics for senior financial officers.
- Effective Date: SEC to propose rules within 90 days of enactment and issue final rules within 180 days.

f. **Audit Committee Financial Expert (§ 407).**

- Summary: Requires the SEC to issue rules to require issuers to disclose in periodic reports whether its audit committee includes among its members at least one "financial expert," and if not, why not. In defining the term "financial expert," the SEC must consider whether a person has, through education and experience as a public accountant or auditor or a principal financial officer, comptroller, or principal accounting officer of an issuer, or position involving similar functions, an understanding of generally accepted accounting principles and financial statements, experience in preparing or auditing financial statements, experience with internal accounting controls, and an understanding of audit committee functions.
- Effective Date: SEC to propose rules within 90 days of enactment and issue final rules within 180 days.

g. **SEC Review of Disclosures (§ 408).**

- Summary: Directs the SEC to review the disclosures of public companies on a regular and systematic basis, and in any event at least once every three years.
- Effective Date: Immediately upon enactment.

h. **"Real time" Disclosure (§ 409).**

- Summary: Supports SEC Chairman Pitt's "current reporting" initiative by amending Section 13 of the Exchange Act to add a

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requirement that each issuer make plain English disclosure on a "rapid and current basis" of such additional information concerning material changes in the financial condition or operations of the issuer as the SEC determines by rule.

- Effective Date: No deadline for SEC rulemaking provided.

6. Auditor and Accounting Related Provisions

The Sarbanes-Oxley Act also contains the following auditor and accounting related provisions:

a. Oversight Board (Title I).

- Summary: Establishes a new regulatory body, the "Public Company Accounting Oversight Board" ("Oversight Board"), to oversee the audit of public companies and companies offering securities to the public, and related matters, subject to oversight by the SEC.
- Effective Date: Members of the Oversight Board must be appointed by the SEC (in consultation with the Federal Reserve Chairman and the Secretary of Treasury) within 90 days of enactment, and the Oversight Board must be organized in accordance with and have the capacity to carry out the requirements of Title I of the Act within 270 days of enactment.

b. Auditor Qualifications; Registration, Oversight and Independence (§ 102; Title II).

- Summary: Requires firms that audit the financial statements of an issuer that has filed a registration statement under the Securities Act of 1933 or that is registered under Section 12 or 15 of the Exchange Act to be registered with and subject to oversight by the Oversight Board. The firms are required to be registered within 180 days after the SEC had determined that the Oversight Board is functional. (§ 102)
- The Act further regulates and redefines the relationship between a registered public accounting firm and its audit clients:
    - *Non-Audit Services (§ 201)*. Amends Section 10A of the Exchange Act to prohibit registered public accounting firms from providing eight categories of non-audit services to their audit clients, including financial information systems design and implementation, valuation services and internal audit outsourcing services. The Oversight Board may, subject to SEC review, exempt any person, issuer, accounting firm or transaction from this provision on a case-by-case basis.

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- *Audit Committee Pre-Approval of Auditor Services (§ 202)*. Amends Section 10A of the Exchange Act to require audit committee pre-approval of all services provided by an issuer's outside auditor, subject to a *de minimis* exception. The audit committee may delegate pre-approval authority to one or more members of the audit committee, and pre-approvals for audit-related services may be made in connection with approval of the audit engagement. Pre-approval of non-audit services to be performed by the issuer's auditor must be disclosed in periodic reports.
- *Audit Partner Rotation (§ 203)*. Amends Section 10A of the Exchange Act to provide that the lead (or coordinating) audit partner and the reviewing audit partner of the registered public accounting firm cannot perform audit services for the same issuer for more than five consecutive fiscal years.
- *Auditor Communication With Audit Committee (§ 204)*. Amends Section 10A of the Exchange Act to require that registered public accounting firms shall timely report to audit committees on critical accounting policies and practices, alternative treatments of financial information that have been discussed with management, and other material written communications with management.
- *Restrictions on Employment of Auditor Personnel (§ 206)*. Amends Section 10A of the Exchange Act to prohibit registered public accounting firms from providing audit services to issuers whose CEO, CFO or chief accounting officer (or any person serving in an equivalent position) was employed by the audit firm and participated in the issuer's audit in any capacity within one year of audit initiation.

- Effective Date: While the effective date is not specifically described in the Act, these provisions are not effective until after the Oversight Board is operational and the auditing firm has qualified as a "registered public accounting firm."

III. Updates on Financial Disclosure

In late 2001 and early 2002, the SEC made several important statements that reflect an intense focus on financial disclosure, particularly in the wake of the Enron Corp. bankruptcy and the ensuing Congressional hearings. The SEC's Chairman and its Chief Accountant have echoed many of the themes articulated by the SEC in its statements. In these statements, the SEC:

- has encouraged companies to identify, analyze and disclose their critical accounting policies and practices;

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- for the first time, offered formal guidance about the use of "pro forma" financial information;
- indicated the importance of the audit committee's role in reviewing accounting principles and related disclosure;
- set forth the process, articulated by the SEC's Chief Accountant, for consultation with the SEC staff in advance of the issuance of financial statements that companies and auditors should consider utilizing in appropriate circumstances; and
- indicated that its Division of Corporation Finance has decided to monitor annual reports filed by all Fortune 500 companies that file periodic reports with the SEC in 2002 as part of its process of reviewing financial and non-financial disclosures made by public companies.

A. General

The SEC has issued two releases containing cautionary advice for companies, their audit committees and their advisors about financial disclosure. The first release, issued on December 4, 2001, concerns the use of "pro forma" numbers in earnings releases and was issued in conjunction with an "Investor Alert" intended to assist shareholders in analyzing pro forma financials.[34] The second release, issued on December 12, 2001, sets forth the views of the Commission as to disclosures it now expects to see in companies' Management's Discussion and Analysis of Financial Condition and Results of Operation ("MD&A") relating to accounting policy decisions.[35] The release also discusses relationships between companies and their auditors, and in particular, the required content of the dialogue between auditors and the audit committee.

On December 21, 2001, the SEC indicated that the Division of Corporation Finance will monitor annual reports filed by all Fortune 500 companies that file periodic reports with the SEC in 2002 as part of its process of reviewing financial and non-financial disclosures of public companies. According to the SEC:

> [t]hrough this process, the Division will focus on disclosure that appears to be critical to an understanding of each company's financial position and results, but which, at least on its face, seems to conflict significantly with generally accepted

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[34] *Cautionary Advice Regarding the Use of "Pro Forma" Financial Information in Earnings Releases*, Release No. 33-8039, 34-45124 (Dec. 4, 2001).

[35] *Cautionary Advice Regarding Disclosure About Critical Accounting Policies*, Release No. 33-8040, 34-45149 (Dec. 12, 2001).

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accounting principles or Commission rules, or to be materially deficient in explanation or clarity.[36]

It is important to note that these are official statements by the entire Commission and not simply staff guidance.

B. Pro Forma Financial Information.

The SEC's cautionary advice about pro forma financial information is intended to "sound a warning" to companies and their advisors about the presentation of earnings and results of operations on the basis of methodologies other than Generally Accepted Accounting Principles ("GAAP"). As Robert K. Herdman, the SEC's Chief Accountant, recently noted, the troubled economy seems to have increased the tendency to report quarterly earnings on a basis other than GAAP.[37]

In the release, the SEC acknowledges that pro forma financial information can be useful because, among other things, it can focus investor attention on significant components of a company's financial results. According to the SEC, a presentation of financial data that focuses on particular components of a company's financial results or calculates financial results on a basis other than GAAP will not be deemed to be misleading simply because it deviates from GAAP. At the same time, the SEC believes that pro forma financial information can mislead investors because this information has no defined meaning and no uniform characteristics. This makes it difficult for investors to compare a company's pro forma financial results with results from other operating periods and other companies.

Accordingly, the SEC alerts companies that they should:

- be mindful of their obligation not to mislead investors when distilling information from financial results prepared in accordance with GAAP because the antifraud provisions of the federal securities laws apply to companies issuing pro forma financial information;
- describe accurately the principles that they have used to arrive at particular pieces of information, such as EBITDA, in order to inform investors fully;
- pay attention to the information that they omit from a pro forma presentation because the presentation may be misleading if it omits material information, such as particular transactions or information about how numbers might compare to other periods; and

[36] *See Program to Monitor Annual Reports of Fortune 500 Companies* (Dec. 21, 2001) (available at http://www.sec.gov/news/digest/12-21.txt).

[37] *See Advancing Investors' Interests*, *Speech before the American Institute of Certified Public Accountants* (Dec. 6, 2001) (available at http://www.sec.gov/news/speech/spch526.htm).

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- consider and follow the best practices issued by the Financial Executives International and the National Investor Relations Institute in their "Earnings Press Release Guidelines."[38]

The message underlying the SEC's cautionary advice is that companies should proceed with care in determining whether to issue pro forma results and how to structure pro forma presentations.[39] To avoid misleading investors, companies that choose to release pro forma results should disclose any assumptions on which the results are based and include a clear, plain English explanation of how the results differ from financial statements prepared in accordance with GAAP.

C. Disclosure About Critical Accounting Policies.

On May 10, 2002, the SEC proposed a new disclosure requirement for companies to include a separately-captioned section within the MD&A to discuss the application of critical accounting policies.[40]

The proposed rules would require two types of disclosures:

- a discussion of specific aspects of the critical accounting estimates that are made by a company in applying accounting policies, and

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[38] Available at http://www.niri.org/publications/alerts/ea042601.cfm. According to these best practices, pro forma results reported in earnings releases should *always* be accompanied by a "clearly described reconciliation" to GAAP. In addition, reconciliations between GAAP and pro forma results should be prepared in a similar manner for comparable periods, so that elements of the reconciliation are not presented for one period without including similar elements in the reconciliations for other periods.

[39] In this regard, the SEC announced on January 16, 2002, that it had brought its first enforcement case regarding pro forma earnings. The SEC issued cease-and-desist proceedings against Trump Hotels & Casino Resorts Inc. for making misleading statements in the company's third-quarter 1999 earnings release. *See SEC Brings First Pro Forma Financial Reporting Case: Trump Hotels Charged With Issuing Misleading Earnings Release* (Jan. 16, 2002) (available at http://www.sec.gov/news/headlines/trumphotels.htm).

[40] *Disclosure in Management's Discussion and Analysis about the Application of Critical Accounting Policies*, Release No. 33-8098, 34-45907 (May 10, 2002). The proposed rule followed an earlier SEC Release (Release No. 33-8040 (Dec. 12, 2001)), which discussed the need for enhanced investor awareness of critical accounting policies. The December release encouraged companies to focus on the evaluation of the critical accounting policies in a company's financial statements, audit committee review of critical accounting policies, and consultation with the Staff in advance of issuance of its financial statements. In its discussion of the proposed rules in the April 30 release, the Staff stated that it viewed many companies' efforts to respond to the December 12 release as falling short of what the SEC sought.

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- specific disclosures regarding a company's initial adoption of an accounting policy.

One of the stated goals of the new proposals is to lead to a better understanding by investors that, although financial statements are stated in terms of precise numbers and drive to a "bottom line" result, there are varying degrees of estimates and subjectivity that go into the production of the financial statements.

1. Critical Accounting Estimates

The proposals define an accounting estimate recognized in the financial statements as a "critical accounting estimate" if:

- the accounting estimate requires the company to make assumptions about matters that are highly uncertain at the time the accounting estimate is made; and
- different estimates that the company reasonably could have used in the current period, or changes in the accounting estimate that are reasonably likely to occur from period to period, would have a material impact on the presentation of the company's financial condition, changes in financial condition or results of operations.

The proposals would require MD&A disclosure in the Form 10-K and in registration statements of the following information with respect to each critical accounting estimate:

- a discussion that identifies and describes the estimate, the methodology used, certain assumptions and reasonably likely changes;
- an explanation of the significance of the accounting estimate to the company's financial condition, changes in financial condition and results of operations and, where material, an identification of the line items in the company's financial statements affected by the accounting estimate;
- a quantitative "sensitivity" discussion of how line items in the financial statements and overall financial performance would change if the company were to assume that the accounting estimate changed (a company could satisfy this either by discussing reasonably possible near-term changes in certain assumption(s) underlying the accounting estimate or by discussing the reasonably possible range of the accounting estimate);
- a quantitative and qualitative discussion of any material changes made to the accounting estimate, the reasons for the changes and the effect of the change on line items in the financial statements and overall financial performance;
- a statement of whether or not the company's senior management has discussed the development and selection of the accounting estimate, and the MD&A disclosure regarding it, with the company's audit committee; and

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- if the company operates in more than one segment, an identification of the segments of the company's business the accounting estimate affects, and a discussion of the estimate on a segment basis, mirroring the discussion required on a company-wide basis.[41]

The proposals also would require companies to update the foregoing disclosures in each Form 10-Q to the extent necessary to reflect any material changes.

2. Initial Adoption of Accounting Policies

The proposals would require MD&A disclosure in Forms 10-K and registration statements regarding a company's initial adoption of an accounting policy if the accounting policy was adopted in the past year and had a material impact on the company's financial condition, changes in financial condition or results of operations. This disclosure was analogized to the disclosures currently required when companies change accounting principles or when new accounting standards are adopted by FASB (as defined below), but would require companies to disclose:

- the accounting principle that has been adopted and the method of applying that principle;
- the events or transactions that gave rise to the initial adoption of the accounting policy;
- the impact on the company's financial condition, changes in financial condition and results of operations, discussed on a qualitative basis;
- if the company is permitted a choice between acceptable principles, an explanation that it has made such a choice, what the alternatives were, and why it made the choice it did; and
- if no accounting literature exists that governs the accounting for the events or transactions giving rise to the initial adoption, an explanation of the company's decision regarding its selection and application of the accounting principle it determined to use.[42]

If alternative accounting policies were available at the time a company initially adopted an accounting policy, the disclosures would not specifically require the effect of the available alternative policies to be quantified, but would require a qualitative discussion as to the effect of the policy that was adopted. This qualitative discussion might include a comparison of the effect of the policy relative to the effect that other possible accounting policies would have.

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[41] *Id.*

[42] *Id.*

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D. MD&A Guidance.

With respect to disclosures required in MD&A, the "Big 5" accounting firms, with the endorsement of the American Institute of Certified Public Accountants, recently petitioned the SEC to issue an interpretive release that would provide guidance to public companies about preparing MD&A disclosure for inclusion in their SEC filings.[43] On January 22, 2002, the SEC responded to this petition by issuing an interpretive release providing guidance to companies about preparing MD&A disclosure.[44] The statement, however, does not create new legal requirements. Instead it is meant to "remind" corporations "that disclosure must be both useful and understandable" and to "suggest steps [companies] should take in meeting their disclosure obligations." The release specifically addresses MD&A disclosure requirements as they relate to liquidity and capital resources, including off-balance sheet arrangements, certain trading activities that include non-exchange traded contracts accounted for at fair value and effects of transactions with related and certain other parties.[45]

In the release, the SEC stated that the disclosure threshold under parts of MD&A is whether a situation, event, trend or uncertainty is "reasonably likely" to have an effect on the company and, in particular, the liquidity of the company. For example, with regard to liquidity, the SEC recommended that registrants consider describing the sources of short-term funding and "the circumstances that are reasonably likely to affect those sources of liquidity."[46] The SEC also stated that "reasonably likely" is a lower threshold than "more likely than not."[47] However, the release reminded registrants that the final determination resulting from the assessments made by management must be "objectively reasonable, as viewed at the time the determination is made."[48]

The SEC also recommended registrants consider applying this "reasonably likely" standard to off-balance sheet transactions that are reasonably likely to materially affect liquidity or the availability of capital resources. Furthermore, the Commission suggested

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[43] *See Petition to U.S. Securities and Exchange Commission for Issuance of Interpretive Release* (Dec. 31, 2001) (available at http://www.sec.gov/rules/petitions/petndiscl-12312001.htm).

[44] *Commission Statement about Management's Discussion and Analysis of Financial Condition and Results of Operations*, Release No. 33-8056, 34-45321 (Jan. 22, 2002).

[45] *Id.*

[46] *Id.*

[47] *Id.*

[48] *Id.*

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that these disclosures of off-balance sheet transactions be "clear and individually tailored to describe the risks to the registrant" and that mere boilerplate language is insufficient.[49]

Second, the SEC recommended that contractual commitments be presented together in a single table, in order to assist investors in understanding future demands on liquidity.[50] Such a table would allow the investor to have a total picture of the obligations currently placed upon the company.

Finally, in addressing disclosure of related party transactions, the SEC states that disclosure of relationships may be necessary even when the relationships are not covered by Item 404 of Regulation S-K or Financial Accounting Standards No. 57. For example, companies should consider whether greater detail is appropriate concerning transactions with other companies where the equity method of accounting is applied.[51] The release suggested that registrants also consider disclosing transactions with parties that do not fall under the definition of a "related party," but whose past relationships with the company or its management enable the company to negotiate transactions that would not be available under traditional "arms-length" negotiations.[52]

E. Statements by SEC Chairman Harvey L. Pitt and Chief Accountant Robert K. Herdman

Many of the principles articulated by the Commission in its releases on financial disclosure highlight themes that SEC Chairman Harvey L. Pitt and SEC Chief Accountant Robert K. Herdman have addressed in recent statements. In a December 2001 *Wall Street Journal* article, Chairman Pitt encouraged the public and private sectors to work together to ensure that investors receive information that is current, clear and informative.[53] In this regard, he encouraged: (1) disclosure of more "trend" and "evaluative" data; (2) identification of critical accounting policies and information about the range of possible effects in differing applications of these policies; and (3) more meaningful investor protection by audit committees, which must be proactive rather than reactive and have the ability to interact effectively with senior management and outside auditors.

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[49] *Id.*

[50] *Id.*

[51] *Id.*

[52] *Id.* An entity whose management is made up of the former management of a company is an example of a potential disclosure in this situation.

[53] *See How to Prevent Future Enrons* (Dec. 11, 2001) (available at http://www.sec.gov/news/speech/spch530.htm).

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In a speech before the American Institute of Certified Public Accountants, SEC Chief Accountant Herdman announced a "three-point plan" for the SEC, the corporate community, the accounting profession and standard-setting bodies such as the Financial Accounting Standards Board ("FASB") to work together "to advance, not just protect, the interests of investors."[54] The three points of the plan are to:

- "get it right the first time" by encouraging companies to pre-clear with the SEC Staff their proposed accounting treatment of novel and unusual accounting questions, so their financial statements contain appropriate disclosure the first time around;
- improve the effectiveness of standard-setting processes; and
- modernize financial reporting and disclosure by providing investors with more timely and understandable financial information.

The third point of Chief Accountant Herdman's plan – to modernize the existing financial reporting and disclosure system in the United States – echoes the agenda announced by Chairman Pitt in his first speech as SEC Chairman.[55] As part of this effort, the SEC proposes to consider whether: (1) in an age of instant communication, a system of "current" disclosure would be more appropriate, so that companies would have an affirmative obligation to disclose "unquestionably" material information as soon as it arises and a company becomes aware of it, even if this happens before the due date of the company's next periodic report; (2) to require broader disclosure of trend information; (3) to simplify financial disclosure in order to make financial statements more useful to ordinary investors; and (4) to update the current accounting model to include disclosure about, or accounting for, intangibles. While this project is still in its initial stages, Chief Accountant Herdman predicted that the likely next step will be for the SEC to issue a concept release identifying the relevant issues and soliciting public input.[56]

F. Guidance for Companies

Companies, boards and audit committees should consider how they can incorporate the SEC's guidance into the processes by which they prepare and review their financial disclosure. Some specific steps that companies may wish to consider are outlined below.

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[54] *See Advancing Investors' Interests*, *Speech before the American Institute of Certified Public Accountants* (Dec. 6, 2001) (available at http://www.sec.gov/news/speech/spch526.htm).

[55] *Remarks Before the AICPA Governing Council* (Oct. 22, 2001) (available at http://www.sec.gov/news/speech /spch516.htm).

[56] *See* Section II of this outline regarding the SEC's proposed rules on accelerated disclosure.

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1. Discuss the SEC's guidance on financial disclosure with the audit committee and have the committee consider its role with respect to critical accounting policies.

Companies should continue to discuss the issues raised in the SEC's releases on financial disclosure with the audit committee. The SEC has addressed the role that audit committees should play with respect to a company's critical accounting policies. Audit committees should understand why critical accounting policies were chosen and how they have been applied, and should have a basis for believing that the end result – the financial disclosure – fairly presents the company's status. In light of this, audit committees should develop a plan for reviewing the selection, application and disclosure of critical accounting policies. Engaging in a proactive dialogue with management should be an important part of the audit committee's review.

2. Consider with legal counsel and outside auditors whether to make changes to MD&A.

Calendar-year companies should consider with their legal counsel and outside auditors whether to make changes in their MD&A. Companies should also consider whether to make changes in their year-end earnings releases to conform to the anticipated MD&A changes. This is particularly true of the SEC's guidelines on the use of pro forma financial information. Companies that have not previously provided very clear disclosure of the differences from GAAP numbers, and a reconciliation to GAAP, should consider doing so.

3. Furnish appropriate disclosure of negative news.

In his December 6, 2001 speech, Chief Accountant Herdman reminded companies of the difficult disclosure issues that a troubled economy presents. In light of the economic downturn that occurred in 2001, and the economic consequences that the September 11 attacks have had for some industries, he emphasized the importance, when disclosing negative news, of applying the accounting principles and disclosure requirements set forth in the SEC's releases, including its guidelines about MD&A disclosure.

4. Assess the transparency of disclosure proposed for inclusion in periodic reports.

Chief Accountant Herdman has proposed several steps that companies and their auditors should take to enhance the transparency of their financial disclosure. First, companies should look at their accounting policies and identify the top three, four or five policies that require significant judgment or complex estimates. Second, companies should assess both the sufficiency of these policies and the explanatory information that accompanies any figures in the financial statements that are subject to these judgments and estimates. Third, companies should consider whether their disclosure provides investors with enough information about the impact of these judgments and estimates on the financial statements. Finally, companies should

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challenge themselves to improve their disclosures, either in the financial statements or MD&A.

5. Consider pre-clearing novel or unusual accounting issues with the SEC Staff.

Companies that face difficult or unusual accounting issues should consider seeking guidance from the SEC Staff. In his December 6 speech, Chief Accountant Herdman encouraged this practice and addressed the responsibilities of companies and their auditors when seeking such guidance. Companies should provide the SEC Staff with a clear and comprehensive submission that explains the issue or transaction, the accounting alternatives considered and the reasons for the accounting treatment being proposed by the company. Companies should also consider and provide the Staff with input on any related questions that they believe the staff would need to address. Finally, companies should inform the staff about the audit committee's views of the proposed accounting treatment.

IV. Corporate Governance Developments

The President, Congress, the Commission, the major securities markets, institutional investors and others have also called for changes in corporate governance practices. The changes proposed and/or passed into law as of August 15, 2002 reflect a number of common themes, including:

- a continued and expanded emphasis on the independence of the board as a whole, including heightened independence standards, requirements for independence determinations, and consideration of "soft" factors such as close relationships with management, political contributions and ties to non-profit organizations that receive corporate contributions;
- the establishment of three key committees of the board – audit, nominating/corporate governance and compensation – each composed entirely of independent directors;
- the development and publication of corporate governance principles and codes of conduct for officers and directors;
- CEO certification requirements; and
- broadened shareholder approval requirements for equity-based compensation plans.

In the wake of the proposals, companies should undertake a corporate governance audit. Although the corporate governance requirements that have been proposed – and particularly the recommended changes to the listing standards of the NYSE and Nasdaq – are not yet in final form, it is not too early to begin assessing their impact. A proactive approach will position companies to comply with the requirements, when implemented, effectively and with minimal disruptions. Moreover, in a time when the investing public has been increasingly vocal in demanding change, prompt attention to corporate governance issues could yield investor relations benefits.

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A. The Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act of 2002, signed into law on July 31, 2002, contained a number of corporate governance provisions. The Act is discussed in detail in Section II.D. of this outline, with an analysis of the corporate governance provisions in Sections II.D.4, 5 and 6.

B. Other Proposals to Enhance Corporate Governance Requirements

On June 6, 2002, the NYSE issued the report of its Corporate Accountability and Listing Standards Committee (Listing Standards Committee), which contains recommendations for comprehensive changes to the NYSE's corporate governance listing standards. Two weeks prior to that, on May 24, Nasdaq announced an initial set of changes to its corporate governance listing standards and indicated that it will be considering additional proposals throughout the summer. On May 14, The Business Roundtable, an association of chief executives of the largest companies in the United States, issued its Principles of Corporate Governance (2002), designed to assist corporate management and boards of directors in their individual efforts to implement corporate governance best practices. On July 16, 2002, the American Bar Association's Taskforce on Corporate Responsibility released its report with suggested procedures for companies to follow and guidelines for attorneys representing corporations on corporate governance issues. On August 1, 2002, the NYSE board approved for filing with the SEC most of the Listing Standards Committee's recommendations, and on August 15, 2002, the NYSE filed its prepared changes with the SEC.

The specific elements of the NYSE and Nasdaq proposed changes are outlined below, followed by a summary of the best practices recommended by The Business Roundtable. Companies should keep in mind that the NYSE and Nasdaq proposals have been submitted to the SEC for approval and put out for public comment, so there may be revisions in the final listing standards.

1. The Major Securities Markets

In February 2002, SEC Chairman Pitt asked both the NYSE and Nasdaq to review their corporate governance listing standards.[57] Among the issues he asked them to address were the need for mandatory codes of conduct, continuing education and ethical training for officers and directors, and whether audit committee requirements should be strengthened by, for example, vesting audit committees with exclusive authority to hire and fire the outside auditor. In addition, Chairman Pitt reiterated his emphasis on the need for full, continuous disclosure by public companies.

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[57] *Pitt Seeks Review of Corporate Governance, Conduct Codes* (Feb. 13, 2002) (available at http://www.sec.gov/news/press/2002-23.txt).

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(a) The New York Stock Exchange

At Chairman Pitt's urging, the NYSE formed a Corporate Accountability and Listing Standards Committee ("Listing Standards Committee") of its board of directors to review listing requirements and matters involving corporate governance.[58] The purpose of the committee is to "gather input from the various constituencies of the Exchange and the financial-services industry to provide guidance to the NYSE and industry governing bodies on measures to bolster public confidence."[59] On June 6, 2002, the NYSE committee issued a report to the NYSE board of directors setting forth recommended changes to the NYSE's corporate governance listing standards, as well as recommendations to the SEC and Congress on regulatory and legislative changes.[60] On August 1, 2002, the NYSE announced its board of directors had approved the final recommendations from the Listing Standards Committee recommendations in the June report, and on August 15, 2002, the proposed changes were filed with the SEC.[61] The final recommendations, which have now been sent to the SEC for review, include changes in the following areas:[62]

(1) Board independence.

- The board must have a majority of independent directors. Companies would have 24 months to comply with the new independence rule and would be required to publicly disclose when they have achieved majority independence.
- Controlled companies, in which more than 50 percent of the voting power is held by an individual, group or another

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[58] *NYSE Appoints Special Board Committee To Advise on Corporate Governance: NYSE Corporate Accountability and Listing Standards Committee* (Feb. 13, 2002) (available at http://www.nyse.com/press/NT00072CAE.html).

[59] *Id.*

[60] The recommendations and the full text of the report are available at http://www.nyse.com/pdfs/corp_recommendations_nyse.pdf and http://www.nyse.com/pdfs/corp_govreport.pdf, respectively.

[61] *NYSE Approves Measures to Strengthen Corporate Accountability*, (Aug. 1, 2002) (available at http://www.nyse.com/press/press.html). *NYSE Files Changes to Listing Standards with SEC*, (Aug. 16, 2002) (available at http://www.nyse.com/press/press.html).

[62] The NYSE's filing with the SEC is available at http://www.nyse.com/pdfs/corp_gov_pro_b.pdf.

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company, rather than the public, need not meet this board independence requirement.

- For a director to be deemed "independent," the board must affirmatively determine that the director has no material relationship with the listed company other than service as a director.
- The basis for board determinations that a relationship is not material must be disclosed in the company's proxy statement. The board may adopt and disclose categorical standards to assist it in making independence determinations, and may make a general disclosure if a director meets these standards. Any determination of independence for a director who does not meet the standards must be specifically explained.
- A five-year "cooling off" period applies, during which the following are not considered independent:

  1) a former employee of the listed company;[63]

  2) a former employee of the listed company's present or former (within the past five years) outside auditor;

  3) a former employee of any company whose compensation committee includes an executive officer of the listed company; and

  4) any immediate family member of the above.[64]
- Employment of a family member in a non-officer position does not preclude a board from determining a director is independent. In addition, if an executive officer dies or becomes incapacitated, his or her immediate family members may be classified as independent immediately

[63] A director who serves as interim chairman or CEO may be deemed independent immediately after service in this capacity ends.

[64] Immediate family members include a person's spouse, parents, children, siblings mothers and fathers-in-law, sons and daughters-in-law, brothers and sisters-in-law, and anyone (other than an employee) who lives in the same home. Employment of a family member in a non-officer position does not preclude a board from determining a director is independent. In addition, if an executive officer dies or becomes incapacitated, his or her immediate family members may be classified as independent immediately after such death or determination of incapacity, provided that they themselves are otherwise independent.

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after such death or determination of incapacity, provided that they themselves are otherwise independent.

(2) Executive sessions of the board/presiding director.

- Non-management directors must meet at regularly scheduled executive sessions without management.
- If one director is chosen to preside at the executive sessions, the company must disclose his or her name in its proxy. The company, however, does not have to select one director to preside, and it may disclose the procedure by which a director is chosen to preside at each individual executive session. According to the report of the Listing Standards Committee, this disclosure is intended to facilitate communications by employees and shareholders directly with non-management directors.

(3) New requirements for audit committee members and audit committees.

- Audit committees must be composed entirely of independent directors.
- Director's fees are the only compensation an audit committee member may receive from the company. Prohibited compensation includes fees paid to a director's firm for consulting, legal or advisory services, even if the director is not the actual service provider.
- If an audit committee member simultaneously serves on the audit committee of more than three public companies, and the listed company does not limit the number of audit committees on which its audit committee members serve, then the board must determine that such simultaneous service would not impair the ability of such member to effectively serve on the listed company's audit committee and disclose such determination in the annual proxy statement. Receipt of a pension or other form of deferred compensation for prior service (provided it is not contingent on continued service) would not prevent compliance with this standard.
- The purpose of the audit committee, which must be set forth in its charter, at a minimum must be to prepare the report included in the annual proxy statement and to assist in board oversight of:

  1) the integrity of the company's financial statements;

  2) compliance with the legal and regulatory requirements;

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3) the outside auditor's qualifications and independence; and

4) performance of the company's internal audit function and of the outside auditor.

- The audit committee must perform additional substantive responsibilities, which must be set forth in its charter. The audit committee must:

  1) have sole authority to retain and terminate the outside auditor, including sole authority to approve all audit engagement fees and terms;

  2) discuss earnings releases, and financial information and earnings guidance provided to analysts and rating agencies;

  3) discuss the company's policies on risk assessment and management;[65]

  4) obtain and review, at least annually, a report by the outside auditor describing the auditor's internal quality control procedures and all relationships between the auditor and the company;

  5) discuss the annual audited financial statements and quarterly financial statements with management and the outside auditor, including the company's MD&A disclosures;

  6) have the authority, without seeking board approval, to obtain advice and assistance from outside legal, accounting or other counsel or consultant;

  7) meet separately, periodically, with management, internal auditors and the outside auditor;

  8) review with the outside auditor any difficulties encountered in the course of its audit work and management's response;

  9) set clear hiring policies for employees or former employees of the outside auditor;

  10) report regularly to the board of directors; and

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[65] The proposed rules recognize it is the job of the company's CEO and senior management to assess and manage the company's exposure to risk, however the proposals indicate the audit committee must discuss guidelines and policies to govern the process by which senior executive officers handle these tasks.

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11) undertake an annual evaluation of the committee's effectiveness.

- In addition to assuring the regular rotation of the lead audit partner as required by the Sarbanes-Oxley Act, the audit committee should further consider whether, in order to assure continuing auditor independence, there should be regular rotation of the audit firm itself. The NYSE does not mandate periodic rotation of audit firms because it believes that this may undercut the effectiveness of the auditor and disrupt the quality of the audit. The audit committee should make its own decision about whether the company is obtaining high-quality audits and whether rotating the auditor would be helpful for the company.
- Every listed company must have an internal audit function.

(4) Nominating/corporate governance and compensation committees.

- Companies must have a nominating/governance committee and a compensation committee.
- Each committee must be composed entirely of independent directors and must have a written charter. Controlled companies need not meet the independence requirement for these committees.
- Companies must have one independent director on the committee within 12 months of SEC approval and must fully comply with the independence requirement within 24 months of SEC approval.
- Companies may allocate the responsibilities of the nominating and compensation committees to committees of their own denomination; however, regardless of the name, the committees must still be composed entirely of independent directors.
- The nominating/corporate governance committee must have a written charter that identifies the committee's purpose, which must, at a minimum, be to:
- 1) identify individuals qualified to become board members and recommend that the board select these nominees; and
- 2) to develop and recommend a set of corporate governance principles to the board.
- The charter for the nominating/corporate governance committee must set out the committee's goals and responsibilities, which must, at a minimum, reflect for the

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board's criteria for selecting new directors and oversight of evaluation of the board and management.

- The compensation committee must have a written charter that identifies the committee's purpose, which must, at a minimum, must be to:
- 1) discharge the board's responsibility relating to compensation of executives; and
- 2) produce an annual report on executive compensation for inclusion in the annual proxy statement.
- The charter for the compensation committee must also set forth the committee's duties and responsibilities, which must, at a minimum, be to:
- 1) review corporate goals and objectives relative to executive compensation, evaluate CEO performance in light of these corporate objectives and set CEO compensation based on achievement of the objectives; and
- 2) make recommendations to the board regarding equity and incentive based compensation plans.
- Both the nominating/corporate governance and compensation committee charters must provide for an annual evaluation of the committee.
- Although not a mandatory standard, the NYSE advises that the nominating/corporate governance committee and the compensation committee should have sole authority, without requiring full board action to retain and terminate outside advisors, such as search firms used to identify director candidates and compensation consultants.

(5) CEO certification.

The NYSE indicated it would defer to the Sarbanes-Oxley Act regarding CEO certifications on the quality of disclosure, however, the CEO must still certify annually to the NYSE that the company has complied with NYSE listing standards.

(6) Shareholder approval of option plans.

- Shareholders must vote to approve or disapprove all equity compensation plans, except employment inducement option plans, option plans acquired through mergers and certain tax qualified option plans such as ESOPs and 401(k)s.

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- Brokers may not vote customer shares on any equity compensation plans unless the broker has the customer's instructions to do so.[66]
- These provisions will take immediate effect upon SEC approval.

(7) Corporate governance principles.

- Companies must adopt a set of corporate governance principles and post these principles on their web sites.
- The corporate governance guidelines must address:
- 1) director qualification standards;
- 2) director responsibilities;
- 3) director access to management and, as necessary and appropriate, independent advisors;
- 4) director compensation, including general principles for determining the form and amount of director compensation and for reviewing those principles;
- 5) director orientation and continuing education;
- 6) management succession; and
- 7) an annual performance evaluation of the board to determine the how effectively the board and its committees are functioning.

(8) Codes of business conduct and ethics.

- Companies must adopt and disclose (including by posting on their web sites) a code of business conduct and ethics for directors, officers, and employees. The code must require that any waivers of compliance with the code for directors or executive officers be made only by the board or a board committee and that such waivers be promptly disclosed to shareholders. The code must also contain compliance standards and procedures that ensure prompt and consistent action against violations of the code.
- A code of business conduct and ethics should address: conflicts of interest; corporate opportunities;

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[66] Under current NYSE listing standards, brokers are only prohibited from voting without customer instructions where the plan to be voted on would authorize the issuance of stock in an amount exceeding 5% of the total outstanding.

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confidentiality; fair dealing with the company's customers, suppliers, competitors and employees; protection and proper use of company assets; compliance with laws, rules and regulations, including laws on insider trading; and reporting illegal or unethical behavior.

(9) CEO certification of compliance with listing standards and penalties for violations.

- The CEO of each listed company must certify to the NYSE annually that he or she is not aware of any violation by the company of the NYSE's corporate governance listing standards. The NYSE certification, and any CEO/CFO certifications required to be filed with the SEC regarding the quality of the company's public disclosure, must be disclosed in the company's annual report.
- NYSE may issue public reprimand letters to listed companies that violate listing standards.

(10) Foreign issuers.

- Listed foreign private issuers must disclose, in a brief, general summary, significant ways in which their corporate governance practices differ from those of domestic companies listed on the NYSE.

(11) Web sites.

- Companies must post charters for the nominating/governance committee, compensation committee, audit committee and other important committees, along with other guidelines and codes of conduct, on their web sites.

(b) Nasdaq.

On July 25, 2002, Nasdaq announced that its board of directors had approved more than 25 new corporate governance reform proposals.[67] These proposals supplement modifications to Nasdaq's corporate governance

[67] Nasdaq Takes New Actions on Corporate Governance Reform, (July 25, 2002), http://www.nasdaqnews.com/news/pr2002/ne_section02_141.html.

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standards announced in May.[68] The proposals must be approved by the NASD board and then forwarded to the SEC for final approval. These proposals were supplemented, according to an August 23, 2002 release from Nasdaq, to ensure consistency with certain provisions in the Sarbanes-Oxley Act.[69] The rule changes approved on July 24, 2002 address:

(1) Board Independence

- A company's board of directors must be composed of a majority of independent directors.
- The independent directors must meet regularly in "executive sessions."
- An independent director is prohibited from receiving payments, including political contributions and payments to a member of the director's family, in excess of $60,000, exclusive of compensation for board service. Additionally, the definition of "independent director" will be tightened to exclude the following:

  1) a director who is a partner in, or a controlling shareholder of, an organization, including a non-profit entity, if the company makes payments to the organization that exceed the greater of $200,000 or five percent of either the company's or the organization's gross revenues;

  2) a director who owns or controls more than 20% of the company's voting securities;

  3) a director who is a relative of an executive officer of the company or any of its affiliates; and

  4) former partners or employees of the company's outside auditors who worked on a company's audit engagement.
- A "cooling off" period of three years applies for directors not deemed to be independent because of: (1) interlocking compensation committees; (2) payment to the director or family member of the director amounts greater than

[68] The press release announcing the previous modifications can be found at http://www.nasdaqnews.com/news/pr2002/ne_section02_113.html. These proposals have already been forwarded to the SEC.

[69] The release, which provides a summary of the Nasdaq proposals can be found at:: http://www.nasdaqnews.com/about/corpgov/CorpGov_Proposals_Public_0823.pdf.

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$60,000 other than for board service; or (3) the director having worked on the company's outside audit engagement.

- Controlled companies, defined as having 50% of the voting power controlled by one person or entity, are exempt from the requirements for a majority independent board, executive sessions and independent compensation and nominating committees.

(2) Strengthen the Role of Independent Directors in Compensation and Nomination Decisions

- Director nominations must be approved by either an independent nominating committee or by a majority of independent directors.
- A single non-independent director may to serve on an independent nominating committee. The single non-independent director must either own more than 20% of the issuer's securities or meet the "exceptional and limited circumstances" which currently allow non-independent directors to serve on audit committees. The "exceptional and limited circumstances" exception is not available for an individual who is an officer or current employee or immediate family member of an officer or current employee.
- CEO compensation and other executive officer compensation must be approved by either an independent compensation committee or by a majority of independent directors in an executive session. The CEO may be present at a meeting where other executive officer compensation is approved.
- A single, non-independent director, who is not an officer, may serve on the compensation committee for two years if the director meets the "exceptional and limited circumstances" which currently apply to audit committees.

(3) Audit Committees

- Audit committees must have the sole authority to hire, fire and determine the compensation of the company's outside auditors.
- Audit committees must approve, in advance, all services provided by the auditor, not related to the audit.
- Require audit committees to have the authority to consult and retain legal counsel and other appropriate experts.

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- Consistent with the Sarbanes-Oxley Act, a member of the audit committee may receive no other compensation than that for board and committee service from the corporation.
- Affiliated persons of the corporation, defined as an individual who owns 20% or more of the issuer's stock or as clarified by SEC rules under Section 301 of the Sarbanes-Oxley Act, may not serve on an audit committee. It does not appear Nasdaq will treat the Sarbanes-Oxley Act as incorporating the definition of an affiliated person from the Investment Company Act of 1940 as being one who owns 5% of the issuer's stock.
- All audit committee members must be able to read and understand financial statements at the time of their appointment.
- A non-independent director may, subject to an "exceptional and limited circumstances" exception, serve on the audit committee for up to two years, although such person still must satisfy the audit committee independence requirements of the Sarbanes-Oxley Act.
- Companies who file reports under Regulation S-B must meet the audit committee standards of all other issuers.
- Audit committees must review and approve all related-party transactions.
- Companies must disclose the receipt of an audit opinion with a going concern qualification.
- The Audit Committee must establish procedures for the confidential and anonymous receipt and treatment of complaints by the issuer.
- Current Nasdaq rules require one member of the audit committee to have experience, through employment, education or otherwise, which results in financial sophistication. Companies will now be required to consider the individual's education and employment experience to determine whether the individual has sufficient financial expertise in the accounting and auditing areas specified in the Sarbanes-Oxley Act.

(4) Non-U.S. Companies

- Non-U.S. companies will be required to disclose of exemptions to corporate governance requirements at the time they are received and on an annual basis thereafter.

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- Require the filing of all interim reports filed in the company's home country and the filing of at least a semi-annual report with the SEC and Nasdaq, with an English translation.

(5) Codes of Conduct

- All companies must have a publicly available code of conduct, which must at least address conflicts of interest and compliance with applicable laws, rules and regulations.
- The code of conduct should also describe an appropriate compliance mechanism and must disclose any waivers granted to executive officers and directors. Waivers may only be granted by independent directors.

(6) Stock Options

- Shareholders must vote to approve all stock option plans and all modifications of such plans.
- Nasdaq would retain the existing exception that allows companies to provide inducement grants to new executive officers, but any such grants would have to be approved by an independent compensation committee or a majority of the independent directors.
- Certain tax-qualified plans, such as ESOPs will be exempt as will the assumption of pre-existing grants in connection with a merger or acquisition.
- Existing option plans are unaffected, unless a material modification is made to the plan.

(7) Penalties for Corporate Governance Violations

- A company can be delisted for making a material misrepresentation or omission to Nasdaq.
- A company's re-listing application can be denied if Nasdaq finds the company has violated its corporate governance standards during the period in which the delisting appeal is pending.

(8) Other Proposals

- Require continuing education for all directors, pursuant to rules to be developed by Nasdaq.
- Mandate accelerated disclosure, within two business days for transactions in company stock by officers and directors exceeding $100,000. It is likely that the $100,000 threshold will be eliminated to conform to new SEC rules.

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Require disclosure of smaller transactions by the second business day of the following week.

- Companies will be permitted to disseminate material via Regulation FD-compliant methods of disclosure, such as conference calls, press conferences and web casts, instead of solely by press release. The public must be given adequate notice and granted access.
- Ban loans to existing executive officers and directors, as required by the Sarbanes-Oxley Act.

2. The Business Roundtable's Principles of Corporate Governance (2002).

In May 2002, The Business Roundtable ("Roundtable") released its Principles of Corporate Governance ("Principles"), a set of guiding principles intended to assist corporate management and boards of directors in their individual efforts to implement corporate governance best practices. The Principles are available on the Roundtable's web site at http://www.brtable.org/pdf/704.pdf. While many of the Roundtable's Principles were followed a month later in the NYSE proposals, the Roundtable recognizes that no structure is right for all corporations, and that not all of the best practices outlined in the Principles will be appropriate for every corporation in every circumstance. The Roundtable recommendations to boards address, among other things:

(a) The roles of the board and management.

- Effective directors are monitors, not managers, of business operations. The board's most important function is the selection, compensation and evaluation of a well-qualified and ethical CEO.
- The CEO, with senior management, operates the corporation on a daily basis. In addition to having the requisite skills and experience, the CEO should be a person of integrity who takes responsibility for the corporation adhering to the highest ethical standards.

(b) Board leadership.

- While most American corporations are well served by a structure in which the CEO also serves as chair of the board, each corporation should make its own determination of what leadership structure works best, given its present and anticipated circumstances.
- Some corporations have found it useful to separate the roles of CEO and chair of the board to provide continuity of leadership in times of transition.

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- The board should have contingency plans to provide for transitional board leadership if questions arise concerning management's conduct, competence, or integrity or if the CEO dies or is incapacitated.

(c) Board independence.

- A substantial majority of directors of the board of a publicly-owned corporation should be independent of management. This best practice is stronger than the NYSE Listing Standards Committee recommendation, which would require that a simple majority of the board be independent.
- Determinations as to independence should be made by the board, which should consider:
    - the appearance (as well as the fact) of independence; and
    - personal and other types of relationships – including those with non-profit organizations that receive corporate contributions – in assessing independence.

(d) Committees of the board.

- As with the proposals of the NYSE Listing Standards Committee, the Roundtable recommends that every corporation not only have an audit committee made up of independent directors (as already required by the major securities markets), but also fully independent committees responsible for addressing nominating/corporate governance and compensation issues.
- The Roundtable spells out specific proposed responsibilities for each of the three key committees and recommends that these responsibilities be clearly defined in a charter or board resolution:
    - *Audit*. The audit committee should (1) supervise the company's relationship with its outside auditor, including making an annual recommendation to the board about the selection of the auditor, evaluating the auditor's performance, and considering whether it would be appropriate for the outside auditor periodically to rotate senior audit personnel or for the corporation periodically to change its outside auditor; (2) develop policies on the provision of non-audit services; (3) review and discuss the corporation's financial statements and critical accounting policies with management and the outside auditor; (4) oversee the corporation's internal controls and internal audit function and review the appointment and replacement of the senior internal auditing executive; and (5) develop policies on the hiring of former auditor personnel. Like the NYSE Listing Standards Committee, the Roundtable

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recommends that the audit committee meet four times per year and meet with the outside auditor, without management present, at every meeting.

- *Corporate governance*. The corporate governance committee should (1) recommend nominees to the board and its committees, including establishing criteria for board membership, reviewing candidates' qualifications and potential conflicts with the corporation's interests, and assessing the contributions of current directors in connection with their renomination; (2) monitor and safeguard the board's independence; (3) oversee and review the corporation's processes for providing information to the board; (4) develop and recommend to the board a set of corporate governance principles; and (5) oversee board and management evaluation.
- *Compensation*. The compensation committee should set CEO and senior management compensation and oversee the corporation's overall compensation structure to assess whether it establishes appropriate incentives for management and employees at all levels.

(e) Board and management evaluation.

- The board should have an effective mechanism for assessing on a continuing basis the effectiveness of the full board, the board's committees, individual directors, and management:
  - the non-management members of the board, under the oversight of a committee made up of independent directors, should annually review the performance of the CEO and participate with the CEO in evaluation of senior management;
  - the performance of the full board and its committees should be evaluated annually; and
  - the board should have a process for evaluating whether individuals sitting on the board have the skills and expertise appropriate for the corporation and how these individuals work as a group, and a director's ability to continue contributing to the board should be evaluated each time the director is considered for renomination.

(f) Director and management compensation.

- A meaningful portion of directors' compensation should be in the form of long-term equity. Corporations may wish to consider establishing a requirement that, for as long as directors remain on

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the board, they acquire and hold stock in an amount that is meaningful and appropriate to each director.

- The structure of management compensation should directly link the interests of management to the interests of shareholders. Companies should establish a management compensation structure that balances short- and long-term incentives and includes different forms of compensation.
- The compensation committee should examine the overall compensation structure of the corporation to determine whether it establishes appropriate incentives not only for directors and senior managers, but for employees at all levels.

(g) Shareholder approval of option plans.

- Corporations should obtain shareholder approval of new stock option and restricted stock plans in which directors or executive officers participate. This conforms to the Nasdaq proposal, and to the stated position of SEC Chairman Harvey Pitt, but does not go as far as the recommendation of the NYSE Listing Standards Committee summarized above.

(h) Corporate governance principles.

- All corporations should adopt and publicize statements of corporate governance principles.

(i) Codes of conduct.

- Companies should have and publicize a code of conduct with effective reporting and enforcement mechanisms. Employees should have a means of alerting management and the board to potential misconduct without fear of retribution, and violations of the code should be addressed promptly and effectively.

(j) Relationship with outside auditor.

- *Selection*. The audit committee should make an annual recommendation to the full board about the selection of the outside auditor, based on a due diligence process that includes a review of the auditor's qualifications, work product, independence and reputation.
- *Non-audit services*. The audit committee should develop policies concerning the provision of non-audit services by the corporation's outside auditor and should consider the nature and dollar amount of all services provided by the outside auditor when assessing the auditor's independence.
- *Auditor rotation*. The audit committee should consider whether it would be appropriate for the outside auditor periodically to rotate

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senior audit personnel or for the corporation periodically to change its outside auditor. The audit committee should base its decisions about selecting and possibly changing the outside auditor on its assessment of what is likely to lead to more effective audits.

- *Hiring former auditor personnel*. The audit committee should consider adopting a "cooling-off" period or other policy restricting the hiring of former auditor personnel. Each corporation should consider what policy is appropriate for it.

3. ABA Taskforce on Corporate Responsibility

On July 16, 2002, the American Bar Association's Taskforce on Corporate Responsibility released its Preliminary Report on Corporate Responsibility.[70] While the report has not yet been approved by the House of Delegates or the Board of Governors of the ABA, and thus can not be said to represent the policy of the ABA as a whole, the preliminary report does make a number of recommendations for corporate governance of public companies as well as for attorneys in representing company's on corporate governance matters.

(a) Recommended Standards for Public Companies

- Boards of Directors should be comprised of a "substantial majority" of independent directors, using a definition of independence consistent with the NYSE proposals.

- A company should have a corporate governance committee, made up of entirely independent directors, responsible for identifying and contacting potential independent directors.

- The audit committee should be composed completely of independent directors and should have authority to engage or remove outside auditors, hire outside accounting or legal advisors if necessary, and establish company policy as it relates to non-audit services provided by the outside auditor.

- A company should have a completely independent compensation committee with the authority to set and take action regarding senior executive compensation. The compensation committee should also be able to hire outside compensation and legal advisers.

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[70] Preliminary Report of the American Bar Association Task Force on Corporate Responsibility, (Jul. 16, 2002) (available at http://www.abanet.org/buslaw/corporateresponsibility/preliminaryreport.pdf).

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- A company should have a corporate governance code of ethics set by the corporate governance committee. The code should provide a mechanism for communication to independent directors regarding material violations of law and breaches of duty to the company.

- All transactions with a director or executive officer of the corporation should be approved by a committee of independent directors. The independent committee should make determinations of fairness, consider the rationale for dealing with the related party, and consider the need for appropriate public disclosure.

- Executive session meetings between the corporate governance and/or audit committees should be held regularly with executive officers responsible for implementing internal corporate governance controls.

(b) Recommended Governance Enhancements for Boards of Directors of Public Companies

- Boards should consider using a "lead independent director" or selecting an independent director as the chair. Boards should also adopt processes for agenda setting and information distribution.

- Boards should consider whether to implement policies setting term limits or automatic rotations for committee memberships and chairs of committees, particularly audit, compensation and corporate governance committees.

- Boards should develop and maintain a director training and education program.

- Boards should adopt procedures to evaluate how effective its meetings, distribution of information, diversity of director experience and contributions of individual directors are.

(c) Recommendations relating to Lawyer Responsibilities and Conduct

The report proposes the following amendments the Model Rules of Professional Responsibility:

- require an attorney, under Model Rule 1.13, to pursue remedial measures for corporate misconduct, regardless of whether the misconduct is related to the representation or discovered through the representation. The attorney would also be required to communicate with a higher corporate authority if other measures to rectify the misconduct fail. The rule would also be revised to make clear that such disclosure of confidential information would

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not violate Model Rule 1.6 and to revise current language which discourages attorneys from communicating with higher corporate authorities.

- require disclosure under Model Rule 1.6 in order to prevent felonies or other serious crimes, including securities laws violations, if the misconduct is known to the lawyer. The amendment would also extend permissible disclosure to include conduct that has resulted or is reasonably certain to result in substantial injury to the financial interests or property of another.
- expand, under Model Rules 1.2(d), 1.13 and 4.1, from the current standard of actual knowledge to include "circumstances in which the lawyer reasonably should know of the crime or fraud."
- revise and improve the integration among the Model Rules relating to an attorney's duties and obligations in dealing with illegal conduct or breach of fiduciary duty by a corporate client.

Additionally, the report recommends proposals for establishing lines of communication between a company's general counsel and its outside counsel. In this regard, the general counsel should meet regularly, according to established company practice, with one or more independent directors, in order to facilitate Board attention to compliance with laws and potential breaches of duty to the corporation. Furthermore, whenever outside counsel is engaged, a direct line of communication should be created through which the outside counsel should inform the general counsel of potential violations of law and breaches of duties to the corporation.

C. What Companies Should Do Now

In the wake of the passage and signing of the Sarbanes-Oxley Act and the other proposals and recommendations outlined above, companies should review their corporate governance practices to assess how their practices compare with those endorsed by the NYSE Listing Standards Committee, Nasdaq and The Business Roundtable. Companies should also understand that any proposed changes to the listing standards of the NYSE and Nasdaq must be put out for public comment and approved by the SEC before they become final. Accordingly, the listing standards that are ultimately adopted may differ from the proposals that have been issued as of August 15, 2002. Nevertheless, companies should begin the process of considering their corporate governance practices now, with an eye toward improving and supplementing their existing practices and implementing the new listing standards promptly after they are approved. Among other things:

- Companies should conduct a corporate governance audit. In assessing and developing corporate governance practices, consideration should be given to the company's size, industry, employees and culture. The nominating/corporate governance committee can play a role in this process by preparing recommendations about practices to the full board.

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- Companies that do not yet have them should establish board nominating/corporate governance and compensation committees, made up entirely of independent directors.
- Referring to the standards under consideration by the market where the company's stock is listed, and the considerations noted in the Roundtable's Principles, each board should review the qualifications and independence of the members of the three key committees. Boards should examine all director relationships, including those that do not currently require disclosure but that could cause investors or regulators to question directors' independence.
- Companies should review existing charters or, if needed, prepare new charters for all key committees for board review and approval as soon as relevant listing standards are adopted. Companies should consider each subject specified in the NYSE Listing Standards Committee recommendations and the Roundtable's Principles, but should also maintain flexibility in their charters to focus on policies and procedures that are important to their specific business operations and company and board culture.
- Audit committees should review their schedules and, if they do not do so now, consider meeting at least four times a year and having a private session with the outside and internal auditors at each meeting. Both of these practices may well be required in the future if approved by the NYSE board and the SEC. Quarterly meetings should take place with sufficient time to review earnings releases and 10-Qs, as well as any report from the outside auditor on its quarterly review of the interim financial statements. The burdens of more frequent meetings can be lessened by altering board schedules to precede earnings release dates and by using audio and video conference capabilities for some committee meetings. Audit committee members should make sure that committee schedules and agendas permit – and encourage – active engagement and give-and-take discussions with management and with the auditors, both in general sessions and in private sessions.
- Companies should review all board and committee meeting schedules to be sure that committees, as well as the full board, thoroughly and thoughtfully cover their respective agenda items, based on listing standards and their charters. This will often mean that committees will need to meet on the day prior to board meetings, so that they are not rushed through their agendas and have the ability to extend the length of their meetings as needed.
- Companies should consider moving immediately to publicize information about their corporate governance practices by posting this information on their web sites.

V. Recent Staff Accounting Bulletins

A. Introduction.

As expressed in speeches by the former Chairman and former Chief Accountant of the SEC, the SEC has focused on accounting issues in response to "new services and new

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technologies . . . creating new questions and challenges that must be addressed."[71] The Staff Accounting Bulletins are intended to address attempts by companies to disclose the value of assets that are increasingly intangible and for which there is not sufficient guidance in the traditional financial reporting model. In addition to the guidance already provided by the recent Staff Accounting Bulletins, the SEC will continue to look at accounting issues in connection with internet activities[72] and international accounting standards[73] and has proposed new rules to provide better disclosure regarding such accounting areas as changes in valuation and loss accrual accounts.[74]

B. Staff Accounting Bulletin No. 99: New Commission Guidance on Materiality

In response to concerns that some companies have avoided disclosing information that investors may deem significant by using an "objective" percentage test, the SEC has released Staff Accounting Bulletin No. 99.[75] Staff Accounting Bulletin No. 99 rejects the notion that materiality may be measured solely on a quantitative basis. An issuer or an auditor may not assume the immateriality of items that fall below a percentage threshold set by management or the auditor to determine materiality.[76] "[E]valuation of materiality requires a registrant and its auditor to consider *all the relevant circumstances*. . ."[77]

The SEC staff also suggested that any small intentional misstatement of financial statements should be presumed to be material, because management would not have bothered unless it believed it to be significant. A misstatement may be material if, for example:

- the misstatement will mask a change in earnings or other trends;

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[71] *See Quality Information: The Lifeblood of Our Markets* (Oct. 18, 1999) (available at http://www.sec.gov/news/speeches/spch304.htm); *Reflections on Times Past, Times to Come* (Nov. 5, 1999) (available at http://www.sec.gov/news/speeches/spch322.htm).

[72] *See* Letter from Lynn E. Turner, Former Chief Accountant, to the Financial Accounting Standards Board (Oct. 18, 1999) (available at http://www.sec.gov/offices/account/calt1018.htm).

[73] *International Accounting Standards*, Release No. 33-7801, 34-42430 (Feb. 16, 2000).

[74] *Supplementary Financial Information*, Release No. 33-7793, 34-42354 (Jan. 21, 2000).

[75] *See* Staff Accounting Bulletin No. 99, *Materiality* (Aug. 12, 1999) (available at http://www.sec.gov/rules/acctreps/sab99.htm).

[76] The position that there is no single percentage threshold for determining materiality has been upheld by the Second Circuit Court of Appeals. *See* Ganino v. Citizens Utilities Co., 228 F.3d 154 (2d Cir. 2000).

[77] *See* SAB No. 99.

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- the misstatement will hide a failure to meet analysts' consensus expectations;
- the misstatement changes a loss into income or vice versa;
- the misstatement is significant to a portion of the business which has been highlighted as significant to the company;
- the misstatement affects compliance with regulatory requirements;
- the misstatement affects compliance with loan covenants or other contractual requirements;
- the misstatement has the effect of increasing management compensation, bonuses or incentive compensation;
- the misstatement involves concealment of an unlawful transaction; or
- the company's stock price is volatile and reacts strongly to small changes in reported results.

The staff indicated that the demonstrated volatility of the price of an issuer's securities in response to certain types of misstatements may provide guidance as to whether investors regard quantitatively small misstatements as material. Therefore, the potential market reaction should be taken into account in considering whether a misstatement is material. Finally, the SEC staff also discouraged "netting" offsetting misstatements that may cancel each other out and suggested that potential misstatements should be considered both individually and in the aggregate.

C. Staff Accounting Bulletin No. 100: New Commission Guidance on Restructuring Charges

On November 24, 1999, the SEC released Staff Accounting Bulletin No. 100[78] to provide guidance regarding accounting for and disclosing certain expenses and liabilities commonly reported in connection with restructuring and exit activities and business combinations, and the recognition and disclosure of asset impairment charges. The bulletin is intended to address the concern expressed by former Chief Accountant Lynn E. Turner that restructuring charges and other loss accruals be adequately disclosed and supported by GAAP at the time they are established.[79] This typically may require purchase price adjustments to record such liabilities and loss accruals at fair value. The staff also discusses criteria found in existing accounting materials, providing examples of how such material should be applied, and discusses additional disclosures that are requested to enhance the transparency of financial statements. Finally, Staff Accounting Bulletin No. 100 provides the

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[78] *See* Staff Accounting Bulletin No. 100, *Restructuring and Impairment Charges* (Nov. 24, 1999) (available at http://www.sec.gov/rules/acctreps/sab100.htm).

[79] *See* Letter from Lynn E. Turner, Former Chief Accountant, to the American Institute of Certified Public Accountants (Dec. 22, 1999) (available at http://www.sec.gov/offices/account/calt1222.htm).

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staff's position that depreciable lives, amortization periods and salvage values of long-lived assets need to be continually evaluated and changed, if appropriate, on a timely basis and discusses the staff's view on assessing and measuring enterprise level goodwill for impairment.

D. Staff Accounting Bulletins Nos. 101, 101A and 101B: Commission Guidance on Revenue Recognition Issues

Staff Accounting Bulletin No. 101,[80] released on December 3, 1999, expresses the views of the SEC staff regarding the application of generally accepted accounting principles ("GAAP") to the recognition, presentation and disclosure of revenue in financial statements filed with the SEC. The staff continued to encounter questionable and inappropriate revenue recognition practices[81] and therefore, purportedly applying existing accounting rules, provides the following criteria for when revenue is realized and earned:

- Persuasive evidence of an arrangement exists,
- Delivery has occurred or services have been rendered,
- The seller's price to the buyer is fixed or determinable, and
- Collectibility is reasonably assured.

Using these criteria and transaction specific rules developed by the staff by analogy, the staff provides various examples of specific fact patterns not addressed by the rules. Staff Accounting Bulletin No. 101 also provides guidance on the disclosures required with respect to revenue recognition policies and revenue recognition in the context of a Management Discussion and Analysis. On March 24, 2000, the SEC staff released Staff Accounting Bulletin No. 101A,[82] which delays for three months the implementation date of Staff Accounting Bulletin No. 101 for companies with fiscal years beginning between December 16, 1999 and March 15, 2000. In addition, on June 26, 2000, the staff released Staff Accounting Bulleting No. 101B,[83] which further delays the implementation date of Staff Accounting Bulletin No. 101 until no later than the fourth fiscal quarter of fiscal years beginning after December 15, 1999. These two extraordinary extensions are an implicit recognition by the SEC staff that, in many instances, Staff Accounting Bulletin No. 101 in

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[80] *See* Staff Accounting Bulletin No. 101, *Revenue Recognition in Financial Statements* (Dec. 3, 1999) (available at http://www.sec.gov/rules/acctreps/sab101.htm).

[81] *See The Year of the Accountant* (June 14, 1999) (available at http://www.sec.gov/news/speeches/spch291.htm).

[82] *See* Staff Accounting Bulletin No. 101A, *Amendment: Revenue Recognition in Financial Statements* (Mar. 24, 2000) (available at http://www.sec.gov/rules/acctreps/sab101a1.htm).

[83] *See* Staff Accounting Bulletin No. 101B, *Second Amendment: Revenue Recognition in Financial Statements* (June 26, 2000) (available at http://www.sec.gov/rules/acctreps/sab101b1.htm).

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fact applies new, stricter revenue recognition requirements in several areas. Finally, in October 2000, the Office of the Chief Accountant released frequently asked questions and answers with respect to Staff Accounting Bulletin No. 101.[84] The release responds to recurring inquiries received from auditors, preparers and analysts about how the guidance provided by Staff Accounting Bulletin No. 101 should be applied in connection with particular transactions.

E. Staff Accounting Bulletins No. 102: Selected Loan Loss Allowance Methodology and Documentation Issues

Staff Accounting Bulletin No. 102,[85] released on July 6, 2001, details the staff's views on the development, documentation, and application of a systematic methodology for determining allowances for loan and lease losses that conforms with GAAP. The release of SAB 102 is the result of an agreement between federal banking agencies to provide parallel guidance on loan loss allowance methodologies and supporting documentation. The agreement was a response to continued observations that registrants engaged in lending activities have insufficient documentation for loan losses, and the fact that such insufficiencies are considered blemishes on the credibility of an institution's financial statements.

Staff Accounting Bulletin No. 102, does not change any of the existing rules regarding accounting for loan loss provisions or allowances. SAB 102 does, however, provide guidance to lending institutions by detailing common elements that should be included in loan loss allowance methodology, specifying items that should be included in the written supporting documentation and providing an example of how a systematic methodology should be applied under GAAP. Given that this has been an area of active SEC interest for the last decade, anyone advising financial institutions or other creditors should consider this important reading.

VI. Clarification of Insider Trading Prohibitions – Rules 10b5-1 and 10b5-2

A. Introduction

At the same time that it adopted Regulation FD[86], the SEC amended the insider trading rules under Rule 10b-5 by adopting Rules 10b5-1 and 10b5-2.[87] The amendments

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[84] *See* Staff Accounting Bulletin No. 101, *Revenue Recognition in Financial Statements – Frequently Asked Questions and Answers* (Oct. 2000) (available at http://www.sec.gov/offices/account/sab101fq.htm).

[85] *See*, Staff Accounting Bulletin No. 102, *Selected Loan Loss Allowance Methodology and Documentation Issues* (July 6, 2001) (available at http://www.sec.gov/interps/account/sab102.htm).

[86] *See* Section VII. Below.

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clarify that insider trading liability can arise in two situations where previously the law was in dispute. However, the SEC also adopted an important set of affirmative defenses from insider trading liability, which – for the first time – established that insider trading liability may not arise from transactions that were planned prior to the time a person came into possession of material nonpublic information. The insider trading rules went into effect on October 23, 2000.

- Rule 10b5-1 provides that a person will be deemed to have traded "on the basis" of material nonpublic information if the person effects the transaction while "aware" of the information. Thus, a person will not be able to claim that material nonpublic information did not affect his or her decision to trade.
- Rule 10b5-1(c) provides a rule-based defense to insider trading liability. A person will not be viewed as having traded "on the basis" of material nonpublic information if the person demonstrates that the transaction was effected pursuant to a contract, instructions or a written plan that was established before the person became aware of the information. An additional defense is available for trading by entities that establish procedures to isolate the person(s) making investment decisions from any material nonpublic information.
- Transactions pursuant to a Rule 10b5-1(c) "trading plan" have other benefits, such as maintaining insiders' ability to sell outside of trading windows, avoiding the need for fine materiality determinations, helping to defeat allegations that insider sales establish scienter in the context of class action lawsuits and providing an easy basis for explaining insider sales to the public.
- Rule 10b5-2 defines the relationships in which a duty of trust or confidence may arise. If a recipient of material nonpublic information regarding a company owes a duty of trust or confidence to the person who communicated the information, then it constitutes insider trading for the recipient of the information to trade the company's stock. Among other instances, a duty of trust or confidence is presumed to exist under the rule when information is communicated to a spouse, parent, child or sibling.

B. Rules 10b5-1 and 10b5-2: An Overview

To date, the law on insider trading has developed primarily through case law interpreting the anti-fraud provisions of the Exchange Act, principally Section 10(b) and Rule 10b-5. As a result, courts have disagreed from time to time as to the scope of the law's proscriptions. The purpose of Rules 10b5-1 and 10b5-2 is to address and provide definitive answers to two questions that the courts have decided differently. The rules were adopted by

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[Footnote continued from previous page]

[87] *Selective Disclosure and Insider Trading*, Release No. 33-7881, 34-43154 (Aug. 15, 2000) (effective Oct. 23, 2000) (available at http://www.sec.gov/rules/final/33-7781.htm).

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the SEC to address discrete issues, and the SEC has stated that the rules do not address or modify in any way any other aspects of insider trading doctrine that have been established by existing case law.

1. Rule 10b5-1

Rule 10b5-1 represents the SEC's effort to address the nature of the causal connection that must be shown between a person's possession of inside information and the person's securities transactions in order for insider trading liability to arise. The issue has been whether insider trading liability can arise only where a person uses inside information in trading or whether trading while in knowing possession of the information is a sufficient basis for liability. Three federal courts have addressed the "use/possession" issue since 1993 and have reached different results. One court held that "knowing possession" was sufficient because of the difficulty of separating awareness from use; a second court held that use had to be proven affirmatively, at least in the context of a criminal case; and a third court held that although use is the ultimate issue, proof of possession gives rise to a strong inference of use and would permit the SEC to establish a *prima facie* case of use without more.

Rule 10b5-1 provides that a person trades "on the basis of" material nonpublic information about a security or company "if the person making the purchase or sale was aware of the material nonpublic information when the person made the purchase or sale." According to the SEC, this standard reflects that a person who is aware of inside information likely makes use of it when trading. Rule 10b5-1 applies this standard under all theories of insider trading liability, regardless of whether based on traditional or temporary insider status, tipper/tippee liability or the misappropriation theory of liability. Thus, as articulated in Rule 10b5-1, it constitutes a "manipulative and deceptive device" prohibited by Exchange Act Section 10(b) and Rule 10b-5 for a person to effect "the purchase or sale of a security of any issuer, on the basis of material nonpublic information about that security or issuer, in breach of a duty of trust or confidence that is owed directly, indirectly, or derivatively" to the issuer, the issuer's shareholders or the person who is the source of the information.

In light of the awareness standard embodied in new Rule 10b5-1, it is important to note that the rule does *not* eliminate or alter the element of *scienter* required to establish insider trading. The law continues to require, as a prerequisite to liability, that a person know, or be reckless in not knowing, that information is both material and nonpublic. Thus, under Rule 10b5-1, a person may be liable for insider trading where the person trades while aware of (and without necessarily having actually used), information that the person knows, or is reckless in not knowing, is both material and nonpublic.

2. The Affirmative Defenses under Rule 10b5-1(c)

Rule 10b5-1(c) establishes two affirmative defenses. The two defenses are exclusive; unless a person can demonstrate that one of the affirmative defenses applies, the person can be found guilty of insider trading if he or she trades while in

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possession of material nonpublic information and in breach of a duty of trust or confidence that is owed directly, indirectly or derivatively to a company, the company's shareholders or the person who is the source of the information. Because they are fashioned as "affirmative defenses," it appears that a defendant will have the burden of demonstrating that one of the defenses is available, once the SEC or a private plaintiff has established that all of the elements of an insider trading claim otherwise exist. However, a defendant would probably raise the defense early in the course of an SEC investigation or a private lawsuit.

(a) Affirmative Defense for Pre-established Trading Plans

The first defense, which protects individuals or entities, applies in situations where material nonpublic information was not a factor in a trading decision because a trade was carried out pursuant to a pre-existing contract, instruction or plan (for ease of reference, any such contract, instruction or plan is referred to as a "trading plan"). Rule 10b5-1(c)(1) provides that a purchase or sale of securities is not "on the basis of" material nonpublic information where the individual or entity making the purchase or sale can show that:

- prior to becoming aware of the material nonpublic information, the individual or entity had:
  - entered into a binding contract for the purchase or sale of the security; or
  - instructed a third party to purchase or sell the security for its account; or
  - adopted a written plan for trading securities; and
  - the trading plan:
    - specified the "amount" of securities to be purchased or sold, and the "price" at which and "date" on which the securities were to be purchased or sold; or
    - included a written formula for determining the amount, price and date of the transaction; or
    - did not permit the individual or entity to exercise any subsequent influence over how, when and whether to conduct the purchases or sales, and delegated those decisions to a person who did not possess material nonpublic information; and
    - the purchase or sale at issue occurred "pursuant to the contract, instruction or plan," meaning that the individual or entity that entered into the trading plan did not alter or deviate from it, or enter into or alter a corresponding or hedging transaction with respect to the securities. However, an insider may modify a

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trading plan at a time when the insider is not in possession of material nonpublic information.

For purposes of the second element of a trading plan:

- "amount" is defined as either a specified number of shares or dollar value of securities;
- "price" is defined as the market price on a particular date, a limit price, or a particular dollar price; and
- "date" is defined, in the case of a market order, as the day of the year on which the order is to be executed or as soon thereafter as possible under principles of best execution and, in the case of a limit order, as any day of the year on which the limit order is in force.

The availability of Rule 10b5-1(c)(1) is explicitly made contingent on the good faith of the individual or entity in entering into the trading plan. The affirmative defense is not available where the trading plan was entered into "as part of a plan or scheme to evade" Rule 10b5-1.

(b) Affirmative Defense for Informational Barriers

The second affirmative defense is available only to entities, and not to individuals. Under Rule 10b5-1(c)(2), an entity can demonstrate that a trade was not "on the basis of" material nonpublic information if the entity shows that:

- the individual who made the investment decision on behalf of the entity was not aware of the information; and
- the entity had implemented reasonable policies and procedures, in light of the nature of the entity's business, to ensure that those making investment decisions on its behalf would not violate the insider trading laws.

The "policies and procedures" may include arrangements designed to prevent individuals who make investment decisions on behalf of an entity from acquiring material nonpublic information, as well as policies designed to restrict trading by those who have come into possession of such information. The requirement that these policies and procedures be designed "to ensure" that violations do not occur does not mean that the defense is unavailable if a violation does in fact occur, but instead requires that the policies and procedures be reasonably designed to prevent insider trading.

(c) Interpretation of Rule 10b5-1(c)

On June 1, 2001, the SEC Division of Corporation Finance issued long-awaited interpretations on the operation of Rule 10b5-1(c) regarding the

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affirmative defense from insider trading for transactions under pre-arranged contracts, instructions or written trading plans. The interpretations appear as Q&A's three through 18 under the heading "Rule 10b5-1," in the Division's Fourth Supplement to its Telephone Interpretations.[88]

The Staff interpretations provide helpful guidance and confirmation of important aspects of Rule 10b5-1(c). Among other items, the interpretations confirm that:

- terminating a trading plan while in possession of material nonpublic information does not necessarily result in loss of the affirmative defense for past transactions, unless the plan termination reflects the fact that the person was not acting in good faith at the time he entered into the plan.[89] In light of this interpretation, it may be advisable for plans to expressly state that the insider reserves the right to terminate the plan, in order to demonstrate that any termination is not inconsistent with the plan's original terms.
- a person can effect a "same way" transaction outside of a trading plan without affecting the availability of Rule 10b5-1(c) for transactions under the trading plan.[90] Of course, the insider cannot claim the benefit of Rule 10b5-1(c) for any transaction occurring outside of the trading plan, unless the insider was not aware of material nonpublic information when he placed the order for that transaction.
- a trading plan can specify some of the terms regarding amount, price and/or date of transactions which are to be conducted under the plan, and may grant discretion over all other aspects of the plan to a third party who is not aware of material nonpublic information.[91] Alternatively, a person need not utilize a broker or other third party to implement a trading plan, but instead can write out and self-implement the plan, as long at the terms of the plan do

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[88] *See Manual of Publicly Available Telephone Interpretations of the Division of Corporation Finance*, Fourth Supplement (May 2000) (available at http://www.sec.gov/interps/telephone/phonesupplement4.htm).

[89] *Id*. at Q&A 15.

[90] *Id*. at Q&A 13.

[91] *Id*. at Q&A 3.

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not allow the insider to exercise any subsequent discretion over how, when or whether the transactions occur.[92]

- a person holding options can rely on Rule 10b5-1(c) to establish a trading plan for future exercises of options (for example, upon the expiration date of an option or when the stock price reaches a certain level), and a person who writes a put or call option can rely on Rule 10b5-1(c) when he or she receives an exercise notice under the option.[93]
- a person can arrange for the affirmative defense to be available if shares are sold pursuant to a margin call by establishing a plan under which shares are automatically sold once the value of the margin collateral declines to a specified level.[94]

The Staff interpretations also illustrate aspects of the rule which should be borne in mind when drafting and operating under a trading plan. For example, the interpretations suggest that when a plan specifies a limit order price for sales, the sales should be executed as soon as the limit price is hit (or as soon thereafter as is practicable under ordinary principles of best execution), unless the plan otherwise grants discretion to a broker or other third party to determine the trade date.[95] The interpretations also demonstrate the importance of monitoring non-trading plan transactions while operating under a Rule 10b5-1(c) trading plan. For example, while a payroll contribution instruction which results in periodic stock purchases under a 401(k) plan can qualify for the Rule 10b5-1(c) affirmative defense, a discretionary transfer of funds out of an employer stock fund account in a 401(k) may cause the protection of Rule 10b5-1(c) to be lost for the periodic purchases. This is because a "corresponding or hedging" transaction that offsets a trading plan transaction results in the loss of Rule 10b5-1(c) protection, unless the corresponding or hedging transaction is itself effected pursuant to a trading plan or is made at a time when the insider is note aware of material nonpublic information.[96]

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[92] *Id*. at Q&A 10.

[93] *Id*. at Q&A 6 and 7.

[94] *Id*. at Q&A 9.

[95] *Id*. at Q&A 11.

[96] *Id*. at Q&A 16.

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Notably, one question not addressed by the Division Staff is whether an insider can rely on the Rule 10b5-1(c) affirmative defense for a trade that occurs while the insider is aware of material nonpublic information if:

- the insider established the trading plan before becoming aware of material nonpublic information that he knows at the time of the trade; but
- the insider was aware of other material nonpublic information at the time he established the trading plan; and
- the material information that the insider knew when he established the trading plan is publicly disclosed before the first trade occurs under the plan.

While the availability of Rule 10b5-1(c) in this situation is supported by the language of the Rule, the adopting release which accompanied Rule 10b5-1(c) (as well as the Staff's telephone interpretations) refers to Rule 10b5-1(c) trading plans as being established while a person is not aware of *any* material nonpublic information. While there are arguments supporting the view that Rule 10b5-1(c) is available in the situation described above, the Staff is also concerned that use of a Rule 10b5-1(c) plan in that situation may be subject to abuse. Therefore, it does not appear that the Staff is yet in a position to issue an interpretation (one way or the other) to address the situation described above. In order to have the strongest argument as to the availability of the Rule 10b5-1(c) affirmative defense, a trading plan should be established only at a time when an insider is not aware of material nonpublic information.

3. Rule 10b5-2

The issue that the SEC addresses under Rule 10b5-2 involves the circumstances under which family, personal and other non-business relationships may give rise to a duty of trust or confidence for purposes of the "misappropriation theory" of insider trading.

Under the misappropriation theory, a person engages in insider trading if the person has received material nonpublic information from an insider and trades on the basis of the information in breach of a duty of loyalty or confidence to the insider. Certain types of business or professional relationships, such as an attorney/client relationship, give rise to a duty of confidence. However, when an insider has communicated material nonpublic information to another person with whom he or she has a close personal relationship and did not intend for the recipient to trade on the basis of the information, the SEC has had difficulty establishing that a subsequent stock trade by the recipient constituted unlawful insider trading. In two cases, courts held that a family relationship did not give rise to a duty of confidence. In those cases, the insider was not liable for "tipping" material nonpublic information because the insider did not intend for the recipient to trade and did not receive any benefit in return for passing on the information, and the recipient of the information was not

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liable for insider trading because the recipient did not breach any duty of confidence when he or she traded on the basis of the information.

Rule 10b5-2 establishes a non-exclusive list of three situations in which a person has a duty of trust or confidence for purposes of the misappropriation theory of insider trading liability. It applies to any insider trading allegation "based on the purchase or sale of securities on the basis of, or the communication of, material nonpublic information misappropriated in violation of a duty of trust or confidence." Rule 10b5-2 provides that a "duty of trust or confidence" exists where a person:

- obtains material nonpublic information from his or her spouse, parent, child or sibling;
- has a history, pattern or practice of sharing confidences with the recipient of the material nonpublic information, such that the recipient "knows or reasonably should know" that the person communicating the information to the recipient expects that the recipient will maintain the information in confidence; or
- agrees to maintain information in confidence.

The first situation establishes a bright-line rule under which the receipt of information from a spouse, parent, child or sibling will provide a sufficient basis for insider trading liability, assuming that all other elements are satisfied. The rule also provides an affirmative defense that permits the family member to rebut the presumption that a duty of confidence exists by showing that he or she did not know, and reasonably should not have known, that the insider-family member communicating the information had an expectation of confidentiality. From a litigation perspective, Rule 10b5-2 shifts the burden of proof in family-related insider cases from the SEC to the defendant, a change which could have major effects on the ability to successfully litigate such cases. As a result, it should be reemphasized to insiders that transactions by their immediate family members carry a high potential for insider trading liability.

C. 10b5-1(c)(1) Trading Plans

The Rule 10b5-1(c)(1) affirmative defense for trading plans codifies an approach to insider trading law that has already been used in some circumstances. For example, many companies have permitted purchases to occur through periodic investments in stock funds under 401(k) plans, without regard to whether a plan participant possessed material nonpublic information at the time purchases occurred. However, the SEC's adoption of a possession standard for insider trading liability and the fact that trading plans constitute one of only two affirmative defenses to liability recognized by the SEC, place a greater burden on insiders who wish to purchase or sell their company's stock. Failure to satisfy one of the defenses means that an insider must be confident that his or her trade will not otherwise be viewed as occurring while the insider was in possession of material nonpublic information. Although the traditional approach of restricting trades to open "window periods" has merit and will continue to be of use in some situations, the advantages and certainty possible through the use of trading plans suggest that they should be widely used.

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1. Benefits of the Affirmative Defense for Trading Plans

The affirmative defense for selling programs found in Rule 10b5-1(c)(1) offers a number of potential benefits.

(a) Flexibility

The rule allows for a wide degree of flexibility. While people tend to think of trading plans as on-going arrangements, in fact a trading plan may provide for a single transaction. For example, if an executive knows that her child's college tuition will be due in September, she can establish a plan in May, at a time when she is not in possession of material nonpublic information, to exercise a sufficient number of options and sell the underlying shares one month before the due date of the tuition. If the executive happens to come into possession of material nonpublic information by the time the transaction is scheduled to occur, she can still execute the trade, provided that she does not deviate from the trading plan. The fact that a trading plan may establish a limit order and can employ a formula or a delegation of discretion should provide insiders with a sufficient degree of certainty and flexibility necessary in achieving their financial planning goals.

(b) Ease of Administration

Companies should find trading plans easier to administer than traditional window period policies. Because a window period policy does not shield insiders from material nonpublic information, but instead represents only a guideline as to when insiders are less likely to possess material nonpublic information, a window period policy is almost invariably combined with a pre-clearance policy for senior officers and directors. Most general counsels have found themselves in the difficult situation of trying to determine whether a senior officer or director should be advised not to engage in a stock sale during an open window period because of the existence of some information which, in hindsight, may be considered material. As standards of materiality become stricter through application of qualitative tests under SEC Staff Accounting Bulletin 99, the frequency of such determinations may increase. The use of a trading plan will relieve the general counsel of having to "shut the window" and cancel pre-planned transactions. In those cases where an insider has not been able to plan for a transaction in advance and therefore has not established a trading plan, for example where an insider is faced with unexpected and pressing financial needs, Rule 10b5-1(c) may be utilized in conjunction with a short-term company loan to the insider to establish a means for the insider to repay the loan through sales under a trading plan.

In addition, because of the nature of their businesses, certain types of companies may have particularly narrow window periods, with the result that their insiders currently have few opportunities to dispose of their securities.

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This is true of companies that have volatile earnings or are constantly exploring significant acquisition possibilities. It is also true of development-stage companies, which may have "material" information each quarter. Particularly in the case of companies that have narrow window periods, Rule 10b5-1(c) will offer insiders greater financial planning opportunities.

(c) Stockholder and Market Perception

Transactions pursuant to trading plans may be better received by a company's stockholders than episodic window period transactions. Under new Rule 10b5-1(c), a company spokesperson will be able to respond to inquiries regarding an insider's stock sale by stating that the transaction was part of a plan that had been pre-established by the insider. With education, the press and market participants will come to understand that this response indicates that they should not attempt to read the insider's transaction as indicating positive or negative news, since it was planned prior to the time that the insider may have come into possession of material nonpublic information. By allowing insiders to spread out their transactions, the availability of Rule 10b5-1(c) trading plans will also reduce the instances in which a company has a large number of insider trades "bunched" during a particular window period. Not only do bunched trades currently increase the prominence of the insiders' transactions, they also often signal that a company has emerged from a period of time when all of its insiders were viewed as having material nonpublic information and has entered a less eventful business stage.

(d) Defenses in Class Action Lawsuits

Rule 10b5-1(c) trading plans may provide more protection than a window period policy for insider transactions in the context of securities fraud class action lawsuits. Under the heightened pleading standard of the Private Securities Litigation Reform Act of 1995, plaintiffs have frequently pointed to sales by insiders following an allegedly inaccurate or misleading disclosure or prior to an allegedly delayed disclosure as evidence of the insiders' motive – or scienter – in making or delaying a particular disclosure. In the *Silicon Graphics* case, the Ninth Circuit ruled that an insider's stock sale will support a claim of scienter "only when it is dramatically out of line with prior trading practices at times calculated to maximize the personal benefit from undisclosed inside information."[97] The Second and Third Circuits, which apply a "motive and opportunity" standard for pleading scienter, have held that "plaintiffs must allege that the trades were made at times and in quantities that were suspicious enough to support the necessary strong inference of

[97] 183 F.3d 970, 986 (9th Cir. 1999).

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scienter."[98] In addition, some commenters have suggested that the pressure to engage in "earnings management" is heightened by the fact that insiders are only permitted to sell shortly after earnings are released.

Under each of these standards, periodic transactions pursuant to a pattern established under a trading plan should be easier to defend than irregular or episodic trades. For example, while it is not clear that a Rule 10b5-1(c) style trading plan was involved, in *Ressler v. Liz Claiborne, Inc.*, the court held that two defendants' sales pursuant to a "periodic divestment plan" did not appear to be unusual in either their amount or their timing, and therefore did not satisfy the necessary scienter pleading standards.[99]

2. Uses of Trading Plans

The wide flexibility available under trading plans will permit them to be used in a variety of contexts. Of course, traditional considerations as to how stockholders will view a particular form of transaction will continue to apply. Nevertheless, companies and insiders should consider the effect of Rule 10b5-1 on their transactions, and will want to examine whether the affirmative defenses under Rule 10b5-1(c) accommodate transactions that previously raised insider trading liability concerns.

(a) Employee Benefit Plan Purchases

An employee can structure participation in an employee stock purchase plan or 401(k) plan to satisfy the affirmative defense provided by Rule 10b5-1(c). The employee could acquire stock through payroll deductions under such a plan by providing oral instructions governing the employee's participation in the plan, or through the use of a written plan. The "amount" of the transaction could be based on a percentage of the employee's salary to be deducted under the plan and the "price" could be computed as a percentage of market price. The "date" of a transaction could be determined pursuant to a formula set out in the plan. In the alternative, the "date" could be determined by the plan's administrator or investment manager, provided that he or she is not aware of material nonpublic information at the time the transaction is executed and the employee does not exercise influence over the timing of the transaction.

[98] *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1424 (3d Cir. 1997).

[99] 75 F. Supp. 2d 43 (E.D.N.Y. 1998), *aff'd sub nom. Fishbaum v. Liz Claiborne, Inc.*, Fed. Sec. L. Rep. ¶90,676 (2d Cir. 1999).

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(b) Stock Option Exercises

Trading plans may be used to address a number of issues that arise in the administration of employee stock option programs. For example, a trading plan could employ a formula to provide that stock options will be exercised once the spread on exercisable options reaches a certain magnitude. Trading plans will also be particularly useful in avoiding problems that insiders often encounter when they have employee stock options that expire in the near term. By providing for periodic exercises and sales under the trading plan, the insider will not encounter the dilemma of being required to exercise and hold when he or she possesses material nonpublic information at the time that the options are about to expire.

Employees who hold both incentive stock options and non-qualified stock options may implement a trading plan to assist them in satisfying the incentive stock option holding period requirements. The employee could establish a written trading plan under which non-qualified stock options are exercised, the option shares are sold on the open market, and the after-tax proceeds are applied to exercise the employee's incentive stock options. The plan could be designed so that the non-qualified stock option exercise and stock sale occur when the employee's incentive stock options first become exercisable. The number of non-qualified stock options exercised would be calculated under a formula designed to generate, on an after-tax basis, sufficient proceeds to pay the aggregate option exercise price. Although the option exercises themselves do not raise insider trading concerns, use of the trading plan protects the open market stock sales from insider trading concerns.

(c) Single Transaction Trading Plans

Although people tend to think of trading plans as providing for a series of transactions, a trading plan may be established for a single transaction. Where an insider's desire to engage in a transaction is known sufficiently in advance, the insider may provide for a single transaction to occur under a trading plan, either in conjunction with reliance on a window period policy or as an alternative to being restricted to a window period transaction. In fact, it may be preferable to use a trading plan in such circumstances because Rule 10b5-1(c) provides a rule-based affirmative defense from insider trading liability, whereas the efficacy of window period policies for avoiding insider trading is vulnerable to after-the-fact challenges asserting that the insider in fact possessed material nonpublic information even during the window period. There may, however, be a disadvantage to establishing a trading plan where a transaction or series of transactions occurs only during window periods that shortly follow earnings releases, since someone could allege that the insider's knowledge of his or her own trading plan caused the insider to exaggerate the company's performance in its public disclosures.

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(d) Company Stock Repurchase Programs

Company stock repurchase programs are an example of the types of transactions that need to be reconsidered in light of Rule 10b5-1. While Rule 10b-18 provides a safe harbor against such programs being viewed as manipulative, it does not insulate repurchases from insider trading liability. Although repurchase programs have not historically been a focus of SEC insider trading cases, the SEC specifically noted in the release adopting Rule 10b5-1 that the affirmative defenses under Rule 10b5-1(c) are available for repurchase programs. Companies will therefore want to reexamine their repurchase guidelines and determine whether there is a risk that they may be repurchasing shares while in possession of material nonpublic information and, if so, whether the affirmative defenses are available for those repurchases. The affirmative defense employed by a company will depend in large part on the objectives of its repurchase program. Some companies may find that it is possible to conduct their repurchase programs pursuant to a prearranged formula, while others will determine that it is better to establish the parameters of a program at a time when the company is not in possession of material nonpublic information, and then delegate the actual trading decisions to a person (such as a broker) over whom the company does not exercise any influence. Most stock purchase programs that are conducted for employee benefit plans by "an agent independent of the issuer," within the meaning of Regulation M and Rule 10b-18, will satisfy this standard. Other companies may decide to vest trading decisions in an internal department that is segregated from inside information by informational barriers.

(e) Hedging and Option Contracts

Companies that have been active in making strategic investments in other companies should evaluate hedging strategies, which may be more attractive as a result of the trading plan defense. For example, previously a company might have been reluctant to write or purchase options on a stock that it holds in its portfolio, out of concern that the company might posses material nonpublic information on the investee company at the time that the option is exercised. Under Rule 10b5-1(c), however, option transactions can be paired with exercise instructions that are issued at a time when the investor is not in possession of material nonpublic information, and the resulting transactions will be able to claim the protection of the affirmative defense against insider trading.

The same opportunity to use derivative securities in trading plans is available to officers and directors of a company, although these persons must consider appearance issues and corporate policies that might be implicated if they hedge their positions in their employer's stock. For example, if an insider writes a call option so that the other party has the ability to exercise the option at any time, this should fall within the affirmative defense because the amount of shares is fixed, the price of the shares is fixed, and the insider

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would have no influence over the date on which the option is exercised. Similarly, an insider could protect a hedge position by entering into an agreement to sell on a certain date, which would be the expiration date of the hedge. Finally, while there are a variety of reasons why margin loans to insiders may be discouraged, an insider may avoid the potential insider trading concerns raised by margin loans by issuing sell instructions that are tied to the stock price at which a margin call would be issued.

3. Elements of a Trading Plan

While Rule 10b5-1(c) allows a variety of arrangements to take advantage of the affirmative defense, there are certain elements that should be considered in establishing any trading plan.

(a) The Basics

The person establishing a trading plan should ensure that each element of the affirmative defense is addressed – that determinations as to amount, price and date are either specified, prescribed by formula, or delegated to someone who does not possess material nonpublic information and over whom the person does not exercise influence. Other than with respect to amount, price and date, Rule 10b5-1(c) does not specify how precisely defined a trading plan must be. Nevertheless, since the burden will be on the person establishing a trading plan to demonstrate that it satisfies the affirmative defense, as many details as possible should be specified. If a person holds several series of employee stock options which are to be exercised and the underlying shares sold, consider specifying which options are to be exercised; if a person holds shares in more than one brokerage account, consider specifying which shares will be sold. For evidentiary purposes, it will be preferable for a trading plan to be in writing whenever possible, although Rule 10b5-1(c) does not require binding contracts or instructions to be in writing (for example, an instruction to execute a transaction under an employee benefit plan may be transmitted electronically through a telephone response system, and under New York law, for example, a binding contract to sell stock need not be in writing).

(b) Establishing and Implementing a Trading Plan

Ideally, a trading plan would be established at a time while a person is not in possession of material nonpublic information. In situations where that is not practical, however, it appears (although the SEC's release adopting Rule 10b5-1 is not entirely clear on the point) that a person can establish a trading plan while in possession of material nonpublic information as long as all of that information has been disclosed prior to the time that the first transaction occurs under the trading plan. Accordingly, in order to reinforce the position that a person does not possess inside information at the time that transactions occur under a trading plan, it is preferable for there to be some

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delay between the time a plan is established and the time the first transaction occurs under the plan. For example, a person may wish to specify that the first transactions under a plan will not occur until after the company next announces its quarterly earnings and/or files its Form 10-Q or 10-K. If a trading plan relies on discretionary actions of another person, such as a broker, that person should be someone with whom there is only an arm's-length, professional relationship, in order to avoid the appearance that an insider can exercise influence over that person. The person to whom the decisions were delegated should maintain policies and procedures designed to ensure that he or she does not possess material nonpublic information, and the plan also may specify that any communications with that person will be conducted only in writing. The trading plan might specify that the person's trading authority will be terminated or suspended if he or she becomes aware of material nonpublic information.

(c) Timing of Transactions and Delegating Responsibility

Rule 10b5-1(c) allows an insider to specify the date that a transaction will occur or to delegate that decision to a different person, such as a broker, who does not possess material nonpublic information. While insiders may initially be inclined to maintain control over the timing of their transactions, there are a number of reasons why it may instead be preferable to delegate that decision to a broker. By establishing a trading plan that sets a minimum transaction price (in effect, a limit order) with discretion on timing, a broker may be able to help maximize the proceeds from sales, since the broker will be able to take into account publicly available information and general market trend information when determining the timing of trades. The fact that the insider will not know the precise timing of trades may also help deflect suggestions that he or she controlled the timing of company disclosures or exaggerated the company's performance in its public disclosures in order to maximize proceeds. Finally, delegating trading authority may also help in responding to various state law concerns that are addressed below.

(d) Disclosing the Plan's Existence

Rule 10b5-1(c) does not require that a trading plan be publicly disclosed.[100] Nevertheless, there are a variety of reasons a person might decide to disclose a trading plan's existence. First, public disclosure will help to educate and prepare stockholders for subsequent Form 144 and Form 4 reports of insider stock sales. Second, if the existence of a plan is in the

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[100] The SEC's proposed rules regarding disclosure of certain management transactions on Form 8-K, if adopted, would require the disclosure of the adoption, modification or termination of 10b5-1(c) trading plans on Form 8-K. *See* Section II.B. of this outline.

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public record (for example, in an SEC filing), it may be easier to introduce the trading plan into evidence at the motion-to-dismiss stage of litigation. Of course, there are various forms of public disclosure: for example, an explanation in the "remarks" column of a Form 144 may serve the second objective, but not the first. Companies may require that trading plans established by their executives or directors be disclosed to and/or approved by the company. Regardless of whether a company requires disclosure of trading plans, a person establishing such a plan should consider disclosing its existence to the company so that the company does not seek to halt or report what might otherwise appear to be suspicious trading activity.

(e) Compliance with Other Laws

One of the most important parts of implementing a trading plan will be addressing the effects of other laws. For example, responsibility for preparing and filing Forms 144 and Section 16 reports will need to be allocated. This is particularly important to consider in cases where decisions on the timing of transactions have been delegated to a broker or other person. Where applicable, the volume limitations of Rule 144 will also need to be satisfied under a trading plan. A significant issue arises in the context of Forms 144, both because the form must be signed by the person for whose account the securities are to be sold, and because the signature block contains an attestation that the person signing the form does not know any adverse material nonpublic information. One feasible approach may be to include a statement in the "remarks" section of the Form 144 that the attestation is being made only with respect to information known at the time that a trading plan was established. Significantly, trading plans do not address disclosure obligations that arise in the context of registered offerings, where the Securities Act does not allow an alternative to prospectus disclosure of any material nonpublic information. Therefore, trading plans may be of limited use in the context of registered offerings.

State law issues also must be examined. At least forty states have adopted some version of the Uniform Securities Act, which has a provision that is similar to Rule 10b-5 but does not currently have a provision corresponding to Rule 10b5-1(c)(1). Other states, including New York and California, have non-Uniform Securities Act provisions prohibiting insider trading.[101] A number of issues arise under these state laws. For example, it is not clear whether the state laws would be interpreted to apply a "possession" standard of liability, and if so whether an affirmative defense would be implied under that standard. Also, many of the state laws differ from

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[101] California has enacted a regulation that expressly adopted the affirmative defenses provided in Rule 10b5-1(c). *See* CAL. CODE REGS. tit. 10, §260.402 (2001).

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Rule 10b-5 in that the states do not allow a private right of action for violations. These states do provide for civil liability to the counterparty, but this may be of limited practical impact in the context of New York Stock Exchange or Nasdaq trading. Private class actions under state laws allowing for a private right of action based on securities fraud may be subject to federal preemption, either under the Securities Litigation Uniform Standards Act (in the case of class actions) or under common law preemption theories. Finally, there are jurisdictional issues that may affect the applicability of the state law provisions.

State law principles also generally prevent an insider who owes a fiduciary duty to a company or its stockholders from profiting from inside information. While it may often be the case that transactions that satisfy the affirmative defense for trading plans will not be found to breach a state law duty of loyalty (for example, if, under state law, the duty of loyalty would be breached only by actual use of inside information), the case law in relevant jurisdictions should be examined.

(f) Modifying or Terminating the Plan

Rule 10b5-1(c)(1)(i)(C) requires that, to be covered by the affirmative defense, a transaction must occur pursuant to the trading plan. This condition will not be satisfied if the trading plan is altered or deviated from, or if the person enters into or alters a corresponding or hedging transaction or position with respect to the securities subject to the transaction. The SEC's release adopting Rule 10b5-1(c) elaborates that a person acting in good faith may, while not in possession of material nonpublic information, modify a prior trading plan, in which case the modified trading plan will be treated as a new arrangement. Thus, while trading plan modifications are not in fact absolutely prohibited, insiders should design a trading plan with the intention that it will not be modified or amended frequently, since changes to the plan will raise issues as to a person's good faith. As with a new trading plan, it may be advisable to delay the effectiveness of any modification.

Significant issues can arise under sophisticated trading plans as to whether various arrangements will be viewed as "corresponding or hedging" transactions or positions that disqualify the trading plan from satisfying Rule 10b5-1(c). The SEC's release adopting Rule 10b5-1(c) states that trading plans may be used to devise hedging arrangements that manage risk. Thus, it appears that a transaction pursuant to a trading plan may be covered by the safe harbor even if it is designed to hedge a person's stockholdings, but a transaction occurring under a trading plan may not itself be hedged or offset. For example, a person who as part of a trading plan writes a call, giving the counterparty the right to purchase a fixed number of shares for a fixed exercise price, may not subsequently purchase a call that limits his or her exposure under the call that he or she wrote.

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Finally, people designing trading plans must consider the duration of the plan and the manner in which it will terminate. Arguments can be made that a person should always be entitled to terminate a trading plan without affecting the availability of the affirmative defense for prior transactions. However, pending the receipt of confirmation on this point from the SEC, a trading plan must address the situations in which it will expire. If a plan has too short of a life, it may not be easy to reinitiate the plan if the person establishing it has come into possession of material nonpublic information that is unlikely to be disclosed in the near term. Alternatively, if a trading plan has too long of a life, it may not be suitable for changing market conditions or for changed investor objectives. In addition, situations may arise where a person has to terminate a trading plan, for example because merger negotiations have commenced and subsequent transactions will defeat the ability of the merger to qualify for pooling-of-interests treatment, or because of concerns under Regulation M, Rule 10b-18, or the tender offer rules. Therefore, it may be advisable to provide a "safety valve" providing that a trading plan will terminate upon the occurrence of any of these events.

(g) Coordinating with the Company

Officers and directors should coordinate with their company in designing a trading plan. Companies can avoid controlling person liability for insider trading by taking appropriate steps to prevent insider trading, and most companies have sought to establish this defense by adopting insider trading policies. Companies may need to revise their policies to address the effects of Rule 10b5-1. While companies may not want to assume the responsibility of approving trading plans, they may want to review them in advance and require that copies of the plans be furnished to the corporate secretary or general counsel. Companies and insiders should discuss the market perception and possible reaction to trading plans and should consider whether and how the plans should be disclosed.

VII. Selective Disclosure – Regulation FD

A. Introduction

Former Chairman Levitt showed significant concern with what he perceived as the growing incidence of "selective disclosure" of material corporate information in conference calls and private meetings that are open only to selected securities analysts and/or institutional investors.[102] The SEC's growing concern about selective disclosure led to its adoption of Regulation FD (for "Fair Disclosure") governing the process by which

[102] *See, e.g., Chats with Analysts May Give Unfair Edge*, USA Today (March 9, 1998).

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companies release such information.[103] Regulation FD significantly impacts company disclosure practices, particularly the practice of providing informal, on-going earnings guidance and one-on-one meetings between company officers and analysts or market participants. Regulation FD became effective on October 23, 2000.

- Under Regulation FD, if a senior company official or investor relations or public relations representative privately discloses material non-public information to one of Regulation FD's "enumerated persons" (which includes any securities analyst, investment manager, or stockholder who could reasonably be expected to trade the company's securities), the company must publicly disclose that information.
- If the material non-public information is intentionally disclosed to an enumerated person, the company must simultaneously publicly disclose the information. If the disclosure is unintentional, the company must publicly disclose the information within 24 hours after the company learns of the disclosure, or (if later) before the start of the next trading day.
- Regulation FD applies to disclosures by a company's executive officers, directors, investor relations and public relations officers and other employees or representatives who routinely communicate with market professionals. Regulation FD does not apply to foreign issuers.
- Regulation FD disclosure obligations are not triggered by disclosures to persons who owe the company a duty of trust or confidence or who expressly agree to keep the information confidential or by disclosures to rating agencies for use in preparation of a ratings that will be published. The SEC states in the adopting release that Regulation FD also does not apply to communications to the media or to routine business communications with customers and suppliers.
- Public disclosure can be effected by filing a Form 8-K with, or furnishing it to, the SEC or by another means that is reasonably designed to result in broad and non-exclusionary distribution of the information to the public. Postings on a website alone do not constitute public disclosure.
- Violation of Regulation FD can result in an SEC enforcement action, but would not by itself constitute a violation of Rule 10b-5 or result in liability to stockholders.

[103] *Selective Disclosure and Insider Trading*, Release No. 33-7881, 34-43154 (Aug. 15, 2000) (effective Oct. 23, 2000) (available at http://www.sec.gov/rules/final/33-7781.htm).

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B. Summary of Regulation FD

1. Covered Company Disclosures

(a) Persons Speaking on Behalf of a Company.

Regulation FD applies to statements by a company or by a person acting on behalf of a company. For this purpose, the term "person acting on behalf of a company" means:

- any executive officer or director of a company;
- any investor relations or public relations officer;
- any person with functions similar to the foregoing persons; and
- any other officer, employee or agent of a company who regularly communicates with stockholders or one of the market professionals covered by Regulation FD.

A company's disclosure obligations under Regulation FD can be triggered by any of the foregoing persons. However, the timing of the company's public disclosure obligations commences only when one of the first three categories of persons intentionally (including recklessly) makes a prohibited selective disclosure or learns, or is reckless in not learning, that one has been made.

Regulation FD is not triggered by disclosures that other employees may make, although a company may not circumvent the rule by having a lower level employee make disclosures.

(b) Material Non-public Information.

The regulation does not alter the traditional federal securities law definition of "material" information. Information is generally considered material where there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision. In the adopting release, however, the SEC acknowledges the potential difficulty of determining whether a specific disclosure would rise to the level of "materiality." Accordingly, the adopting release provides the following examples of types of information or events that may be considered material:

- earnings information;
- mergers, acquisitions, tender offers, joint ventures, or changes in assets;
- new products or discoveries, or developments regarding customers or suppliers (e.g., the acquisition or loss of a contract);
- changes in control or in management;

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- change in auditors or auditor notification that the issuer may no longer rely on an auditor's audit report;
- events regarding the issuer's securities – e.g., defaults on senior securities, calls of securities for redemption, repurchase plans, stock splits or changes in dividends, changes to the rights of security holders, public or private sales of additional securities; and
- bankruptcies or receiverships.

The SEC states not only that this list is not exhaustive, but also that the list does not imply that each item is per se material. Rather, issuers will continue to have to make independent materiality decisions, taking into account the SEC staff's issuance of Staff Accounting Bulletin No. 99, which states the SEC's position on materiality and emphasizes that the test is not solely an objective quantitative one.[104]

(c) Earnings Guidance.

In the adopting release, the SEC singles out one particular situation that it says raises special concerns: the practice of issuers engaging in private discussions with analysts regarding earnings estimates. The release states that if an issuer selectively discloses to an analyst any material nonpublic information about the company's anticipated earnings in relation to analyst forecasts, this is likely to be a violation of Regulation FD. According to the SEC, this is true regardless of whether the issuer provides the information expressly, impliedly, or even piecemeal:

> If the issuer official communicates selectively to the analyst nonpublic information that the company's anticipated earnings will be higher than, lower than, or even the same as what analysts have been forecasting, the issuer likely will have violated Regulation FD. This is true whether the information about earnings is communicated expressly or through indirect "guidance," the meaning of which is apparent though implied.[105]

However, the release also states that issuers will not be in violation of the rule if they disclose non-material information that enables an analyst, through specialized insight and acumen, to extrapolate from the information and reach material conclusions regarding earnings or other material information or events – often referred to as the "mosaic" theory.

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[104] *See* discussion of Staff Accounting Bulletin No. 99 in Section V.B. above.

[105] Release No. 33-7881.

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2. Communications that Trigger Disclosure

Due to concerns about the broad range of persons to whom disclosure was forbidden under the proposed regulation, the SEC has narrowed the scope of the final regulation to prohibit disclosure only to certain categories of persons. These categories include persons whom the SEC views as being the most likely recipients of improper selective disclosure. Regulation FD is not intended to cover persons who only engage in ordinary-course business communications with an issuer.

(a) Enumerated Persons.

Regulation FD applies only to disclosures to those persons outside the issuer that are enumerated in the rule:

- broker-dealers or persons associated with broker-dealers;
- investment advisers, institutional investment advisers that filed a report on Form 13F for the most recent quarter, registered investment companies, unregistered private investment companies, and associated or affiliated persons of these persons; and
- holders of the issuer's securities where it is "reasonably foreseeable that these holders will purchase or sell the issuer's securities on the basis of the information."

Accordingly, disclosures of material nonpublic information to other persons, including the press, are not prohibited by Regulation FD.

(b) Excepted Persons.

Regulation FD does not apply to disclosures to certain excepted persons. These are:

- persons who owe a duty of trust or confidence to the issuer, such as lawyers, investment bankers and accountants;
- persons who have an express confidentiality agreement with respect to the information; and
- ratings agencies, provided the disclosure is made solely for the purpose of developing a credit rating and the entity's ratings are publicly available.

For example, the adopting release specifically contemplates the disclosure of material nonpublic information to other parties to a business combination without the necessity of public disclosure if the party receiving the information agrees to hold the information in confidence.

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3. Timing and Mechanics of Required Disclosure

(a) Timing for Intentional and Non-Intentional Disclosures.

The timing of required disclosures under Regulation FD depends on whether the disclosure of material nonpublic information is intentional or unintentional. If an issuer or any senior official or any employee who regularly communicates with market professionals or stockholders makes an intentional disclosure of material non-public information, the regulation requires that the issuer simultaneously publicly disclose the same information. A disclosure will be deemed intentional "when the person making the disclosure either knows, or is reckless in not knowing," that the information is both material and nonpublic.

Alternatively, if the disclosure is unintentional, there must be prompt public disclosure "as soon as reasonably practicable" after a senior official knows (or is reckless in not knowing) of the unintentional disclosure. "Prompt" disclosure must be made by the later of 24 hours or the opening of the next day's trading on the New York Stock Exchange.

(b) Means of Disclosure.

Regulation FD provides flexibility in determining what types of public disclosure will satisfy its requirements. In all cases, the furnishing or filing of a Form 8-K that contains the information will be sufficient. "Furnishing" a Form 8-K is a new concept added under Regulation FD, which essentially allows issuers to use the SEC as a repository for information. Furnishing a Form 8-K to the SEC will not alone subject the issuer to liability under Securities Act Section 11 and Exchange Act Section 18, unless the issuer takes steps to include the information disclosed in the Form 8-K in a filed report, proxy statement or registration statement. Filing a Form 8-K, on the other hand, would mean that the information may be subject to liability under Securities Act Sections 11 and 12(2) and Exchange Act Section 18 and will be incorporated by reference into any registration statements that provide for incorporation by reference (e.g., S-2s, S-3s and S-8s). Importantly, all information filed or furnished on Form 8-K remains subject to the antifraud provisions of the securities laws.

Alternatively, an issuer could satisfy Regulation FD if it made public disclosure in another way or combination of ways reasonably designed to provide broad, non-exclusionary public access. For example, an issuer can use a combination of several of the following means, provided that the combination is designed to disseminate the information immediately, broadly and in a non-exclusionary manner: disseminate a press release containing the information through a widely circulated news or wire service; make an announcement at a press conference to which the public is granted access and for which notice has been provided in a form that is reasonably available to

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investors; or disclose the information by another means of electronic transmission, such as listener-access teleconferences or a webcast. An issuer need not take all of the steps all the time. The issuer must be certain, however, that the method or methods of disclosure it chooses, taken together, are "reasonably designed" to provide "broad, non-exclusionary distribution" to the public. One method that the SEC specifically states will not be sufficient on its own, however, is the mere posting of the information on the issuer's website, although the adopting release does state that website posting can be "an important component of an effective disclosure process."[106]

4. Liability under Regulation FD

The adopting release also discusses the extent of an issuer's liability under Regulation FD.

(a) Limited Private Liability.

Regulation FD was adopted pursuant to the reporting provisions of the Exchange Act rather than the antifraud provisions (e.g., Section 10(b)), and expressly provides that failing to disclose information required by Regulation FD does not give rise to private liability. Specifically, Rule 102 provides that Regulation FD does not create a new duty under Rule 10b-5 and stipulates that failing to make a public disclosure required by Regulation FD alone does not constitute a Rule 10b-5 violation. An action under Rule 10b-5 may, of course, lie if disclosure provided pursuant to Regulation FD contains any material misstatement or omission. Noncompliance could subject the issuer to an SEC enforcement action and could also result in an enforcement action against the personnel at the issuer who are responsible for noncompliance.

(b) Collateral Consequences of a Violation.

A number of the SEC's rules and forms, such as Rule 144 and Forms S-2, S-3 and S-8, are conditioned on an issuer being timely and current in its filing of Exchange Act reports, including Form 8-K. Regulation FD provides that a mere failure to provide information on Form 8-K will not affect whether an issuer is timely and current in its Exchange Act reports with respect to eligibility for Forms S-8, S-2, S-3 or Rule 144(c). Thus, an issuer's failure to comply with Regulation FD by filing a Form 8-K would not affect the issuer's ability to raise capital under these short-forms or the ability of the issuer's shareholders to sell securities under Rule 144.

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[106] *Id.*

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5. Operation of Regulation FD during Securities Offerings

The SEC has excluded from the scope of Regulation FD disclosures made under certain circumstances in connection with securities offerings that are registered under the Securities Act.

(a) Registered Offerings.

Except in certain limited circumstances, Regulation FD does not apply to issuer disclosures made in connection with a registered securities offering. In the view of the SEC, "the Securities Act already accomplishes at least some of the policy imperative of Regulation FD within the context of a registered offering."[107] Mechanically, the exemption operates by defining the starting and ending points of a registered offering and excepting disclosure made during such periods. Under Regulation FD, an underwritten offering commences when the issuer reaches an understanding with the managing underwriter and continues until the later of (1) the end of the period during which a dealer must deliver a prospectus and (2) the sale of the issuer's securities. The regulation also defines the starting and ending points of various kinds of non-underwritten offerings. Nonetheless, in order for the exemption to apply, any disclosure must be made "in connection" with the offering. The adopting release points out that a regularly scheduled analyst call concerning financial performance would not be considered a disclosure "in connection with" an offering, even if it happened to occur during an offering period, and thus would not be exempt.

(b) Unregistered Offerings.

The SEC has not extended the public offering exemption to unregistered private offerings. Reporting companies making unregistered offerings must either publicly disclose any material information they disclose nonpublicly to investors or potential investors or, alternatively, require that those who receive such information agree to maintain it in confidence. The SEC states in the release that Regulation FD disclosure is absolutely required in the absence of a confidentiality agreement, and that disclosure is appropriate "even if, as a result of such disclosure, the availability of the Securities Act registration exemption may be in question."[108]

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[107] *Id*.

[108] *Id*.

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C. SEC Release on Regulation FD Study

On December 6, 2001, the SEC released a report prepared by SEC Commissioner Laura S. Unger examining the impact of Regulation FD on the marketplace.[109] The report identified issues of common concern under Regulation FD and made recommendations to the Commission for increasing the effectiveness of Regulation FD. The report made three key recommendations that the SEC should:

- provide more guidance on materiality through issuance of an interpretive release, and, if enforcement action is warranted, consider issuing a Section 21(a) report expressing its views on materiality under Regulation FD;
- make it easier for issuers to use technology to satisfy Regulation FD; and
- examine both the amount and type of information being disclosed post-Regulation FD and, if it is causing companies to cut back on making projections, the SEC should consider using its authority under the Private Securities Litigation Reform Act (PSLRA) to expand the safe harbor to encourage more forward-looking information.

1. Materiality.

With regard to providing more guidance on materiality, the report recommended that the Commission:

- consider issuing an interpretive release that would provide an opportunity to make its position on materiality under Regulation FD clearer by using real-world factual scenarios;
- pay particular attention to the meaning of "earnings information" as used in the adopting release for Regulation FD and to whether factory and plant private tours, which may convey a competitive advantage but not material information, are permissible; and
- consider issuing a Section 21(a)[110] report on materiality under Regulation FD if enforcement action is warranted.[111]

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[109] Unger, Laura S., *Special Study: Regulation Fair Disclosure Revisited* (Dec. 2001) (available at http://www.sec.gov/news/studies/regfdstudy.htm).

[110] Section 21(a) of the Securities Exchange Act of 1934 authorizes the Commission, in its discretion, to publish information "concerning any . . . violations" and to investigate "any facts, conditions, practices or matters which it may deem necessary or proper" in fulfilling its responsibilities under the Exchange Act.

[111] Unger, *Special Study: Regulation Fair Disclosure Revisited* (Dec. 2001).

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2. Use of Technology.

The report recommended making the use of technology easier in Regulation FD compliance by working with SROs to amend their rules to expand the range of tools that would satisfy both Regulation FD and the SRO information dissemination requirements.[112] The report also urged the Commission to "embrace technology to expand opportunities for issuers to disseminate information online" and to encourage issuers to "post written transcripts of webcast presentations and to archive webcasts and transcripts of webcasts on their websites."[113]

3. Disclosure by Issuers Post-Regulation FD.

Finally, the report recommended that the Commission examine what issuers are disclosing post-Regulation FD to determine whether the regulation has created a chilling effect on corporate disclosure. To do this, the report suggested that the Commission look at the amount and type of information issuers are providing in Form 8-K filings, webcasts, press releases and through other modes of dissemination. In its examination, the report recommended that the Commission should try to determine whether the information disclosed is general or specific, whether companies are disclosing earnings forecasts or discussing future business plans and how the depth and specificity of the disclosures compare to pre-regulation disclosures. The report recommended that if Regulation FD has caused companies to cut back on making future projections, the Commission "should consider using its authority under the PSLRA to expand the safe harbor to encourage more forward looking disclosure."[114]

D. ABA Business Law Section Committee Study and Report

On February 1, 2002, the American Bar Association's Business Law Section's Committee on Federal Regulation of Securities issued a study and report on Regulation FD.[115] The study examined surveys of the effects of Regulation FD in its first 15 months of operation and proposed changes designed to enhance the effectiveness of Regulation FD and correct perceived deficiencies. The report recommended changes to Regulation FD, including:

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[112] *Id.*

[113] *Id.*

[114] *Id.*

[115] *Report on Regulation FD*, American Bar Association Section of Business Law Committee on Federal Regulation of Securities (Feb. 1, 2002) (the report can be found at www.abanet.org/buslaw/fedsec/home.html).

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- a more precise interpretation of "materiality" under Regulation FD to provide companies greater certainty in making judgments regarding materiality;
- interpreting Regulation FD to recognize electronic media as an acceptable stand-alone means of public dissemination; and
- technical changes.[116]

E. Guidance for Companies

In light of the significant impact that Regulation FD has on issuer disclosure, all public companies should have in place communications policies and practices adopted to take into account Regulation FD. In October 2000, the staff of the Division of Corporate Finance issued a fourth supplement to the Division's telephone interpretation manual dealing with the application of Regulation FD.[117] There are a number of issues that companies should continue to consider.

1. One-on-one discussions with analysts and giving "guidance" about earnings forecasts are high-risk activities under Regulation FD.

The SEC states in the adopting release that an issuer engaging in a one-on-one discussion with analysts seeking guidance about earnings forecasts takes on "a high degree of risk under Regulation FD." The release also makes clear that it would be a violation of Regulation FD for the issuer to disclose selectively that its earnings are expected to be higher or lower than, or even the same as, what analysts have forecasted. This means that it could be highly problematic for issuers even to confirm that nothing has changed in a component of their earnings models. Likewise, it could be a problem to tell an analyst that the company is comfortable with his or her estimates.

It does appear permissible for a company to point out already publicly disclosed facts that may affect the analyst's estimates but are not reflected in the analyst's model, and to review analysts' reports, but only for purposes of pointing out inaccuracies or omissions of publicly disclosed information. To address this new limitation, some companies may consider more frequent public announcements of

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[116] *Id.* Suggested "technical changes" included allowing increased electronic compliance, revising the public dissemination requirement to give credit to good faith, change the meaning of intentional from the current hair trigger definition to one based on a premeditation standard, permit a longer period of time to remedy selective disclosure if it occurs overseas or after trading hours in the primary market, work with the NYSE and Nasdaq to reconcile their rules, and confirm that embargoing information with analysts and information barriers work under FD.

[117] *See Manual of Publicly Available Telephone Interpretations of the Division of Corporation Finance*, Fourth Supplement (Oct. 2000) (available at http://www.sec.gov/interps/telephone/phonesupplement4.htm).

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material factors affecting their businesses (the same way retailers announce same store sales on a monthly basis and airlines announce their traffic on a monthly basis).

2. The prohibition on selective disclosure is not limited to a company's senior officials.

Regulation FD prohibits any senior official, and any other officer, employee or agent of an issuer who regularly communicates with securities market professionals or shareholders of the issuer from making selective disclosure of material nonpublic information. Companies should be aware that the prohibition is not limited to their senior employees; it extends to any employee who regularly communicates and interacts with these individuals as part of his or her normal job responsibilities. Companies may wish to consider narrowing the scope of "who regularly communicates with" securities market professionals and shareholders. Companies will need to educate their officials and employees about the kinds of communications that are permitted under Regulation FD and implement systems for determining if material nonpublic information has been disclosed.

3. Disclosures exclusively to the press appear to be permitted under Regulation FD.

A company's disclosure of material nonpublic information exclusively to the press should not violate Regulation FD because members of the press are not among the "enumerated persons" to whom disclosure is prohibited. However, once a prohibited disclosure has been made, it is uncertain whether disclosure to the press (absent a formal press release) will satisfy the obligations for "public disclosure" (i.e., a means "reasonably designed to provide broad, non-exclusionary distribution of the information"), since there is no way to be certain whether and when the press will cover the news.

4. The circumstances under which companies may safely disclose nonpublic, non-material information are unclear.

The adopting release is unclear as to the circumstances under which an issuer may disclose nonpublic, non-material information consistent with Regulation FD. The release cautions issuers against attempts to render material information non-material by breaking it into smaller pieces. The release also suggests, however, that the "mosaic" theory is still alive under Regulation FD. As a result, an issuer could safely disclose a piece of non-material information even though an analyst may use that information to complete a "mosaic" of information that, in the aggregate, is material. On the other hand, the SEC does point out that materiality is to be judged by what is material to a reasonable investor, and not necessarily based on what a highly trained and sophisticated analyst may want to know.

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5. Companies should be sensitive to what is required in order to make a "broad, non-exclusionary distribution" of information to the public.

Press conferences and conference calls should be open to the public, either in person or by phone or the Internet. The public must be given adequate notice (by press release and/or furnishing information on Form 8-K) of the conference or call and the means for accessing it. Giving members of the public the opportunity to listen to a call does not mean that they must be allowed to participate. The call could be conducted in "listen-only" mode. It is unclear whether allowing the media only to participate is sufficient. The adopting release speaks broadly of allowing the "public" to participate and, as noted above, it is unclear whether merely inviting media to events will satisfy the public disclosure standard, both because it may not result in further dissemination and therefore may not be a means reasonably designed to result in broad, non-exclusionary disclosure and, with respect to intentional material disclosures, because of the requirement for simultaneous public disclosure.

Posting information on the issuer's website, by itself, is insufficient public disclosure. The adopting release does indicate, however, that website posting may be used as one of a combination of methods designed to make public disclosure.

Live webcasting of analyst conferences or conference calls would enable issuers to satisfy Regulation FD's requirement of simultaneous disclosure for intentional disclosures, and prompt disclosure for inadvertent disclosures. In the latter case, if information is disclosed accidentally during the analyst conference or call, the requirement that it be disclosed "promptly" would be satisfied because of the simultaneous webcast. The public must be given adequate notice of a webcast and the means for accessing it. Until the SEC has clarified the issue, an issuer should also consider summarizing material statements from a pre-planned script in the notice press release or in a press release issued or filed or furnished on Form 8-K prior to or simultaneously with the start of the webcast. The notice might also indicate that viewers who are unable to watch the webcast live can replay it by going to the issuer's website.

6. The decision whether to "file" or "furnish" information on Form 8-K.

The decision whether to "file" or "furnish" information on a Form 8-K may depend upon the type of information being disclosed. Information that is filed will be subject to liability under Securities Act Sections 11 and 12(2) and Exchange Act Section 18 and will be incorporated by reference into any registration statements that provide for this. As a result, filing a Form 8-K would be more appropriate for information that would traditionally be considered material. Furnishing a Form 8-K might be more appropriate to announce a publicly accessible conference or for material that an issuer does not believe contains material information, but that the issuer wants to disclose in order to be sure it has complied with Regulation FD.

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7. Regulation FD prohibits selective disclosure to 13F filers.

Some companies may be 13F filers (that is, institutional investment managers within the meaning of Exchange Act 13(f)(5)) even though they are not financial institutions by virtue of their investments in securities of other companies. This is particularly likely with high-tech companies that have made "partnership," "toehold" or "venture" investments in public companies. Under Regulation FD, companies that filed a report on Form 13F for the most recent quarter ended prior to the date of the issuer's disclosure are included among the "enumerated persons" to whom Regulation FD prohibits selective disclosure of material nonpublic information. As a result, companies that are 13F filers may find public companies in which they have invested reluctant to disclose information about themselves for fear of violating Regulation FD, unless the investor company enters into an express non-disclosure agreement.

8. Regulation FD may create problems for unregistered offerings.

The adopting release indicates that if an issuer discloses material nonpublic information during an unregistered offering of any kind, the issuer must make simultaneous public disclosure of the information or obtain a confidentiality agreement from every private source that receives information. This raises two issues. First, where an issuer elects to make public disclosure, this may result in the creation of a "duty to correct" or "duty to update" if expectations change. Subsequent statements by the issuer would not be protected from liability by the Regulation FD safe harbor under Rule 10b-5. Second, public disclosure of the information may render the issuer's private placement exemption unavailable if not properly structured.

Regulation FD covers all companies registered under the Exchange Act, even companies that have never had an equity IPO and only, for example, have outstanding debt that originally was privately placed and then swapped for registered debt in an Exxon Capital A/B exchange. For such companies, the notion of what is material information may be narrowly construed, since there is no active trading market and the securities trade on the basis of yield and creditworthiness, not current operating data.

9. Individuals should be mindful of traditional concerns about disclosure of material nonpublic information.

Even though customers, suppliers and business partners are not among the "enumerated persons" to whom Regulation FD prohibits disclosure, Regulation FD may create issues where, for example, a business partner is known to be a large shareholder because it has made a significant "strategic investment" in an issuer. Individuals should continue to be mindful of the traditional concerns about "tipping" material nonpublic information and about disclosures leaking into the marketplace.

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VIII. Recent Staff Legal Bulletins

Below are summaries of recent Staff Legal Bulletins issued by the staff of the Commission to communicate the staff's position on certain issues. All of the Staff Legal Bulletins are available on the SEC's website (http://www.sec.gov) under the heading "Other Commission Notices and Information."

A. Staff Legal Bulletin No. 12 -- Frequently Asked Questions About Rule 11Ac1-5

Staff Legal Bulletin No. 12, issued on March 12, 2001, sets forth the view of the staff's Division of Market Regulation in response to frequently asked questions concerning Rule 11Ac1-5 under the Exchange Act, adopted in November 2000, regarding public electronic reports by market centers including uniform statistical measures of execution quality.[118] In the revision of Staff Legal Bulletin No. 12, dated June 22, 2001, the staff added nine (9) questions and responses that have been raised since the Bulletin's original issue date.

B. Staff Legal Bulletins Nos. 13 and 13A -- Frequently Asked Questions About Rule 11Ac1-6

Staff Legal Bulletin No. 13, issued June 22, 2001, sets forth the views of the Division of Market Regulation in response to frequently asked questions concerning Rule 11Ac1-6 under the Exchange Act.[119] Rule 11Ac1-6 requires that all broker-dealers that route orders in equity and option securities make available quarterly reports that present a general overview of their routing practices, including significant venues used and material aspects of the broker-dealer's relationship with those venues. Additionally, Rule 11Ac1-6 requires, on customer request, disclosure of the specific venues to which the customer's individual order was sent. On October 16, 2001, the Division of Market Regulation issued Staff Legal Bulletin No. 13A modifying certain views set forth in Staff Legal Bulletin No. 13 and adding responses to additional frequently asked questions concerning Rule 11Ac1-6.[120]

C. Staff Legal Bulletin Nos. 14 and 14A -- Shareholder Proposals

Staff Legal Bulletin No. 14, issued July 13, 2001, deals with Rule 14a-8 of the Exchange Act, which allows certain shareholders to include proposals in a company's proxy

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[118] *See* Staff Legal Bulletin No. 12, *Frequently Asked Questions About Rule 11Ac1-5* (*revised* June 22, 2001) (available at http://www.sec.gov/interps/legal/slbim12.htm).

[119] *See* Staff Legal Bulletin No. 13, *Frequently Asked Questions About Rule 11Ac1-6* (June 22, 2001) (available at http://www.sec.gov/interps/legal/mrslb13.htm).

[120] *See* Staff Legal Bulletin No. 13, *Frequently Asked Questions About Rule 11Ac1-6* (Oct. 16, 2001) (available at http://www.sec.gov/interps/legal/mrslb13a.htm).

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materials for presentation to a vote at an annual or special shareholder meeting.[121] The bulletin provides a detailed explanation of the rule as well as the procedures involved regarding no-action requests with respect to specific proposals.

The bulletin specifically discusses factors considered (as well as those *not* considered) by the staff in analyzing a no-action request from a company. The staff will analyze only bases for exclusion advanced by the company seeking such exclusion based on the substantive provisions of Rule 14a-8. The staff will also consider prior no-action letters and case law cited by the company and the shareholder as well as those found by the independent research of the staff and determined to support the staff's analysis. A number of examples illustrate how the specific wording of a proposal can govern whether or not a company may exclude that proposal from its proxy materials.[122] For example, the staff concurred that a proposal requiring that independent directors be appointed for all future openings on specified committees be excluded, while the staff did not agree that a proposal requiring a transition to independent directors for each seat on specified committees as openings occur could be excluded.

Additionally, Staff Legal Bulletin No. 14 discusses eligibility and procedural requirements for shareholders to submit proposals for inclusion in proxy materials, and it specifies limited circumstances in which the staff will allow shareholders to make revisions to their proposals, even though such revisions are not specifically provided for in Rule 14a-8.

On July 12, 2002, the SEC released Staff Legal Bulletin No. 14A to clarify certain issues regarding exclusion of shareholder proposals from proxy materials under Rule 14a-8(i)(7), which allows exclusion of proposals relating to ordinary business matters.[123] The SEC indicated it had received four no-action requests regarding exclusion of shareholder approval of equity compensation plans that would potentially result in a material dilution to existing shareholders. In response to each of the requests, the SEC took the view that the proposals could be excluded based on Rule 14a-8(i)(7). Partially due to the significant public debate about shareholder approval of equity compensation plans, Staff Legal Bulletin No. 14A clarifies this position. The bulletin discusses the analysis the SEC will use in the future in dealing with shareholder proposals that relate to shareholder approval of equity compensation plans. According to the bulletin, proposals that focus on equity compensation plans that include compensation only for senior executive officers and directors may not be excluded from proxy materials based on Rule 14a-8(i)(7). Conversely, if the equity compensation plan includes only the general workforce, with no senior executive officer or

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[121] *See* Staff Legal Bulletin No. 14, *Shareholder Proposals* (July 13, 2001) (available at http://www.sec.gov.interps/legal/cfslb14.htm).

[122] *Id.* at Section B.6.

[123] *See* Staff Legal Bulletin No. 14A, *Shareholder Proposals* (July 12, 2002) available at http://www.sec.gov/interps/legal/cfslb14a.htm).

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director involvement, the company may rely on Rule 14a-8(i)(7) to exclude the proposal from proxy materials. If, however, the equity compensation plan includes both senior executive officers and directors and the general workforce, the company may only rely on Rule 14a-8(i)(7) to exclude the proposal from proxy materials if there is no potential of a material dilution to existing shareholders.

D. Staff Legal Bulletin No. 15 -- Listing Standards for Trading Security Futures Products

Staff Legal Bulletin No. 15, issued September 5, 2001, sets forth how a national securities exchange or national securities association may satisfy the condition requiring the filing of listing standards with the SEC before trading security futures products.[124]

The Congressional enactment of the Commodity Futures Modernization Act ("CFMA") on December 21, 2000 lifted the ban on single stock and narrow-based stock index futures. The CFMA also amended the Exchange Act to require that these newly permissible futures contracts be listed on a national securities exchange or national securities association and conform with listing standards that are no less restrictive than those for options traded by the same mechanisms. Staff Legal Bulletin No. 15 sets out sample eligibility and maintenance criteria for security futures and specifically addresses application of these criteria to restructure securities.

IX. Other Corporation Finance Rules and Other Issues

A. The SEC's Response to the Indictment and Subsequent Conviction of Arthur Andersen LLP

Following the March 14, 2002 indictment by a federal grand jury of Arthur Andersen LLP in the Enron Corp. scandal, the SEC announced that it had "approved necessary and immediate regulatory actions to assure a continuing and orderly flow of information to investors and U.S. capital markets and to minimize any potential disruptions that may occur as a result of the indictment of Arthur Andersen LLP."[125] Shortly thereafter, the SEC released temporary and finals rules on the matter, summarized below.[126]

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[124] *See* Staff Legal Bulletin No. 15, *Listing Standards for Trading Security Futures Products* (Sept. 5, 2001) (available at http://www.sec.gov.interps/legal/mrslb15.htm).

[125] *SEC Announces Actions for Issuers in Light of Indictment of Arthur Andersen LLP* (Mar. 14, 2002) (available at http://www.sec.gov/news/headlines/regulatoryactions.htm).

[126] *Temporary Final Rule and Final Rule: Requirements for Arthur Andersen LLP Auditing Clients*, Release No. 33-8070; 34-45590; 35-27503; 39-2395; IA-2018; IC-25464; FR-62 (Mar. 18, 2002) (available at http://www.sec.gov/rules/final/33-8070.htm).

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On June 15, 2002, Andersen was convicted of a felony obstruction of justice charge by a jury in Houston, Texas. Immediately thereafter, the SEC released a statement regarding the conviction and the confirmation that Andersen will cease practicing before the SEC by August 31, 2002.[127] Andersen released its own statement acknowledging the conviction and announcement that it would cease to practice before the SEC by August 31, 2002.[128]

1. Registrants that Continue to Engage Andersen Through August 31, 2002.

Companies to whom Andersen issues a manually signed audit report after March 14, 2002 are required to file a letter as an exhibit to their filings stating "that Andersen has represented to the issuer that the audit was subject to Andersen's quality control system for U.S. accounting and auditing practice to provide reasonable assurance that the engagement was conducted in compliance with professional standards and that there was appropriate continuity of Andersen personnel working on audits, availability of national office consultation and availability of personnel at foreign affiliates of Andersen to conduct the relevant portions of the audit."[129]

The SEC expects that "these assurances will be given in connection with the issuance of the audit report," and noted that "[s]o long as Andersen continues to be in a position to provide those assurances, the Commission will continue to accept financial statements audited by Andersen."[130] Prior to the conviction of Andersen, the Commission emphasized the importance of companies making their own decisions regarding completion of current audits. As such, the actions taken by the SEC do not apply to issuers to whom Andersen issued a signed audit report on or before March 14, 2002. After Andersen's conviction, the SEC stated that the relief announced on March 14, 2002 was "of finite duration and is intended solely to

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[127] *SEC Statement Regarding Andersen Case Conviction* (June 15, 2002) (available at http://www.sec.gov/news/press/2002-89.htm).

[128] *Arthur Andersen LLP Statement Regarding Its Audit Practice* (June 15, 2002) (available at http://www.andersen.com/website.nsf/content/MediaCenterNewsReleaseArchiveSECstatement!OpenDocument).

[129] Release No. 33-8070 at Sections II.A. and IV.A. Section II applies to registrants under the Securities Act, Section IV applies to registrants under the Exchange Act.

[130] *Id.*

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address temporary disruptions that affected issuers may face as a result of Andersen's conviction."[131]

2. Registrants that Are Unable to, or Choose Not to, Engage Andersen.

For those companies that are unable to obtain from Andersen or elect not to have Andersen issue a manually signed audit report, the Commission will require adherence to existing filing deadlines, but will accept filings that include unaudited financial statements.

(a) Registrants Under the Securities Act of 1933.

While disclosure requirements differ from issuer to issuer, each issuer under the Securities Act that is unable to obtain from Andersen or elects not to have Andersen issue a manually signed audit report must provide on the cover page of their filings "a prominent statement that the filing includes unaudited financial statements in lieu of audited financial statements because the issuer was unable to obtain from Andersen or elected not to have Andersen issue the manually signed audit report."[132] These issuers also must prominently state "when and how the issuer intends to provide audited financial statements" and "that no auditor has opined that the unaudited financial statements present fairly, in all material respects, the financial position, etc., for each of the periods reported in accordance with generally accepted accounting principles."[133] These companies will then be required to file a pre-effective amendment, post-effective amendment or an amendment to a document incorporated by reference, as appropriate, containing the audited financial statements for the required periods if the registered offering or offerings have not been completed.

Each issuer filing a Securities Act registration statement containing financial statements as to the examination of which Andersen had been engaged as the independent public accountant is required to file a written consent from Andersen. Realizing that issuers may be unable to obtain these consents, the Commission adopted Securities Act Rule 437a which provides that, in certain cases where Andersen clients cannot obtain the consent, those requirements have been waived provided the filing includes appropriate

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[131] *SEC Statement Regarding Andersen Case Conviction* (June 15, 2002) (available at http://www.sec.gov/news/press/2002-89.htm).

[132] Release No. 33-8070 at Sections II..B.(3).

[133] *Id.*

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disclosure and the registrant has made reasonable efforts to obtain the consent.[134]

Additionally, the SEC adopted temporary Rule 427T under the Securities Act to extend for eligible users the 16 month requirement in Section 10(a)(3) as it relates to audited financial statements. Under Rule 427T, the Section 10(a)(3) timeliness requirement for audited financial statements will be satisfied by any eligible issuer if, (1) the prospectus used more than nine months after the effective date of the registration statement is updated to include unaudited financial information that is as of a date not more than 16 months prior to use and (2) the prospectus used more than nine months after the effective date of the registration statement is updated to include audited financial information that is as of a date not more than 18 months prior to use.[135]

(b) Registrants Under the Exchange Act of 1934

In general, public companies for whom Andersen does not complete audits or reviews will be allowed to file unaudited financial statements rather than audited ones, in order to meet existing periodic reporting, proxy statement, tender offer and registration requirements, as long as they disclose that the financial statement are unaudited (or not reviewed), provide audited (or reviewed) financial statements at a later date and explain any material differences between the unaudited and audited financial statements.[136] Issuers electing this alternative will generally be required to amend their filings within 60 days to include audited financial statements.

For Exchange Act issuers who file annual reports on Form 10-K or Form 10-KSB, the relief provided by the order under the Exchange Act applies to issuers with a fiscal year ending between and including November 30, 2001 and April 15, 2002. For issuers that file quarterly reports on Form 10-Q or Form 10-QSB, the relief provided by the order under the Exchange Act applies to issuers with a fiscal year ending between and including January 26, 2002 and June 15, 2002. For issuers that file proxy statements or information statements that require audited financial statements pursuant to Item 13 or Item 14 of Schedule 14A or Item 1 of Schedule 14C, the 34 Act order permits the filing of unaudited financial statements of issuers, and where applicable, of acquired companies, where the independent public

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[134] *Id.* at Section IV.B.

[135] *Id.* at Section II.B.

[136] *See id.* at Sections II.B and IV.B.

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accountant of the entity in question had been Andersen on or after March 14, 2002. For issuers furnishing proxy statements or information statements in connection with their annual meetings of security holders, or written consent in lieu of annual meetings, at which directors are to be elected, the relief provided by the order under the Exchange Act applies to issuers with a fiscal year ending between and including November 30, 2001 and April 15, 2002 for proxy statements or information statements sent on or before September 13, 2002.[137]

3. Benefits of the SEC's Actions Regarding Andersen

The SEC stated that the benefit of the temporary rules and orders issued is "the mitigation of disruption, uncertainty, lost opportunity, and other costs that, however unlikely, might be visited upon the market and the terminated clients."[138] Additionally, "by virtue of addressing and resolving certain questions, the temporary rules mitigate the costs to terminated clients from having to formulate capital-raising plans in an uncertain regulatory environment."[139] The SEC hopes these rules will help mitigate any possible disruptions to the capital-raising process and will benefit issuers by extending regulatory deadlines that would otherwise be difficult to meet.

Regardless of the effect and benefits of these temporary rules and orders, it is important to note that none of the actions announced by the Commission affect the liability standards to which an issuer's filing is subject.

B. Disclosure by Issuers in a Down Market

In the wake of the terrorist attacks of September 11, 2001, the SEC relaxed a number of rules to aid in the recovery of the market. However, reporting companies must still face the issue of how to disclose results and other events in light of the faltering economy. Companies must resist the desire to avoid difficult disclosure issues and should consider the disclosures that might be necessary in light of a down market and slowing economy.

Management should scrutinize MD&A disclosure in particular in order to provide full disclosure. In a down economy, companies should review their existing financing documentation to determine whether disclosure regarding their compliance with financial covenants is appropriate in the Liquidity and Capital Resources section of MD&A. In addition, diminished refinancing opportunities and reduced access to capital markets should also be considered. In disclosing results of operations, a company should consider whether it is dependent on a dominant customer or supplier that is not performing well in troubled

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[137] *Id.* at Section IV.B.

[138] *Id.* at Section XII.B.

[139] *Id.*

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times, including changing credit issues with respect to those customers or suppliers, and should consider discussing asset impairment and discontinued lines of business if necessary.

Companies should also be cautious in giving projections in a troubled market by fully disclosing the basis on which projections are made and disclosing all material facts necessary to make such statements not misleading. Issuers should adjust previous earnings guidance and projections, if necessary, in light of a major event such as the events of September 11th. Similarly, reporting issuers should recognize and disclose enhanced market risks of certain transactions involving significant potential for losses from fluctuations in the market value of securities or assets involved. William L. Tolbert Jr., assistant director in the Division of Corporation Finance, expressed the SEC's view that, in crafting risk factors dealing with September 11th, issuers should measure risks, if possible, "do the best you can" if a risk is not measurable and, in any event, "let the [SEC] know what you are thinking" in including such risk factor.[140]

C. Employee Stock Options

1. Disclosure of Equity Compensation Plan Information.

On December 21, 2001, the SEC adopted amendments to its disclosure requirements relating to equity compensation plans to require additional information provided in annual reports filed on Forms 10-K and 10-KSB, and in proxy and information statements when the company is submitting a compensation plan for shareholder approval.[141] The SEC's amendments to its equity compensation plan information disclosure rules were prompted, at least in part, by a concern that as the use of equity compensation, particularly stock options, continues to grow, and as companies issue more shares of stock to their employees, the ownership interests of current shareholders may become diluted. Because the distribution of additional shares may result in a significant reallocation of ownership between existing shareholders and management and employees, the SEC believed that investors have a strong interest in understanding companies' equity compensation programs and additional, and more clear, disclosure was necessary.

(a) Content of the Disclosure.

The amended disclosure requirements apply to all equity compensation plans in effect as of the end of a company's last completed fiscal year that provide for the award of company stock or options, warrants, or rights to

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[140] *Securities Official Offers Disclosure Guidance on Risk Factors of Sept. 11 Attacks*, BNA Daily Report for Executives, No. 217 at A-27 (Nov. 13, 2001).

[141] *Disclosure of Equity Compensation Plan Information*, Release No. 33-8048, 34-45189 (Dec. 21, 2001) (available at http://www.sec.gov/rules/final/33-8048.htm).

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purchase stock.[142] An equity compensation plan is "in effect" as long as securities remain available for future issuance under the plan, or as long as previously granted options, warrants, or rights remain outstanding. Disclosure is required regardless of whether the plan participants are company employees (including officers) or non-employees (e.g., directors, consultants, vendors, or customers). Under the amended disclosure requirements, public companies must disclose, in tabular format:

- the number of securities to be issued upon the exercise of any outstanding options, warrants, and rights;
- the weighted-average exercise price of such outstanding options, warrants, and rights; and
- the number of securities remaining available for future issuance under equity compensation plans, excluding those securities reflected above.

The above information must be divided into two categories, based on whether or not the compensation plan was approved by shareholders. Within these two categories, information may be aggregated; it is not necessary to disclose information on a plan-by-plan basis. Information regarding individual equity compensation arrangements and "assumed" plans (*i.e.*, cases in which the company assumed an equity compensation plan in connection with a merger, consolidation, or other acquisition and will be making subsequent grants and awards under this plan) also must be included in the disclosure, in the appropriate category.[143] In the case of individual options, warrants, and rights that are assumed, companies must disclose the number of shares underlying the assumed options, warrants, and rights and the related weighted-average exercise price information on an aggregated basis in a footnote to the table.

If any plan included in the table is a so-called "evergreen plan," containing a formula that automatically increases the number of shares available for issuance by a percentage of the number of shares outstanding, the company also must describe this formula in a footnote to the table.[144]

In addition, for each compensation plan that was adopted without shareholder approval, companies must provide a brief narrative description of the material features of the plan. Companies may satisfy this disclosure

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[142] *Id*.

[143] *See* Release No. 33-8048, at 22.

[144] *Id*.

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requirement by cross-referencing to the financial statement footnote disclosures required by Statement of Financial Accounting Standard No. 123 ("SEAS 123") containing the relevant information.[145] The cross-reference should identify the specific plan or plans in the SEAS 123 disclosure that were not approved by shareholders, as companies are not required to distinguish between shareholder approved and non-shareholder approved plans in their SEAS disclosures.

(b) Location of the Disclosure

The amendments require the table to be included each year in a company's annual report on Form 10-K. In addition, it must be included in a proxy statement when a company is submitting a compensation plan for shareholder approval. To avoid redundancy, the amendments permit companies that are required to include the information in both a Form 10-K and in a proxy statement to satisfy their Form 10-K disclosure requirements by incorporating the information by reference to their definitive proxy statements (if that proxy statement involves the election of directors and is filed not later than 120 days after the end of the fiscal year covered by the Form 10-K). The disclosure is not required in Securities Act registration statements.

(c) When Disclosure is Not Required

The new disclosure requirements do not apply to plans that issue warrants or rights to all shareholders on a pro rata basis or to any qualified employee benefit plan.

(d) Filing of Non-Shareholder Approved Plans

The amendments also revise the exhibit requirements contained in Item 601 of Regulation S-K to require companies to file with the SEC a copy of any non-shareholder approved equity compensation plan in which any employee participates, unless the plan is immaterial in amount or significance.[146] Existing non-shareholder approved plans are subject to this requirement, and copies of such plans must be filed as an exhibit to the Form 10-K for the company's first fiscal year ending on or after March 15, 2002.

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[145] *Id.*

[146] *Id*. at 23.

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(e) Guidance for Companies

- First, companies should gather the required information regarding all equity compensation plans. Companies should note that the SEC considers both individual arrangements and assumed plans to be subject to the disclosure rules. Individual arrangements are "plans" that apply to only one person within the company, for example a corporate officer. Assumed plans are those that a company acquired in connection with a merger, consolidation, or other form of acquisition. Information regarding both individual arrangements and assumed plans are to be aggregated with the information pertaining to other equity compensation plans, and divided into the two categories of shareholder approved and non-shareholder approved.
- Second, companies should review the required information and prepare a mock-up of the table, as it would appear in an annual report or proxy statement. This step will provide companies with a concrete image of how shareholders will be presented with the information.
- Third, based on the mock-up of the table, companies should consider how shareholders will perceive their plans, and whether it is in their best interests to modify or terminate any plans before disclosure is required. Note that disclosure is required with respect to any compensation plan "in effect" as of the end of the Company's last completed fiscal year. As mentioned earlier, a plan is "in effect" as long as securities remain available for issuance under the plan or as long as options, warrants or rights previously granted under the plan remain outstanding.

2. Repricing of Stock Options

The Division has been stating informally that it believes exchange offers involving option repricings may involve a tender offer subject to Rule 13e-4 as well as Regulation 14E and requiring the filing of a Schedule TO-I at the time the exchange offer commences. On March 21, 2001, the Division of Corporate Finance issued an exemption order under the Exchange Act for issuer exchange offers that are conducted for compensatory purposes.[147] The order exempts such exchange offers, typically stock option exchange offers, from the "all holders" and "best price" provisions reflected in Rules 13e-4(f)(8)(i) and (ii) of the Exchange Act, so long as all of the following conditions are met:

[147] *Exemptive Order* (Mar. 21, 2001) (available at http://www.sec.gov/divisions/corpfin/repricing.htm).

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- the issuer is eligible to use Form S-8, the options subject to the exchange offer were issued under an employee benefit plan as defined in Rule 405 under the Securities Act and the securities offered will be issued under such an employee benefit plan;
- the exchange offer is conducted for compensatory purposes;
- the issuer discloses in the offer to purchase the essential features and significance of the exchange offer, including risks that option holders should consider in deciding whether to accept the offer; and
- except as exemption in the order, the issuer complies with Rule 13e-4.

In its interpretive guidance with respect to the exemptive order,[148] the Division also stated that such disclosure should contain financial information about the issuer, which generally is material to the investment decision of the option holder, but that such financial information may be in summary form if the issuer incorporates its financial statements by reference. The Division has taken the position that a tender offer is involved unless the offer is limited to executive or senior officers of the issuer, the exchange is a privately negotiated compensation arrangement, the exchange only involved the lowering of the option exercise price of outstanding stock options with no other changes or such change can be unilaterally effected without option holder consent.

3. Registration under Section 12(g)

Many issuers that granted stock options to employees in anticipation of an initial public offering and that subsequently failed to go public now find themselves confronting the registration requirements of Section 12(g) of the Exchange Act. Section 12(g) requires any issuer having 500 or more holders of record of a class of equity securities and more than $10 million in assets at the end of its most recent fiscal year to register the class of equity securities. Under the Exchange Act, the definition of "equity securities" includes options.[149] Consequently, for issuers that granted options to 500 or more employees, the prospect of registration has caused concern. Although these issuers have no public investors, and no market for trading the options or the underlying stock, upon registration under Section 12(g), these issuers would become subject to the reporting requirements of the Exchange Act and must furnish the same disclosures as any publicly held company. These disclosures would include annual and quarterly reports, including audited financial statements. In addition, registration under Section 12(g) would place other burdens on these issuers.

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[148] *Current Issues and Rulemaking Projects Quarterly Update* (Mar. 31, 2001), (available at http://www.sec.gov/divisions/corpfin/cfcrq032001.htm).

[149] Section 3(a)(11) of the Exchange Act defines "equity security" to include any warrant or right to subscribe for or purchase any stock or similar security.

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Registration would, among other things, subject the issuer's stockholders to Section 13(d) of the Exchange Act, dealing with reporting ownership above 5%, and would also subject the issuer to the proxy rules under the Exchange Act.

On March 29, 2001, the SEC's Division of Corporation Finance revised the conditions that issuers must satisfy in order to obtain relief from registering employee stock options under Section 12(g). The action taken in March loosened the restrictions that the SEC has imposed in the past as a condition to granting such relief.

In the past, the SEC had granted no-action relief to issuers who would otherwise have been required to register because they had more than $10 million in assets and 500 or more employees who held stock options, provided that the following conditions were met:

- options would be granted under a stock option plan only to employees;
- options would be granted without consideration, and at fair market value exercise prices, for the purposes of incentivizing employees to work to improve share value;
- holders of options would be under no obligation to exercise options and options would not become exercisable until a future public offering or at some other relatively distant date;
- options would be non-transferable;
- the issuer would have the right to cancel options under various circumstances in return for a cash payment based on an annual appraisal of the underlying common stock, but there would be no other market or methodology by which an option holder could receive anything of value for an option prior to its exercise, and accordingly no trading interest in the options would exist;
- the issuer would undertake to provide option holders with certain material information about the options; and
- the no-action relief requested would be limited to options granted under the stock option plan.[150]

In its March 31, 2001 quarterly update to its Current Issues and Rulemaking Projects Outline,[151] the Division of Corporation Finance indicated that it would relax

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[150] *See* Mitchell Int'l Holding, Inc., 2000 SEC No-Act LEXIS 1033 (Dec. 27, 2000); General Roofing Services, Inc., 2000 SEC No-Act LEXIS 496 (Apr. 13, 2000); Kinkos, Inc., 1999 SEC No-Act LEXIS 928 (Nov. 30, 1999); WRQ, Inc., 1997 SEC No-Act LEXIS 1100 (Dec. 31, 1997); BSG Corp., 1995 SEC No-Act LEXIS 617 (Aug. 1, 1995); Superior Services, Inc., 1994 SEC No-Act LEXIS 374 (Mar. 18, 1994); Starbucks Corp., 1992 SEC No-Act LEXIS 483 (Apr. 2, 1992).

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the conditions for relief from registration in several ways. Issuers must still apply to the SEC for no-action relief from the registration requirements of Section 12(g), but they may either satisfy the conditions listed above or provide more disclosure to optionholders but satisfy the conditions subject to the following modifications:

- the options can be immediately exercisable;
- former employees may retain their vested options;
- the options may be transferable on the employee's death or disability;
- the stock received upon exercise of the options may not be transferable except back to the issuer or in the event of the employee's death or disability; and
- consultants may participate in an option plan if they would be able to participate under Securities Act Rule 701.

An issuer may only take advantage of these relaxed conditions if it provides its employee option holders with the same level of information that would be available if the issuer were in fact subject to the reporting requirements of the Exchange Act. This information includes the information that would be found in an initial registration statement, annual and quarterly reports, including audited annual financial statements and unaudited quarterly financial statements prepared in accordance with GAAP. The preparation of equivalent disclosure will impose substantial costs on issuers and may necessitate that they disclose to employee option holders financial and proprietary information.[152]

For calendar-year companies that met the threshold for registrations under Section 12(g) as of December 31, 2000, the deadline for filing an Exchange Act registration statement was April 30, 2001. The Division of Corporation Finance indicated in its March 31, 2001 quarterly update that it would consider extending the

[Footnote continued from previous page]

[151] *See* Division of Corp. Fin., U.S. Sec. and Exch. Comm'n, Section 12 Registration Relief Involving Employee Stock Option Plans, Quarterly Update to Current Issues and Rulemaking Projects Outline (Mar. 31, 2001).

[152] In most cases, issuers that are in this situation will have issued more than $5 million in options during the applicable 12 month periods under Rule 701 of the Securities Act. Consequently, even in the absence of the more onerous information disclosure requirements imposed by the SEC, Rule 701 requires that the issuer distribute to option holders the financial information required by Part F/S of Form 1-A. Such information, however, while still raising the same issues about disclosure of proprietary information, would not have to be audited, and would not have to be accompanied by all of the other information required in annual and quarterly reports.

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filing date to July 30 of this year for any issuer that submitted a no-action request to the SEC by April 30. The staff is responded to letters it received by April 30.[153]

4. Other Developments Affecting Equity Compensation Plans

An overall increase in the use of equity compensation and more relaxed security holder approval requirements has prompted concerns that investors may not be able to readily assess the dilutive effect of a registrant's equity compensation program. These concerns have generated attention to the shareholder approval requirements of the New York Stock Exchange ("NYSE") and the Nasdaq Stock Market. At the same time, the newly reconstituted International Accounting Standards Board ("IASB") has announced its plan to study equity-based compensation plans with a view to developing an international financial reporting standard.

(a) NYSE/Nasdaq Shareholder Approval Requirements

As discussed above, both the NYSE's and Nasdaq's proposed changes for their respective listing standards, include requirements that shareholders be given the opportunity to vote on most equity compensation plans. The NYSE proposals would exempt only inducement options, plans relating to mergers and acquisitions, and tax qualified and excess benefit plans from the shareholder approval. Similarly, the Nasdaq proposals exempt inducement grants (provided the grant is approved by an independent compensation committee or a majority of independent directors), certain tax-qualified plans and grants in connection with a merger or acquisition.

(b) IASB Study

In July 2001, the IASB adopted a plan to study the accounting treatment of equity compensation plans, noting that share-based compensation is increasing worldwide, yet there is no international standard for accounting. The starting point for its study was a July 2000 discussion paper issued by G7+1, a group of representatives of the national standard-setting bodies in Australia/New Zealand, Canada, the United Kingdom, and the United States, which called for, among other things, recognizing share-based payments in companies' financial statements using an option pricing model to estimate the fair value of each option. IASB is working on recommendations that would require stock compensation, whether used for employees or non-employees, to be charged to earnings, based on a measure of fair value. IASB is expected to issue its proposals for public comment in the fourth quarter of 2002.

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[153] See, e.g. Tality Holdings, SEC No-Action Letter, 2001 WL 1117941 (S.E.C.) (September 24, 2001); AMIS Holdings, SEC No-Action Letter, 2001 WL 856459 (S.E.C.) (July 30, 2001).

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(c) FEI's Position

On December 10, 2001, the Financial Executives International ("FEI"), a professional association for senior financial executives, many of whom are chief financial officers, treasurers, and controllers, submitted a comment letter to the NYSE supporting listing standards that would require shareholder approval of all option plans that include officers and directors. FEI also recommended that the NYSE and Nasdaq require shareholder approval of all "broadly based" plans in accordance with the NYSE Task Force recommendation. The FEI stated its belief that employee stock option issuance is a matter of corporate governance, and therefore "it is 'best practice' to obtain shareholder approval of all such plans." FEI strongly opposes the approach that IASB seems to be taking, and recommended in a white paper issued in October 2001 that the IASB instead encourage the adoption of the current U.S. model for accounting for stock options.

(d) Voluntary decisions by a number of Companies to Expense Stock Option Grants

Given the considerable scrutiny of corporate accounting procedures, a number of companies have made voluntary decisions to expense stock options as costs according to FASB Statement No. 123, Accounting for Stock-Based Compensation. Prior to these recent announcements by a number of companies, very few corporations, including Winn-Dixie and Boeing, expensed option grants as costs on financial statements. In recent months, companies that have announced plans to begin expensing stock options include: Amazon.com, AMB Property Corp., Ambac, Bank One, Cinergy, Coca Cola, Computer Associates, Fannie Mae, Freddie Mac, Gambelli Asset Management, General Electric, Household International, Home Depot, iStar Financial, Level 3 Communications, Macdermind, NetFlix, Neuberger Berman, Rambus, Scotts Company, Sovereign Bancorp, Toronto-Dominion Bank, Wachovia Bank, and The Washington Post.[154]

(e) FASB Announcements

FASB has also made two recent public comments regarding the accounting treatment of stock options. FASB, which has, since the mid-1990's release of its Statement No. 123, recommended the expensing of stock options according to their fair value, issued a press release on July 31, 2002, in which it praised the several public companies that have recently announced

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[154] This list was compiled based on partial lists released by The Motley Fool web site (www.fool.com) and other web reports. It should not be considered a conclusive list of companies who have decided to expense stock options.

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intentions to expense stock options.[155] The release also disclosed FASB's plans to study the expected proposals from IASB later this fall and consider, based on those proposals, changes to its current policies.

On August 20, 2002, FASB released a project update, in which it announced plans to undertake a "limited project" to reconsider the transition and disclosure provisions of Statement No. 123.[156] The project does not include a requirement for companies to adopt the fair value expensing of stock options, but it does provide several optional transition methods for companies who do decide to expense option grants. Companies that decide to exempt option grants according to their fair value may:

- recognize the cost of the grant after the beginning of the fiscal year in which the change in accounting method is made;
- recognize the cost of the grant for the year of change equal to that which would have been recognized had Statement 123 been adopted as of its effective date; or
- recognize the cost of the grant for the year of the change and restate prior years financial statements presented as though the accounting method had been adopted as of its effective date.

The update also proposed to amend financial disclosure requirements with regard to option grants. Under the proposed amendments, a company would have to disclose the method of accounting for stock options used in each reporting period. Also, a company must, for stock option grants recognized in reports, but not measured according to the fair value recognition provisions of Statement 123, the company must present, in tabular format, the total stock compensation cost included in net income for the period, additional stock compensation that would have been included had the company followed the fair value method of 123, and pro forma net income and earnings per share that would have been reported had fair value recognition provisions of Statement 123 been adopted as of its effective date.

FASB expects to issue an Exposure Draft for comment in late September 2002.

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[155] *FASB's Plans Regarding the Accounting for Employee Stock Options*, (Jul. 31, 2002) (available at http://www.fasb.org/news/nr073102.shtml).

[156] Amendment of the Transition and Disclosure Provisions of Statement 123, (Aug. 20, 2002) (available at http://www.fasb.org/project/amend_123.shtml).

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GIBSON, DUNN & CRUTCHER LLP

FEBRUARY 13, 2002

AFTER ENRON: ISSUES FOR BOARDS AND AUDIT COMMITTEES TO CONSIDER

In light of the circumstances surrounding Enron's bankruptcy, boards of directors and audit committees should reexamine their own reporting and oversight practices. Below, we offer a number of practical suggestions for boards and audit committees to consider. In summary:

- While much can be learned from Enron's collapse, boards and audit committees should tailor policies and procedures to their own companies and the specific issues and risks facing those companies.
- Board and audit committee review of policies and procedures should focus on staffing and on communication with management, outside auditors and internal audit and financial personnel.
- The audit committee should be fully briefed on critical accounting policies, off-balance sheet financing, related-party transactions and other issues affecting the company's financial operations and reporting.
- Audit committees should maintain flexibility in their charters to focus on policies and procedures that are important to companies' specific business operations and financial risk profile, which also may change from time to time.

Directors should keep in mind that the specific "problem areas" that contributed to Enron's downfall may not be the sensitive areas for their own companies. Rather than focusing on Enron-specific issues, boards and audit committees should assess the financial risks and critical accounting policies that affect their *own* financial statements and disclosures, and they should make a renewed commitment to adhere to prescribed policies and procedures. Many audit committee practices that were sound before Enron remain sound today. Although these practices may need to be supplemented, radical revision to recently adopted or amended audit committee charters should not be necessary.

Not all of these ideas will be appropriate for every company. Directors – and especially audit committee members – should consider how (and whether) each issue impacts their own company. Because every company's circumstances are different, audit committees should not set forth a list of tasks and responsibilities that respond to the problems that arose at Enron. Instead, audit committees must retain flexibility in their charters and procedures to identify and respond to company-specific and new issues as they arise.

Again, we do not believe that extensive revision of audit committee charters will be necessary for most companies at this time. For those boards considering some adjustments, however, we are attaching a revised, marked copy of our model audit committee charter.

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Audit Committee Liability

Many audit committee members have asked whether they face an increased liability risk in the post-Enron environment. While audit committees will no doubt face greater scrutiny, the relevant standards of director care and liability have not changed. Like other directors, audit committee members have two basic duties: care and loyalty. The duty of loyalty is implicated when a director enters into a transaction with, or has a conflict of interest with, the company he or she serves. Because audit committee members for New York Stock Exchange ("NYSE") and Nasdaq listed companies must meet high standards of independence, the duty of loyalty is rarely implicated in audit committee work for these companies. Nevertheless, the audit committee should examine more broadly any relationships that exist between the committee members and the company. These relationships should be disclosed to the board members, who should consider whether the relationships impair independence or create the appearance of impairing independence. (Note that questions have been raised about the independence of several Enron audit committee members who had consulting arrangements with the company or were affiliated with charitable institutions supported by the company.)

The duty of care, which relates to a director's responsibility to exercise appropriate diligence and act in good faith, requires audit committee members to attend meetings, actively participate in discussions and vote on appropriate matters. Although audit committee members are not accountants, they must learn about and understand their company's critical accounting issues well enough to ask tough, insightful questions. Audit committee members should become and stay informed about the business and affairs of the company, and they should inquire into potential problems when alerted by circumstances or events. Courts have stated that the duty of care includes a responsibility to see that the company has in place a system of internal controls reasonably designed to prevent violations of law and corporate policy and to permit the company to prepare accurate financial reports. In this regard, audit committee members should verify that the company's information and reporting procedures and controls are adequate to ensure that appropriate information comes to the board's attention in a timely manner. In overseeing the financial reporting process, committee members should adopt an attitude of constructive skepticism. They should assure themselves through discussions with outside auditors and, if necessary, legal counsel and other outside advisors, that the outside auditor is independent, understands that it is accountable to the board of directors through the audit committee, and has properly staffed and scoped its audit services.

Like other directors, audit committee members are not guarantors of perfection. The courts have long recognized that it is bad policy to apply "20/20 hindsight" to past business judgments made in good faith. This core principle has not changed. If audit committee members review committee processes in light of current concerns, satisfy themselves that those processes are designed to provide reasonably careful oversight of internal controls and financial reporting, and conscientiously oversee the implementation of

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procedures they have established, they should not be concerned about increased liability risks.

Auditor Independence

The Enron debacle has reopened the debate about the provision of non-audit services by outside auditors and its effect on independence. Enron paid its outside auditor, Andersen, over $50 million in 2000, $27 million of which constituted compensation for "non-audit" services, including risk management and internal audit services. A number of accounting firms already have announced that they will no longer provide certain of these services to their audit clients, and legislation has been introduced in Congress prohibiting the provision of some types of services to audit clients. Accordingly, audit committees should reexamine their company's practices in this area.

At a minimum, an audit committee should consider adopting a policy (or, if it already has a policy, reviewing that policy) governing the provision of non-audit services by an outside auditor. Such policies are now common and generally address such issues as categories of prohibited and permitted services and audit committee advance approval thresholds and procedures. More specific guidance with respect to the factors audit committees should consider is provided by *The Panel on Audit Effectiveness: Report and Recommendations* (the "O'Malley Panel Report") (Aug. 31, 2000). Even after adopting such a policy, the audit committee should periodically monitor the non-audit services that are actually being provided by outside auditors and should confirm compliance with its policy and consider the potential impact on auditor independence of the amount and type of services provided.

An audit committee might consider discussing in its audit committee report (or elsewhere in the company's annual proxy statement) the nature of any non-audit services performed by the company's outside auditor and the company's policy with respect to such services. Although SEC rules currently require disclosure of the *amount* of fees paid for audit and non-audit services, additional discussion of the *nature* of non-audit services obtained from a company's outside auditors may be helpful in allaying concerns about auditor independence.

Financial Management and Auditor Competence and Staffing

Audit committees regularly meet with senior financial management and with the leading members of the outside auditor's engagement team. The audit committee should use these opportunities to assess the professionalism, responsiveness and candor of the outside auditors. When the outside auditor presents its audit plan and scope, the audit committee should question not only the plan but also the personnel who will play important roles in carrying it out. We understand that some of the national accounting firms have prepared presentations regarding staffing, training and peer review issues; audit committees should inquire about the availability of such presentations. The committee should be comfortable that the audit team has leadership experienced in the relevant market, and it should be certain that the audit team has access to the relevant technical experts in the auditor's national office.

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In their private sessions with outside auditors, committee members should ask for candid assessments of senior management (particularly financial management), focusing on the culture set by management and the quality of accounting and disclosure judgments made by management. Audit committees should also address these types of issues with its internal audit staff or, if there is no internal audit function, with the chief financial officer and controller. Audit committee members should be comfortable with the competence – and the adequacy of budget and staffing – of the company's internal audit and financial accounting staff. If the committee does not have confidence in management or the audit engagement team – or if it has concerns about key accounting or disclosure policies – it should insist on changes until it is comfortable.

Audit Committee Composition

Another area of concern in the post-Enron environment has been the independence of audit committee members. The media has reported that a number of Enron directors – including some members of the audit committee – had personal or financial connections to the company's management. Some of these connections did not require disclosure under current SEC requirements, which focus on employment, family and business relationships between directors and management.

Prominent shareholder groups have urged the SEC to adopt new rules mandating disclosure of *all* personal, family, business, political and philanthropic connections between directors and management. Such rules would require disclosure, for example, of company and management donations to charities supported by particular directors, political contributions to family members of directors, and the provision of any legal, financial or medical services by a director or family member to any company officer. In light of these concerns, we encourage boards and audit committees to reexamine *all* director relationships, including those that do not currently require disclosure but that could cause investors or regulators to question directors' independence (particularly in hindsight).

In addition, boards should consider the process they follow with respect to committee and chair assignments. Does the nominating/corporate governance committee, the full board, or the CEO select who will serve on the audit committee and who will chair it? Does audit committee membership or chairmanship change from time to time so that a fresh perspective is brought to bear on committee matters?

Audit Committee Communications

One of the central themes to emerge from the Report of Investigation by the Special Investigative Committee of Enron's Board of Directors was the failure of communication among the company's management, board of directors, audit committee and outside auditors. As a result, many audit committees are reexamining their practices and procedures for communicating with management, internal financial and accounting staff, and outside auditors. In reviewing their current practices, audit committee members should make sure that committee schedules and agendas permit – and encourage – active engagement and give-and-take discussions with management and auditors, both singly and in groups. For example, annual private sessions with internal and outside auditors may

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not be sufficient; many committees now hold such sessions at every meeting. A one-hour audit committee meeting just before a full board meeting may be too short. Many audit committees now schedule a more open-ended time slot on the day before a full board meeting in order to ensure that the committee is not rushed through its agenda. The board and audit committee also should consider whether the company has in place effective mechanisms for company employees, particularly financial and accounting staff and lower level officers, to voice concerns or register complaints about internal controls or financial irregularities.

Communications with management. The audit committee should meet regularly with the chief executive, chief financial and chief accounting officers, not only to discuss accounting and reporting issues but also (as noted above) to assess the quality and effectiveness of these officers. Committee members should ask thought-provoking questions: What policies and risks concern you? What financial reporting practices are our competitors following? What financial commitments is the company reliant on? What are your contingency plans if things do not go as you expect? Committee members should make it clear that they expect to be alerted to potential areas of concern *before* they become significant problems.

Communications with internal auditors. There should be regular private sessions between the audit committee and the head of internal audit. If the company does not have an internal audit staff, similar conversations should be held with the staff responsible for financial reporting. The head of internal audit should be directly accountable to the audit committee, which should oversee the hiring, compensation and career path of employees in the internal audit function. If an outside firm is retained to perform this function, the audit committee should be comfortable that the company has sufficient expertise to oversee the contractor's performance.

Communications with outside auditors. Audit committee members should make it crystal clear to the company's outside auditors, as required by NYSE and Nasdaq rules, that the outside auditors are accountable to the board of directors through the audit committee, *not* to management. Audit committee policies and procedures should encourage communications between the outside auditors and the audit committee. The outside auditors should be encouraged to disclose all significant areas of concern or discussion with management as to accounting principles or controls, even if the area of concern was resolved with management to the auditor's satisfaction. The audit committee members should not leave it to the auditors to raise issues, but rather should ask their own questions. For example, audit committee members might ask whether the outside auditor has made any recommendations that management has not followed, whether issues have arisen that the auditor discussed with its national office, and whether the auditor would make any changes to the financial statements if it were in management's shoes. In both private sessions and meetings involving management, the audit

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committee should solicit the auditor's views on the overall quality of the company's financial reporting, including financial disclosures and important accounting principles. Although these discussions are required in connection with the annual audit, more frequent communications may be appropriate.

Codes of Conduct and Related Party Transactions

Related party transactions are one element of the Enron situation that *every* audit committee should focus on. Media reports indicate that Enron's board waived parts of the company's code of conduct on at least two occasions, allowing the company's chief financial officer to become involved with private partnerships that did business with Enron. Congressional investigators, as well as Enron's own Special Investigative Committee, have questioned whether the board should have approved these related party transactions and whether certain controls imposed by the board were properly implemented. In addition, the SEC's recent statement concerning Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") flagged related party disclosures as warranting particular attention. *See* Release Nos. 33-8056, 34-45321 (Jan. 22, 2002).

We strongly encourage boards and audit or other responsible committees to review their existing codes of conduct or conflict-of-interest policies with particular focus on related party transaction practices and procedures. To the extent that waivers or deviations from such policies are permitted, they should be carefully documented and monitored. Company approval procedures should be scrupulously followed, and the audit committee should insist on follow-up reports. The SEC's recent MD&A statement specifically states that audit committees should review the terms and effects of related party transactions prior to recommending that a company's financial statements be included in its Form 10-K. In conducting the review, audit committees should take an expansive view of what is considered a "related party," focusing on "sweetheart deals" in addition to relationships required to be disclosed under SEC or accounting rules. Even if the audit committee is not the board committee responsible for overseeing the company's code of conduct, it should review all related party transactions to the extent that they could significantly affect the company's financial statements.

Critical Accounting Policies and Other Material Risks

According to SEC Chairman Harvey Pitt, every public company has "three, four, or five . . . critical accounting policies upon which [its] financial status depends, and which involve the most complex, subjective, or ambiguous decisions and/or assessments." *See* Harvey L. Pitt, Testimony Concerning Legislative Solutions to Problems Raised by Events Relating to Enron Corporation, House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises (Feb. 4, 2002). In the wake of the Enron debacle, the SEC has recommended that "[i]nvestors . . . be told, concisely and clearly, how these principles are applied, as well as information about the range of possible effects in differing applications of these principles." *Id.* *See also* SEC Release Nos. 33-8040, 34-45149 (Dec. 12, 2001). In light of these comments, audit committee

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members should engage in a candid dialogue with financial management and outside auditors to identify what critical accounting policies most affect their companies' financial statements. They should make sure that they understand what these critical principles are, how they operate, how they affect reported results and how they compare with principles followed by peer companies. They should also discuss with management the extent to which these policies are disclosed in the companies' MD&A. If they are not already doing so, they should review both complimentary and critical press and analyst reports, and they should understand what questions analysts and commentators are raising about their companies' operations and financial reports.

Every company has its own risk profile, and each company's profile is different. The audit committee should focus on identifying and reviewing with senior management and outside auditors the key areas of business and financial risk to which the company is exposed. The process of overseeing management as it manages, identifies and responds to such risks is the most important job of any audit committee. To this end, a company's audit committee should consider devoting a portion of its annual agenda to a briefing and dialogue with the corporate managers of the company's various operating groups in order to understand the risks presented by, and the risk management techniques employed in, those functions or operations.

A mistake that many companies make is to look backward rather than forward – to concentrate on past problems or on problems at other companies (e.g., Enron) rather than on risks presented by current operations. While directors should learn from the mistakes at Enron and at other companies, they should carefully assess how, if at all, the issues apply to their own companies. An audit committee should focus on the clarity, completeness and transparency of its own company's financial reports – not on the business risks or disclosure shortcomings of Enron or some other company.

Off-Balance Sheet Financing Arrangements and Other Disclosures

One of the key issues at Enron was that company's use of off-balance sheet financing arrangements. Although this may not be a sensitive area for many companies, audit committees should pay attention to any off-balance sheet financing arrangements to the extent that they are material to the company's financial statements. Committee members should ask whether there are alternative accounting presentations for such arrangements and, if so, how such presentations would affect reported results. The SEC recently published guidance on disclosure of liquidity and capital resources, including off-balance sheet arrangements. *See* SEC Release Nos. 33-8056, 34-45321 (Jan. 22, 2002). Where information about off-balance sheet transactions is necessary to understand how significant aspects of the company's business are conducted, audit committees should consider whether the company's disclosure of such information in financial statements and published reports is sufficiently transparent to the reader.

The use of off-balance sheet financing arrangements is not the only area receiving increased attention from the SEC and investors. Investors, as well as the credit rating agencies and

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the SEC, also are giving heightened scrutiny to MD&A disclosures, to the other commitments and contingencies affecting liquidity and financial obligations, and to reporting of pro forma financial information. The chief accountant for the SEC's Division of Enforcement recently warned that companies strictly following accounting rules still could be accused of securities fraud if their filings do not accurately reflect their underlying economic condition. According to this SEC official, companies should go through "two extra tests" in evaluating financial disclosures: (1) does the overall result violate the accounting principles upon which the relevant accounting rule is based; and (2) does the result mislead investors as to a material issue? Boards and audit committees should take reasonable steps to confirm that the answer to both of these questions is "no."

Audit Committee Charter

In the past year or two, most boards of directors and their audit committees adopted or amended their audit committee charters as a result of rule changes by the SEC, the NYSE and Nasdaq. In the wake of Enron, many commentators have encouraged boards and audit committees to revisit their charters, and some have suggested that numerous "action items" be added. Such detail, while well-intentioned, may create the risk that audit committees will develop a "checklist" mentality. Enron, in fact, had a detailed audit committee charter, covering everything from audit committee review of Form 10-K footnote disclosure to committee oversight of electronic data processing procedures.

We do not believe that developing a list of "check the box" responsibilities or required procedures in the audit committee charter is an appropriate response to the Enron situation. Instead, we believe that the audit committee charter should be a document that empowers the committee with the authority to develop and change its specific policies and procedures from time to time to address the company's specific business operations, financial risks and concerns.

A more detailed audit committee charter could increase audit committee members' exposure to personal liability, particularly if the charter's prescriptions are not followed. At a minimum, a highly regimented charter could make audit committee members more likely than other directors to be named as defendants in shareholder lawsuits. By lengthening the list of explicit audit committee responsibilities, boards may inadvertently encourage courts to apply differential liability standards for audit committee members – effectively discouraging thoughtful directors from serving as members of audit committees. In addition, there likely will be SEC rulemaking – and possibly new stock market requirements and/or congressional legislation – impacting audit committee charters in the coming year. This raises the possibility that boards would need to amend their audit committee charters yet again.

Although we have attached a revised model audit committee charter, we advise caution in amending existing charters at this time. Rather than making wholesale changes to charter provisions, boards and audit committees might consider revising their annual schedules and meeting agendas to address

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specific policies and procedures of concern under their existing charters.

Conclusion

The collapse of Enron justifiably is causing corporate boards and their audit committees to ask, "Could this happen to us?" With heightened scrutiny by the press, Congress, regulators and investors on the integrity and transparency of financial reporting, it is incumbent upon directors to be able to say with reasonable confidence, "It won't happen at our company." Accordingly, boards and audit committees should focus on how things could go wrong at their *own* companies, not on how things went wrong at Enron. They should begin by making sure that they understand their companies' financial and business risks. Armed with this knowledge, audit committees can reexamine existing policies to provide appropriate procedures addressing critical areas and accounting practices. Once sound procedures are in place, of course, they must be appropriately followed. Audit committee members should regularly assess the quality of management and the independence of outside auditors, and they should assure themselves (through thoughtful discussions with management and auditors) that their companies' financial statements and financial reporting accurately and understandably reflect economic reality. The investing public is demanding no less.

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For more information on this client letter, please contact the Gibson, Dunn & Crutcher LLP attorney with whom you work, or John F. Olson (202-955-8522), Ronald O. Mueller (202) 955-8671, Amy L. Goodman (202) 955-8653 or Stephanie Tsacoumis (202) 955-8277. To contact any of these attorneys by email, use the first letter of the attorney's first name, followed by the attorney's last name, followed by "@gibsondunn.com".

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AUDIT COMMITTEE CHARTER

1. Members. The Board of Directors shall appoint an Audit Committee of at least [three] members, consisting entirely of "independent" directors of the Board, and shall designate one member as chairperson. For purposes hereof, "independent" shall mean a director who meets the [National Association of Securities Dealers, Inc. ("NASD")] [New York Stock Exchange ("NYSE")] definition of "independence.," as determined by the Board. [for Nasdaq company, specify NASD and delete "as determined by the Board"]

Each member of the Company's audit committee must be financially literate, and at least one member of the audit committee shall have accounting or related financial management expertise, both as provided in the Board's judgment. [for Nasdaq company, replace "as provided in the Board's judgment with" as provided in the NASD rules"][NASD] [NYSE] rules.

2. Purposes, Duties, and Responsibilities. The Audit Committee shall represent the Board of Directors in discharging its responsibility relating to the accounting, reporting, and financial practices of the Company and its subsidiaries, and shall have general responsibility for surveillance of internal controls and accounting and audit activities of the Company and its subsidiaries. The Audit Committee does not itself prepare financial statements or perform audits, and its members are not auditors or certifiers of the Company's financial statements. Specifically, the Audit Committee shall:

(i) Recommend to the Board of Directors, and evaluate, the firm of independent certified public accountants to be appointed as auditors of the Company, which firm shall be ultimately accountable to the Board of Directors through the Audit Committee.

(ii) Review and discuss with the outside auditorswith the independent auditor their audit procedures, including the scope, fees and timing of the audit, and the results of the annual audit examination and any accompanying management letters, and any reports of the outside auditors with respect to interim periods..

(iii) Review with the independent auditorand discuss the written statement from the outside auditor of the Companyauditor, required by Independence Standards Board Standard No. 1, concerning any relationships between the auditor and the Company or any other relationships that may adversely affect the independence of

the auditor and, based on such review, assess the independence of the outside auditor.

(iv) Review and discuss with management and the independent auditoroutside auditors the Company's annual audited financial statements of the Company, including a discussionan analysis of the auditors' judgment as to the quality of the Company's accounting principles.

(v) Recommend to the Board of Directors whether, based on the review and discussions described in paragraphs (ii) through (iv) above, the financial statements should be included in the Annual Report on Form 10-K.]

(vi) Review and discuss with management and the independent auditorthe outside auditors: (a) any material financial or non-financial arrangements of the Company which do not appear on the financial statements of the Company; and (b) any transactions or courses of dealing with parties related to the Company which transactions are significant in size or involve terms or other aspects that differ from those that would likely be negotiated with independent parties, and which arrangements or transactions are relevant to an understanding of the Company's financial statements. the results of any significant matters identified as a result of the independent auditor's interim review procedures prior to the filing of each Form 10-Q or as soon thereafter as possible. [The Audit Committee Chair may perform this responsibility on behalf of the Audit Committee.]

[(vi) Recommend to the Board of Directors whether, based on the review and discussions described in paragraphs (iii) through (v) above, the financial statements should be included in the Annual Report on Form 10-K.]

(vii) Review and discuss with management and the outside auditors [and the head of internal audit] the adequacy of the Company's internal controls [and internal audit procedures].

(viii) Review and discuss with management and the outside auditors the accounting policies which may be viewed as critical, and review and discuss any significant changes in the accounting policies of the Company and accounting and financial reporting rule changesproposals that may have a significant impact on the Company's financial reports.

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(ix) Establish policies and procedures for the engagement of the outside auditor to provide non-audit services, and consider whether the outside auditor's performance of information technology and other non-audit services is compatible with the auditor's independence.

(ix) Review material pending legal proceedings involving the Company and other contingent liabilities.

(xi) Review the adequacythe appropriateness of the Audit Committee Charter on an annual basis, and recommend changes if the Committee determines changes are appropriate.

3. Meetings. The Audit Committee shall meet as often as may be deemed necessary or appropriate in its judgment, generally [four] times each year, either in person or telephonically. The Audit Committee shall meet in executive session with the independent outside auditors [and Internal Auditorhead of internal audit] at least annually. The Audit Committee may create subcommittees who shall report to the Audit Committee. The Audit Committee shall report to the full Board of Directors with respect to its meetings. [and shall make such reports to shareholders as are required by applicable regulations or as are deemed advisable in the Committee's judgment.] The majority of the members of the Audit Committee shall constitute a quorum.

4. Outside Advisors. The Audit Committee shall have the authority to retain such outside counsel, experts, and other advisors as it determines appropriate to assist in the full performance of its functions.

5. Investigations. The Audit Committee shall have the authority to conduct or authorize investigations into any matters within its scope of responsibilities and shall have the authority to retain outside advisors to assist it in the conduct of any investigation.

[Optional Disclaimer Paragraph – "The Audit Committee represents and advises the full Board of Directors in performing some of its oversight responsibilities, but does not itself prepare financial statements or perform audits, and its members are not auditors or certifiers of the Company's financial statements." Although some companies include a disclaimer similar to this in their charters, it is our view that it is more appropriate to include the disclaimer in the audit committee report required to be included in proxy statements beginning on December 15, 2000.]

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GIBSON, DUNN & CRUTCHER LLP

June 25, 2002

RECENT POST-ENRON CORPORATE GOVERNANCE DEVELOPMENTS

To Our Clients and Friends:

The months following the collapse of Enron have brought heightened scrutiny to corporate governance issues. The President, Congress, the Securities and Exchange Commission (SEC), the major securities markets, institutional investors and others have called for changes in corporate governance practices. The changes proposed to date reflect a number of common themes, including:

- a continued and expanded emphasis on the independence of the board as a whole, including heightened independence standards, requirements for independence determinations, and consideration of "soft" factors such as close relationships with management, political contributions and ties to non-profit organizations that receive corporate contributions;
- the establishment of three key committees of the board – audit, nominating/corporate governance and compensation – each composed entirely of independent directors;
- the development and publication of corporate governance principles and codes of conduct for officers and directors;
- CEO certification requirements; and
- broadened shareholder approval requirements for equity-based compensation plans.

In the wake of the proposals, companies should undertake a corporate governance audit. Although the corporate governance requirements that have been proposed – and particularly the recommended changes to the listing standards of the New York Stock Exchange (NYSE) and the Nasdaq Stock Market, Inc. (Nasdaq) – are not yet in final form, it is not too early to begin assessing their impact. A proactive approach will position companies to comply with the requirements, when implemented, effectively and with minimal disruptions. Moreover, in a time when the investing public has been increasingly vocal in demanding change, prompt attention to corporate governance issues could yield investor relations benefits.

I. Proposals to Enhance Corporate Governance Requirements

On June 6, 2002, the NYSE issued the report of its Corporate Accountability and Listing Standards Committee (Listing Standards Committee), which contains recommendations for comprehensive changes to the NYSE's corporate governance listing standards. Two weeks prior to that, on May 24, Nasdaq announced an initial set of changes to its corporate governance listing standards and indicated that it will be considering additional proposals throughout the summer. On May 14, The Business Roundtable, an association of chief executives of the largest companies in the United States, issued its Principles of Corporate Governance (2002), designed to assist corporate management and boards of directors in their individual efforts to implement corporate governance best practices.

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In addition, more than 30 bills have been introduced in the House and Senate to date. The Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002 (sponsored by Michael Oxley (R-OH)) passed the House of Representatives on April 24. Various bills are currently pending in the Senate, including the Public Company Accounting Reform and Investor Protection Act of 2002 (sponsored by Paul Sarbanes (D-MD)), which was reported out of the Senate Banking, Housing, and Urban Affairs Committee by a 17-4 vote on June 18.

The specific elements of the NYSE and Nasdaq proposed changes are outlined below, followed by a summary of the best practices recommended by The Business Roundtable. Companies should keep in mind that the NYSE and Nasdaq proposals must be submitted to the SEC for approval and put out for public comment, so there may be revisions in the final listing standards.

A. The Major Securities Markets

In February 2002, SEC Chairman Pitt asked both the NYSE and Nasdaq to review their corporate governance listing standards. Among the issues he asked them to address were the need for mandatory codes of conduct, continuing education and ethical training for officers and directors, and whether audit committee requirements should be strengthened by, for example, vesting audit committees with exclusive authority to hire and fire the outside auditor. In addition, Chairman Pitt reiterated his emphasis on the need for full, continuous disclosure by public companies.

The New York Stock Exchange

On June 6, 2002, the NYSE's Listing Standards Committee issued a report to the NYSE board of directors setting forth recommended changes to the NYSE's corporate governance listing standards, as well as recommendations to the SEC and Congress on regulatory and legislative changes. The recommendations and the full text of the report are available at http://www.nyse.com/pdfs/corp_recommendations_nyse.pdf and http://www.nyse.com/pdfs/corp_govreport.pdf, respectively. After a two-month public comment period, the NYSE board of directors expects to take action on the report at its August 1 meeting. The report recommends changes in the following areas:

1. Board independence.

- The board must have a majority of independent directors. Companies would have 24 months to comply with the new independence rule and would be required to publicly disclose when they have achieved majority independence.

- For a director to be deemed "independent," the board must affirmatively determine that the director has no material relationship with the listed company other than service as a director.

- The basis for board determinations that a relationship is not material must be disclosed in the company's proxy statement.

- A five-year "cooling off" period applies, during which the following are not considered independent:

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  - a former employee of the listed company;
  - a former employee of the listed company's present or former (within the past five years) outside auditor;
  - a former employee of any company whose compensation committee includes an executive officer of the listed company; and
  - any immediate family member of the above.

2. Executive sessions of the board/Presiding director.

   - Non-management directors must meet at regularly scheduled executive sessions without management.
   - The independent directors must designate a director to preside at executive sessions and the company must disclose the name of this director in its proxy statement. According to the report of the Listing Standards Committee, this disclosure is intended to facilitate communications by employees and shareholders directly with non-management directors.

3. New requirements for audit committee members and audit committees.

   - *Additional qualifications*. Audit committee members must meet additional qualifications (beyond the independence requirement):
     - director fees must be the only compensation an audit committee member receives from the company;
     - a committee member who holds 20% or more of the company's stock or who is a general partner, controlling shareholder or officer of any such holder, cannot chair the committee or vote; and
     - the audit committee chair must have accounting or related financial management expertise, as defined under existing listing standards.[1]
   - *Additional responsibilities*. The audit committee must perform additional substantive responsibilities, which must be set forth in its charter. The audit committee must:
     - discuss earnings releases, and financial information and earnings guidance provided to analysts and rating agencies; and
     - discuss the company's policies on risk assessment and management.

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[1] Legislation proposed by Senator Sarbanes would direct the SEC to require companies to disclose whether they have at least one "financial expert" (a term that would be defined in the legislation) on their audit committees. Financial Executives International, an organization of senior financial professionals, has proposed that the NYSE and Nasdaq set higher standards for audit committee "financial experts."

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- *Meetings*. The audit committee must meet separately, at least quarterly, with management, the internal auditors, and the outside auditor.
- *Outside advisors*. The audit committee must have the authority (which should be set forth in its charter) to retain legal, accounting and other advisors without seeking board approval.
- *Outside auditor*. The audit committee must have exclusive authority, without deliberation or approval by the full board, to hire and fire the outside auditor, including authority to approve all engagement fees and terms and to approve any significant non-audit relationship with the independent auditor.
- *Best practice recommendations on auditor rotation and hiring former auditor personnel*. The Listing Standards Committee does not recommend mandatory periodic rotation in its report because it believes that this may undercut the effectiveness of the auditor and disrupt the quality of the audit. As a matter of best practices, however, the report recommends that the audit committee consider whether, in order to assure continuing independence, there should be regular rotation of the lead audit partner or of the audit firm itself. The audit committee should make its own decision about whether the company is obtaining high-quality audits and whether rotating the auditor would be helpful for the company. The Listing Standards Committee also recommends, as a best practice, that the audit committee set clear policies for hiring employees or former employees of the outside auditor.

4. <u>Nominating/corporate governance and compensation committees</u>**.**

- Companies must have a nominating/governance committee and a compensation committee. Each committee must be composed entirely of independent directors and must have a written charter. Companies must post these charters (along with the charters of the audit committee and other important committees) on their websites.
- The nominating/corporate governance committee and the compensation committee should have sole authority, without requiring full board action to retain and terminate outside advisors, such as search firms used to identify director candidates and compensation consultants.
- The Listing Standards Committee report spells out specific responsibilities for the audit, nominating/corporate governance and compensation committees that must be included in their respective charters, including annual performance evaluations for each committee.

5. <u>CEO certification</u>**.**

- The CEO of each listed company must certify to the NYSE each year that:
  - the company has established procedures for verifying the accuracy and completeness of information provided to investors, that those procedures have been carried out and that, based upon the CEO's assessment of the adequacy of the procedures and the diligence of those carrying them out, the CEO has no reasonable cause to believe that the information provided to investors is not accurate and complete in all material respects;

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  - the CEO has reviewed these procedures, and the company's compliance with them, with the board; and
  - the CEO is not aware of any violations by the company of NYSE listing standards.
- The Listing Standards Committee proposed an additional certification requirement in its recommendations to the SEC. This proposal recommends that the SEC require CEOs to certify to shareholders that, to their best knowledge and belief, their companies' financial statements and disclosures fairly present the information that reasonable investors should have to make informed investment decisions.[2]

6. Shareholder approval of option plans.

- Shareholders must vote to approve or disapprove all equity compensation plans.
- Brokers may not vote customer shares on any equity compensation plans unless the broker has the customer's instructions to do so.[3]

7. Corporate governance principles.

- Companies must adopt a set of corporate governance principles and post these principles on their websites.
- The principles should address: director qualification standards and responsibilities; director access to management and independent advisors; director compensation; director orientation and continuing education; management succession; and annual board evaluations.

8. Codes of business conduct and ethics.

- Companies must adopt and disclose (including by posting on their websites) a code of business conduct and ethics for directors, officers, and employees. The code must:
  - require that any waivers of the code for directors or executive officers can be made only by the board or a board committee and that such waivers be promptly disclosed to shareholders; and

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[2] On June 15, 2002, the SEC proposed new rule Rule 13a-14 under the Securities Exchange Act of 1934, which would require the principal executive officer and principal financial officer of a company each to certify, with respect to the company's quarterly and annual reports, that: (1) he or she has read the report; (2) to his or her knowledge, the information in the report is true in all important respects as of the last day of the period covered by the report; and (3) the report contains all information about the company of which he or she is aware that he or she believes is important to a reasonable investor as of the last day of the period covered by the report.

[3] Under current NYSE listing standards, brokers are only prohibited from voting without customer instructions where the plan to be voted on would authorize the issuance of stock in an amount exceeding 5% of the total outstanding.

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  - contain compliance standards and procedures that ensure prompt and consistent action against violations of the code.

- A code of business conduct and ethics should address: conflicts of interest; corporate opportunities; confidentiality; fair dealing with the company's customers, suppliers, competitors and employees; protection and proper use of company assets; compliance with laws, rules and regulations, including laws on insider trading; and reporting illegal or unethical behavior.

9. Penalties for violating listing standards.

- Suspending trading or delisting a company is harmful to a company's shareholders. Accordingly, the NYSE should be able to impose the lesser sanction of issuing a public reprimand letter to companies that violate its listing standards.

10. Foreign issuers.

- Listed foreign private issuers must disclose significant ways in which their corporate governance practices differ from those of domestic companies listed on the NYSE.

Nasdaq

On May 24, 2002, Nasdaq announced that its board of directors had approved modifications to its corporate governance standards. Nasdaq has indicated that these modifications, which grew out of recommendations from Nasdaq's Listing and Hearing Review Council, are only a first step and that it will continue to review corporate governance issues. The text of the rule proposals (as submitted to the SEC) is available on Nasdaq's website at http://www.nasdaqnews.com/. The Listing and Hearing Review Council is scheduled to meet to consider additional reform proposals on June 26-28. The rule changes approved on May 24 address:

1. Board independence.

- The definition of "independent director," which prohibits directors from receiving more than $60,000 in compensation (other than for board service, benefits under a tax-qualified retirement plan, or non-discretionary compensation), will be tightened to address additional relationships that may impair a director's independence. The definition will be extended to:

  - prohibit any payments, including political contributions, in excess of $60,000 (the existing exceptions will remain intact);

  - cover the receipt of any such payments by a director's family;

  - cover any director who is a partner in, or a controlling shareholder or executive officer of, an organization, including a non-profit entity, if the company makes payments to the organization that exceed the greater of $200,000 or five percent of either the company's or the organization's gross revenues.

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2. Shareholder approval of option plans.

    - Shareholders must vote to approve stock option plans that include executive officers or directors.

    - Nasdaq would retain the existing exception that allows companies to provide inducement grants to new executive officers, but any such grants would have to be approved by an independent compensation committee or a majority of the independent directors.

3. Related-party transactions.

    - The audit committee or a comparable body of the board must review and approve all related-party transactions.

4. Penalties for misrepresenting information to Nasdaq.

    - Companies can be delisted for making an intentional misrepresentation to Nasdaq, intentionally omitting necessary material information in a communication with Nasdaq, or otherwise failing to provide requested information to Nasdaq.

5. Require disclosure of audit opinions with going concern qualifications.

    - Companies must disclose the receipt of an audit opinion with a going concern qualification.

6. Regulation FD.

    - Companies will be permitted to disseminate material information via Regulation FD-compliant methods of disclosure, such as conference calls, press conferences and webcasts, instead of solely by press release. The public must be given adequate notice (generally by press release) and granted access.

B. The Business Roundtable's Principles of Corporate Governance (2002)

In May 2002, The Business Roundtable (Roundtable) released its Principles of Corporate Governance (Principles), a set of guiding principles intended to assist corporate management and boards of directors in their individual efforts to implement corporate governance best practices. The Principles are available on the Roundtable's website at http://www.brtable.org/pdf/704.pdf. While many of the Roundtable's Principles were followed a month later in the NYSE proposals, the Roundtable recognizes that no structure is right for all corporations, and that not all of the best practices outlined in the Principles will be appropriate for every corporation in every circumstance. The Roundtable recommendations to boards address, among other things:

1. The roles of the board and management.

    - Effective directors are monitors, not managers, of business operations. The board's most important function is the selection, compensation and evaluation of a well-qualified and ethical CEO.

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- The CEO, with senior management, operates the corporation on a daily basis. In addition to having the requisite skills and experience, the CEO should be a person of integrity who takes responsibility for the corporation adhering to the highest ethical standards.

2. Board leadership.

- While most American corporations are well served by a structure in which the CEO also serves as chair of the board, each corporation should make its own determination of what leadership structure works best, given its present and anticipated circumstances.

- Some corporations have found it useful to separate the roles of CEO and chair of the board to provide continuity of leadership in times of transition.

- The board should have contingency plans to provide for transitional board leadership if questions arise concerning management's conduct, competence, or integrity or if the CEO dies or is incapacitated.

3. Board independence.

- A substantial majority of directors of the board of a publicly owned corporation should be independent of management. This best practice is stronger than the NYSE Listing Standards Committee recommendation, which would require that a simple majority of the board be independent.

- Determinations as to independence should be made by the board, which should consider:
  - the appearance (as well as the fact) of independence; and
  - personal and other types of relationships – including those with non-profit organizations that receive corporate contributions – in assessing independence.

4. Committees of the board.

- As with the proposals of the NYSE Listing Standards Committee, the Roundtable recommends that every corporation not only have an audit committee made up of independent directors (as already required by the major securities markets), but also fully independent committees responsible for addressing nominating/corporate governance and compensation issues.
- The Roundtable spells out specific proposed responsibilities for each of the three key committees and recommends that these responsibilities be clearly defined in a charter or board resolution:
  - *Audit*. The audit committee should (1) supervise the company's relationship with its outside auditor, including making an annual recommendation to the board about the selection of the auditor, evaluating the auditor's performance, and considering whether it would be appropriate for the outside auditor periodically to rotate senior audit personnel or for the corporation periodically to change its outside auditor; (2) develop policies on the provision of non-audit services; (3) review and discuss the corporation's financial statements and critical accounting policies with management

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and the outside auditor; (4) oversee the corporation's internal controls and internal audit function and review the appointment and replacement of the senior internal auditing executive; and (5) develop policies on the hiring of former auditor personnel. Like the NYSE Listing Standards Committee, the Roundtable recommends that the audit committee meet four times per year and meet with the outside auditor, without management present, at every meeting.

- *Corporate governance*. The corporate governance committee should (1) recommend nominees to the board and its committees, including establishing criteria for board membership, reviewing candidates' qualifications and potential conflicts with the corporation's interests, and assessing the contributions of current directors in connection with their renomination; (2) monitor and safeguard the board's independence; (3) oversee and review the corporation's processes for providing information to the board; (4) develop and recommend to the board a set of corporate governance principles; and (5) oversee board and management evaluation.
- *Compensation*. The compensation committee should set CEO and senior management compensation and oversee the corporation's overall compensation structure to assess whether it establishes appropriate incentives for management and employees at all levels.

5. Board and management evaluation.

- The board should have an effective mechanism for assessing on a continuing basis the effectiveness of the full board, the board's committees, individual directors, and management:
  - the non-management members of the board, under the oversight of a committee made up of independent directors, should annually review the performance of the CEO and participate with the CEO in evaluation of senior management;
  - the performance of the full board and its committees should be evaluated annually; and
  - the board should have a process for evaluating whether individuals sitting on the board have the skills and expertise appropriate for the corporation and how these individuals work as a group, and a director's ability to continue contributing to the board should be evaluated each time the director is considered for renomination. (This last recommendation goes beyond the proposals of the NYSE Listing Standards Committee).

6. Director and management compensation.

- A meaningful portion of directors' compensation should be in the form of long-term equity. Corporations may wish to consider establishing a requirement that, for as long as directors remain on the board, they acquire and hold stock in an amount that is meaningful and appropriate to each director.
- The structure of management compensation should directly link the interests of management to the interests of shareholders. Companies should establish a management compensation structure that balances short- and long-term incentives and includes different forms of compensation.

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- The compensation committee should examine the overall compensation structure of the corporation to determine whether it establishes appropriate incentives not only for directors and senior managers, but for employees at all levels.

7. Shareholder approval of option plans.

- Corporations should obtain shareholder approval of new stock option and restricted stock plans in which directors or executive officers participate. This conforms to the Nasdaq proposal, and to the stated position of SEC Chairman Harvey Pitt, but does not go as far as the recommendation of the NYSE Listing Standards Committee summarized above.

8. Corporate governance principles.

- All corporations should adopt and publicize statements of corporate governance principles.

9. Codes of conduct.

- Companies should have and publicize a code of conduct with effective reporting and enforcement mechanisms. Employees should have a means of alerting management and the board to potential misconduct without fear of retribution, and violations of the code should be addressed promptly and effectively.

10. Relationship with outside auditor.

- *Selection*. The audit committee should make an annual recommendation to the full board about the selection of the outside auditor, based on a due diligence process that includes a review of the auditor's qualifications, work product, independence and reputation.

- *Non-audit services*. The audit committee should develop policies concerning the provision of non-audit services by the corporation's outside auditor and should consider the nature and dollar amount of all services provided by the outside auditor when assessing the auditor's independence.

- *Auditor rotation*. The audit committee should consider whether it would be appropriate for the outside auditor periodically to rotate senior audit personnel or for the corporation periodically to change its outside auditor. The audit committee should base its decisions about selecting and possibly changing the outside auditor on its assessment of what is likely to lead to more effective audits.

- *Hiring former auditor personnel*. The audit committee should consider adopting a "cooling-off" period or other policy restricting the hiring of former auditor personnel. Each corporation should consider what policy is appropriate for it.

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II. What Companies Should Do Now

In the wake of the proposals and recommendations outlined above, companies should review their corporate governance practices to assess how their practices compare with those endorsed by the NYSE Listing Standards Committee, Nasdaq and The Business Roundtable. Companies should also understand that any proposed changes to the listing standards of the NYSE and Nasdaq must be submitted to the SEC, put out for public comment and approved by the SEC before they become final. Accordingly, the listing standards that are ultimately adopted may differ from the proposals that have been issued to date. Nevertheless, companies should begin the process of considering their corporate governance practices now, with an eye toward improving and supplementing their existing practices and implementing the new listing standards promptly after they are approved. Among other things:

- Companies should conduct a corporate governance audit. In assessing and developing corporate governance practices, consideration should be given to the company's size, industry, employees and culture. The nominating/corporate governance committee can play a role in this process by preparing recommendations about practices to the full board.

- Companies that do not yet have them should establish board nominating/corporate governance and compensation committees, made up entirely of independent directors.

- Referring to the standards under consideration by the market where the company's stock is listed, and the considerations noted in the Roundtable's Principles, each board should review the qualifications and independence of the members of the three key committees. Boards should examine all director relationships, including those that do not currently require disclosure but that could cause investors or regulators to question directors' independence.

- Companies should review existing charters or, if needed, prepare new charters for all key committees for board review and approval as soon as relevant listing standards are adopted. Companies should consider each subject specified in the NYSE Listing Standards Committee recommendations and the Roundtable's Principles, but should also maintain flexibility in their charters to focus on policies and procedures that are important to their specific business operations and company and board culture.

- Audit committees should review their schedules and, if they do not do so now, consider meeting at least four times a year and having a private session with the outside and internal auditors at each meeting. Both of these practices may well be required in the future if approved by the NYSE board and the SEC. Quarterly meetings should take place with sufficient time to review earnings releases and 10-Qs, as well as any report from the outside auditor on its quarterly review of the interim financial statements. The burdens of more frequent meetings can be lessened by altering board schedules to precede earnings release dates and by using audio and video conference capabilities for some committee meetings. Audit committee members should make sure that committee schedules and agendas permit – and encourage – active engagement and give-and-take discussions with management and with the auditors, both in general sessions and in private sessions.

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- Companies should review all board and committee meeting schedules to be sure that committees, as well as the full board, thoroughly and thoughtfully cover their respective agenda items, based on listing standards and their charters. This will often mean that committees will need to meet on the day prior to board meetings, so that they are not rushed through their agendas and have the ability to extend the length of their meetings as needed.

- Companies should consider moving immediately to publicize information about their corporate governance practices by posting this information on their websites.

- If companies disagree with any of the recommendations issued by the NYSE Listing Standards Committee or Nasdaq, they should submit comments as soon as possible.

NYSE. Comments can be submitted to the NYSE at:

corporategovernancefeedback@nyse.com

or

Mr. Richard Grasso
Chairman and Chief Executive Officer
New York Stock Exchange, Inc.
11 Wall Street
New York, NY 10005

Nasdaq. Comments on the Nasdaq proposals can be submitted:

to the SEC, to the attention of:	or	to Nasdaq, to the attention of:
Secretary Securities and Exchange Commission 450 Fifth Street, NW, Washington, DC 20549-0609		Hardwick Simmons Chairman and Chief Executive Officer The Nasdaq Stock Market, Inc. One Liberty Plaza, 50th Floor New York, NY 10006

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For more information on this client letter, please contact the Gibson, Dunn & Crutcher LLP attorney with whom you work, or John F. Olson (202-955-8522), Ronald O. Mueller (202) 955-8671, Brian J. Lane (202) 887-3646, or Amy L. Goodman (202) 955-8653. To contact any of these attorneys by email, use the first letter of the attorney's first name, followed by the attorney's last name, followed by "@gibsondunn.com".

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GIBSON, DUNN & CRUTCHER LLP

DRAFT Last updated August 19, 2002

Corporate Governance Practices

A Comparison to Recent Proposals

of

The New York Stock Exchange. On June 6, 2002, the NYSE issued the report of its Corporate Accountability and Listing Standards Committee, which contains recommendations for comprehensive changes to the NYSE's corporate governance listing standards. The NYSE sought comments on the recommendations and changes were made. The NYSE board approved final recommendations from the committee on August 1 and the NYSE filed the text of its proposed listing standards with the SEC on August 15. The proposed listing standards must be put out for public comment and approved by the SEC before they become final. Approval could occur as early as October, and the NYSE has indicated that the new listing standards (with certain exceptions noted in the chart), will take effect within six months of SEC approval.

The Business Roundtable's Principles of Corporate Governance (2002). In May, The Business Roundtable published its Principles of Corporate Governance (2002), a set of guiding principles intended to assist corporate management and boards of directors in their individual efforts to implement corporate governance best practices. The Roundtable is an association of chief executive officers of leading corporations with a combined workforce of more than 10 million employees in the United States and $3.5 trillion in revenues. The Roundtable has been recognized as an authoritative voice on corporate governance for nearly 25 years, since issuing its first statement on corporate governance issues in 1978.

The Sarbanes-Oxley Act of 2002. The Sarbanes-Oxley Act, which significantly increases federal regulation of accounting and corporate governance, was signed into law by President Bush on July 30, 2002.

Institutional Shareholder Services Corporate Governance Principles. ISS is a provider of proxy voting and corporate governance services.

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Corporate Governance Practices

A Comparison to Recent Proposals

Issue	Sarbanes-Oxley Act of 2002 and New York Stock Exchange	BRT Principles of Corporate Governance (2002) and ISS Corporate Governance Principles
Board size.*		• Boards of large, publicly owned corporations vary in size by industry and by company. In determining board size, directors should consider the nature, size and complexity of the corporation as well as its stage of development. The experience of many Roundtable members suggests that smaller boards are often more cohesive and work more effectively than larger boards (The Business Roundtable Principles ("BRT Principles"), p.9). • The typical large-cap company has 10-13 directors, which many observers believe is optimal (Institutional Shareholder Services Corporate Governance Principles ("ISS Principles"), p.2).
Board independence.*	• A majority of the board must be independent (Proposed NYSE Rule 303A(1)). • Companies will have 24 months from the date of SEC approval to achieve majority independence.	• A substantial majority of directors of the board of a publicly owned corporation should be independent of management (BRT Principles, p.10). • A majority of the directors on the board should be independent (ISS Principles, p.1).
Definition of "independence."	• The Sarbanes-Oxley Act requires each member of the audit committee to be independent and "independent" is defined to preclude payment of consulting and other advisory fees and affiliations with the company, subject to exceptions developed by the SEC (§301). ➢ Because the phrase "affiliated person" is not defined in the Sarbanes-Oxley Act, it is unclear whether the SEC will formulate a definition by rule or rely on an existing definition. Section 301 of the Sarbanes-Oxley Act amends the Securities Exchange Act of 1934, which incorporates the definition of "affiliated person" in the Investment Company Act of 1940. Under the Investment	• Independence standard recognizes need to: ➢ consider personal and other types of relationships – including those with non-profit organizations that receive corporate contributions – in assessing independence (BRT Principles, pp.10-11); ➢ look at the appearance (as well as the fact) of independence (BRT Principles, p.10). • Determinations as to independence should be made by the board (BRT Principles, p.10).

* Denotes a rating factor used by Institutional Shareholder Services in calculating its Corporate Governance Quotient. The CGQ is a rating that ISS has developed to evaluate a company's governance structure and is calculated on the basis of approximately 50 different factors.

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Issue	Sarbanes-Oxley Act of 2002 and New York Stock Exchange	BRT Principles of Corporate Governance (2002) and ISS Corporate Governance Principles
	Company Act, an "affiliated person" includes, among other things: (1) a holder of 5% or more of a company's outstanding voting securities; (2) anyone directly or indirectly controlling, controlled by or under common control with a 5% holder; and (3) any officer, director, partner, copartner or employee of a 5% holder. In the alternative, the SEC might rely on the existing definition in Rule 144(a) under the Securities Act of 1933, which defines an "affiliate" as a person that controls, is controlled by, or is under common control with, an issuer. The current rule-of-thumb for determining the existence of control and affiliate status under Rule 144 is 10% stock ownership. • For a director to be deemed "independent," the board must affirmatively determine that the director has no material relationship with the company (Proposed NYSE Rule 303A(2)(a)). • A five-year "cooling off" period applies, during which the following are not considered independent: ➢ a former employee of the listed company (a director who serves as an interim Chairman or CEO may be deemed independent immediately after service in this capacity ends); ➢ a director who is, or has in the past five years been, affiliated with or employed by a present or former (within the past five years) outside auditor of the company or an affiliate; ➢ a director who is, or has in the past five years been, part of an interlocking directorate in which the compensation committee of a company that concurrently employs the director includes an executive officer of the listed company; and ➢ a director with an immediate family member in any of the above categories, except that employment of a family member in a non-officer position does not preclude a determination that a director is independent (Proposed NYSE Rule 303A(2)(b) & commentary). • The basis for board determinations that a relationship is not material must be disclosed in the company's proxy statement (Proposed NYSE Rule 303A(2)(a)). The board may adopt and disclose categorical	• An "independent director" is an individual who has not been a present of former employee of the company and has no significant financial or personal tie to the company other than stock ownership and compensation as a director (ISS Principles, p.1).

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	standards to assist it in making independence determinations, and may make a general disclosure if a director meets these standards. Any determination of independence for a director who does not meet the standards must be specifically explained (Commentary to proposed NYSE Rule 303A(2)(a)).	
Board responsibilities.		• The business of a corporation is managed under the direction of its board. The selection, compensation, and evaluation of a well-qualified and ethical CEO is the single most important function of the board (BRT Principles, p.2). • Directors should have substantial discretion in choosing the specific mechanisms that the board uses to fulfill its duties. Key responsibilities include selecting and monitoring top management and determining the board's structure and composition (ISS Principles, pp.1-2).
Board meetings.		• Directors must meet as frequently as necessary to properly discharge their responsibilities. Frequency and length of board meetings depend largely on the complexity of the corporation and its operations (BRT Principles, p.20). • The Chairman of the Board should be responsive to individual directors' requests to add items to the agenda and open to suggestions for improving the agenda (BRT Principles, p.22). • Directors should be provided with, and review, information from a variety of sources, including management, board committees, outside experts, auditor presentations, and analyst and media reports. The board should be provided with information before board and committee meetings with sufficient time to review and reflect on key issues and to request supplemental information as necessary (BRT Principles, p.22).
Executive sessions of the board.*	• Non-management directors must meet at regularly scheduled executive sessions without management (Proposed NYSE Rule 303A(3)). • The independent directors must designate a director to preside at	• Independent directors should have the opportunity to meet outside the presence of the CEO and any other management directors (BRT Principles, p.21). • Independent directors should have opportunities to meet regularly

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	executive sessions, although there is no requirement to designate a single director who will preside at all sessions. If one director is chosen,, the director's name must be disclosed in the proxy statement. Alternatively, a company may disclose the procedure by which a presiding director is selected and a means for stockholders and employees to communicate with the presiding director or the non-management directors as a group (Commentary to proposed NYSE Rule 303A(3)).	without the CEO or other insiders present (ISS Principles, p.1).
Board leadership.*		• Most American corporations are well served by a structure in which the CEO also serves as Chairman of the Board. The CEO serves as a bridge between management and the board, ensuring that both act with a common purpose. Some corporations have found it useful to separate the roles of CEO and Chairman of the Board to provide continuity of leadership in times of transition. Each corporation should make its own determination of what leadership structure works best, given its present and anticipated circumstances (BRT Principles, p.11). • In some circumstances, stockholders may favor selecting an independent board chairman. When the CEO is Chairman, boards may create a counterbalance by naming an independent director as the "Lead Director" (ISS Principles, p.2).
Committees—General.	• Companies must have audit, nominating/governance and compensation committees (Proposed NYSE Rules 303A(4)(a), (5)(a) and existing NYSE Rule 303.01(A)).). • Companies may allocate the responsibilities of the nominating/ corporate governance and compensation committees to committees of their own denomination, provided that the committees responsible for these functions are composed entirely of independent directors and that they have published charters (Commentary to proposed NYSE Rule 303A(4)).	• The functions generally performed by the audit, compensation and corporate governance committees are central to effective corporate governance (BRT Principles, p.12).
Committees—Charters.	• Each of the audit, nominating/corporate governance and compensation committees must have a written charter that addresses the committee's	• The responsibilities of each committee should be clearly defined and understood. A written charter approved by the board, or a board

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	purpose, specific responsibilities enumerated by the NYSE, and an annual performance evaluation of the committee (Proposed NYSE Rules 303A(4)(b), (5)(b) &7(b)).	resolution establishing the committee, is appropriate (BRT Principles, p.12).
Committees—Assignments.		• Decisions about committee membership should be made by the full board, based on recommendations from a committee responsible for corporate governance issues. The board should designate the chairs of the various committees if this is not done by the committees themselves (BRT Principles, p.12).
Committees—Reporting to board.	• The charters of the nominating/corporate governance and compensation committees should address committee reporting to the board (Commentary to proposed NYSE Rules 303A(4) & (5)). • The audit committee must report regularly to the board. It should review regularly with the full board any issues that arise with respect to the quality or integrity of the company's financial statements, the company's compliance with legal or regulatory requirements, the performance and independence of the company's outside auditor, or the performance of the internal audit function (Proposed NYSE Rule 303A(7)(b)(ii)(J) & commentary).	• Committees should apprise the full board of their activities on a regular basis, regardless of whether the board grants plenary power to its committees with respect to particular issues or prefers to take recommendations from the committees (BRT Principles, pp.12, 21). Processes should be developed and monitored for keeping the board informed through oral and/or written reports (BRT Principles, p.12).
Audit committee—General and composition.*	• The Sarbanes-Oxley Act requires each member of the audit committee to be independent, and "independent" is defined to preclude payment of consulting and other advisory fees. In addition, an audit committee member may not be an "affiliated person" of the company or its subsidiaries (§301). Because "affiliated person" is not defined in the statute, it is unclear whether the SEC will formulate a definition by rule or rely on the existing rule-of-thumb, which is 10% stock ownership. • Director fees are the only compensation an audit committee member can receive from the company. Receipt of a pension or other form of deferred compensation for prior service (provided that it is not contingent on continued service) would not prevent compliance with this standard. Prohibited compensation includes fees paid to a director's firm for consulting, legal or advisory services, even if the	• Every publicly owned corporation should have an audit committee comprised solely of independent directors (BRT Principles, p.12). • Audit committee members should meet minimum financial literacy standards, and at least one of the committee members should have accounting or financial management expertise, as required by the listing standards of the major securities markets. However, more important than financial expertise is the ability of audit committee members, as with all directors, to understand the corporation's business and risk profile, and to apply their business experience and judgment to the issues for which the committee is responsible with an independent and critical eye (BRT Principles, p.13). • The audit committee should be made up solely of independent directors (ISS Principles, p.1).

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	director is not the actual service provider (Proposed NYSE Rule 303A(6) & commentary)). Companies will have 24 months from the date of SEC approval to comply with this requirement. • The Sarbanes-Oxley Act requires companies to disclose whether at least one member of their audit committee is a "financial expert," as defined by the SEC. In defining this term, the SEC must consider whether, through (1) education and experience as a public accountant or auditor, (2) as a company's principal financial officer, comptroller or principal accounting officer, or (3) from a position involving the performance of similar functions, a person has: ➢ an understanding of GAAP and financial statements; ➢ experience in preparing or auditing the financial statements of generally comparable companies and in applying GAAP in connection with accounting for estimates, accruals and reserves; ➢ experience with internal accounting controls; and ➢ an understanding of audit committee functions (§407).	
Audit committee—Charter.	• The audit committee must have a written charter that addresses the committee's purpose, specific responsibilities enumerated by the NYSE and an annual performance evaluation of the committee (Proposed NYSE Rule 303A(7)(b)).	• The responsibilities of each committee should be clearly defined and understood. A written charter approved by the board, or a board resolution establishing the committee, is appropriate (BRT Principles, p.12).
Audit committee--Meetings.	• The audit committee must meet separately, periodically, with management, the internal auditor and the outside auditor (Proposed NYSE Rule 303A(7)(b)(ii)(G)).	• Audit committee meetings should be held frequently enough to allow the committee to appropriately monitor the annual and quarterly financial reports. For many corporations, this means four or more meetings a year. The audit committee should meet with the internal and outside auditors, without management present, at every meeting and communicate with them between meetings as necessary (BRT Principles, p.16).
Audit committee—Responsibilities.	• The Sarbanes-Oxley Act requires audit committees to: ➢ put in place procedures for the submission of complaints and concerns about auditing and accounting matters;	• The primary functions of the audit committee include: ➢ understanding the corporation's risk profile and overseeing the corporation's risk assessment and management practices;

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	➢ be "directly responsible," in its capacity as a committee of the board, for the appointment, compensation and oversight of the work of the outside auditor; and ➢ have the authority to engage outside advisors and to compensate both the advisors and the outside auditor (§301). • In connection with the certification required under Section 302 of Sarbanes-Oxley, the CEO and CFO must evaluate the company's internal controls each quarter and disclose any significant deficiencies to the audit committee and outside auditor (§302). Sarbanes-Oxley also requires that a company's annual report contain a report on the effectiveness of the company's internal controls (§404). • The Sarbanes-Oxley Act requires that all audit services, and all permissible non-audit services (subject to a *de minimis* exception), be pre-approved by the audit committee and the pre-approval of non-audit services must be disclosed in the company's 10-Ks and 10-Qs (§202). • The purpose of the audit committee, which must be set forth in its charter, at a minimum must be to prepare the report included in the annual proxy statement and to assist in board oversight of: ➢ the integrity of the company's financial statements; ➢ compliance with legal and regulatory requirements; ➢ the outside auditor's qualifications and independence; and ➢ performance of the company's internal audit function and of the outside auditor (Proposed NYSE Rule 303A(7)(b)(i)). • As part of its duties and responsibilities, which must be set forth in its charter, the audit committee must: ➢ have sole authority to retain and terminate the outside auditor, including sole authority to approve all audit engagement fees and terms; ➢ obtain and review, at least annually, a report by the outside auditor describing the auditor's internal quality control procedures and all	➢ supervising the corporation's relationship with the outside auditor; ➢ considering the independence of the outside auditor and developing policies on the provision of non-audit services by the outside auditor; ➢ reviewing and discussing with management and the outside auditor the corporation's critical accounting policies and the quality of accounting judgments and estimates made by management; ➢ understanding, and periodically reviewing the adequacy of, the corporation's internal controls; ➢ unless another committee does so, reviewing the corporation's procedures on compliance with the law and important corporate policies, such as the code of ethics or conduct; ➢ reviewing and discussing the corporation's annual financial statements with management and the outside auditor and recommending that the board approve the financial statements for publication and filing; ➢ overseeing the corporation's internal audit function, including reviewing the appointment and replacement of the senior internal auditing executive; ➢ providing a channel of communication to the board for the outside and internal auditors; and ➢ adopting a policy on the hiring of former auditor personnel (BRT Principles, pp.13-16).

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	relationships between the auditor and the company; ➢ discuss the annual audited financial statements and quarterly financial statements with management and the outside auditor, including the company's MD&A disclosures; ➢ discuss earnings press releases, and financial information and earnings guidance provided to analysts and rating agencies (this can be a general discussion of the types of information to be disclosed and the type of presentation to be made); ➢ have the authority, without seeking board approval, to obtain advice and assistance from outside legal, accounting or other advisors; ➢ discuss policies with respect to risk assessment and risk management; ➢ meet separately, periodically, with management, the internal auditors, and the outside auditor; ➢ review with the outside auditor any difficulties encountered in the course of its audit work and management's response; ➢ set clear hiring policies for employees or former employees of the outside auditor; ➢ report regularly to the board of directors (Proposed NYSE Rules 303A(7)(b)(ii)(A)-(J) & commentary); and ➢ undertake an annual evaluation of the committee's effectiveness (Proposed NYSE Rule 303A(7)(b)(iii)). • Each listed company must have an internal audit function (NYSE Proposed Rule 303A(7)(c)).	
Nominating/ corporate governance committee—General and composition.*	• The nominating/corporate governance committee must be composed entirely of independent directors (Proposed NYSE Rule 303A(4)(a)). • Companies must have one independent director on the committee within 12 months of SEC approval, and must fully comply with the independence requirement within 24 months of SEC approval.	• Every publicly owned corporation should have a committee that addresses corporate governance issues. The corporate governance committee should be comprised solely of independent directors (BRT Principles, pp.16 & 17). • The committee charged with oversight of board

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	independence requirement within 24 months of SEC approval.	governance/nomination functions should be made up solely of independent directors (ISS Principles, p.1).
Nominating/ corporate governance committee—Charter.	• The nominating/corporate governance committee must have a written charter that addresses the committee's purpose, specific responsibilities enumerated by the NYSE and an annual performance evaluation of the committee (Proposed NYSE Rule 303A(4)(b)). • The charter of the nominating/corporate governance should address: committee member qualifications, appointment and removal; and committee structure, operations (including authority to delegate to subcommittees) and reporting to the board (Commentary to proposed NYSE Rule 303A(4)).	• The responsibilities of each committee should be clearly defined and understood. A written charter approved by the board, or a board resolution establishing the committee, is appropriate (BRT Principles, p.12).
Nominating/ corporate governance committee—Responsibilities.	• The purpose of the nominating/ corporate governance committee, which must be set forth in its charter, must, at a minimum, be to: ➢ identify individuals qualified to become board members, and to select or recommend that the board select, director nominees; and ➢ develop and recommend to the board a set of corporate governance principles (Proposed NYSE Rule 303A(4)(b)(i). • The responsibilities of the nominating/corporate governance committee, which must be set forth in its charter, must reflect at a minimum: ➢ the board's criteria for selecting new directors; and ➢ oversight of board and management evaluations (Proposed NYSE Rule 303A(4)(b)(ii)). • The charter must provide for an annual evaluation of the committee (Proposed NYSE Rule 303A(4)(b)(iii)).	• The corporate governance committee: ➢ performs the core function of recommending nominees to the board, including establishing criteria for board and committee membership, considering rotation of committee members, reviewing candidates' qualifications and any potential conflicts with the corporation's interests, assessing the contributions of current directors in connection with their renomination, and making recommendations to the full board (BRT Principles, p.17); ➢ monitors and safeguards the board's independence; ➢ oversees and reviews the corporation's processes for providing information to the board; ➢ develops and recommends to the board a set of corporate governance principles; and ➢ oversees the evaluation of management (BRT Principles, pp.18-19). • While it is appropriate for the CEO to meet with potential director nominees, the final responsibility for selecting nominees rests with the board (BRT Principles, p.17).
Compensation	• The compensation committee must consist entirely of independent	• Every publicly owned corporation should have a committee comprised

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committee—General and composition.*	directors (Proposed NYSE Rule 303A(5)(a)). • Companies must have one independent director on the committee within 12 months of SEC approval, and must fully comply with the independence requirement within 24 months of SEC approval.	solely of independent directors that addresses compensation issues (BRT Principles, p. 18). • The committee charged with executive/board compensation functions should be made up solely of independent directors (ISS Principles, p.1).
Compensation committee—Charter.	• The compensation committee must have a written charter that addresses the committee's purpose, specific responsibilities enumerated by the NYSE and an annual performance evaluation of the committee (Proposed NYSE Rule 303A(5)(b)). • A compensation committee charter should address committee member qualifications, appointment and approval; and committee structure, operations (including authority to delegate to subcommittees) and reporting to the board (Commentary to proposed NYSE Rule 303A(5)).	• Every publicly owned corporation should have a committee that addresses compensation issues. The compensation committee should be comprised solely of independent directors (BRT Principles, p.18).
Compensation committee—Responsibilities.	• The purpose of the compensation committee, which must be set forth in its charter, at a minimum must be to: ➢ discharge the board's responsibilities relating to compensation of executives; and ➢ produce an annual report on executive compensation for inclusion in the proxy statement (Proposed NYSE Rule 303A(5)(b)(i)). • The compensation committee's responsibilities, which must be set forth in its charter, at a minimum must be to: ➢ review and approve corporate goals and objectives relevant to CEO compensation, evaluate the CEO's performance in light of these objectives, and set the CEO's compensation based on this evaluation; and ➢ make recommendations to the board with respect to incentive-compensation plans and equity-based plans (Proposed NYSE Rule 303A(5)(b)(ii)). • The charter must provide for an annual evaluation of the committee	• The compensation committee oversees the corporation's overall compensation programs and sets CEO and senior management compensation. The committee should look broadly at the overall compensation structure of the corporation to determine that it establishes appropriate incentives for management and employees at all levels (BRT Principles, pp.18-19).

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	(Proposed NYSE Rule 303A(5)(b)(iii)).	
Outside advisors to board committees.*	• The Sarbanes-Oxley Act requires that the audit committee have the authority to engage outside advisors and to compensate both outside advisors and the outside auditor (§301). • The audit committee must have the authority to retain outside advisors without seeking board approval (Proposed NYSE Rule 303A(7)(b)(ii)(E) & commentary). The nominating/corporate governance and compensation committees should have sole authority to hire and fire search firms and compensation consultants, respectively (Commentary to proposed NYSE Rules 303A(4) & (5)).	• From time to time, it may be appropriate for boards and board committees to seek advice from outside advisors independent of management with respect to matters within their responsibility. For example, there may be technical aspects of the corporation's business – such as risk assessment and risk management – or conflict of interest situations for which the board or a committee determines that additional expert advice would be useful. Similarly, a compensation committee may find it useful to engage separate compensation consultants. The Business Roundtable believes that board and committee access to outside advisors in such cases is an important element of an effective corporate governance system (BRT Principles, p.23). • The board should have access to expert advice from a source independent of management (ISS Principles, p.3).
Board evaluations.*	• The board should conduct a self-evaluation at least annually to determine whether it and its committees are functioning effectively. A company's corporate governance guidelines must address an annual performance evaluations of the board (Commentary to proposed NYSE Rule 303A(9)). • The charters of each of the three core committees (audit, nominating/corporate governance and compensation) must address an annual performance evaluation of the committee (Proposed NYSE Rules 303A(4)(b)(iii), 5(b)(iii) &7(b)(iii)).	• The performance of the full board should be evaluated annually, as should the performance of its committees. The board should conduct periodic – generally annual – self-evaluations to determine whether it and its committees are following the procedures necessary to function effectively (BRT Principles, p.23). • The board should have a process for evaluating whether the individuals sitting on the board bring the skills and expertise appropriate for the corporation and how they work as a group. A director's ability to continue to contribute to the board should be considered each time the director is considered for renomination (BRT Principles, p.23). • Under the oversight of a committee comprised of independent directors, the nonmanagement members of the board should annually review the CEO's performance and participate with the CEO in the evaluation of senior management. The results of the CEO's evaluation should be promptly communicated to the CEO by representatives of the nonmanagement directors (BRT Principles, p.24).

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		• An independent board committee should regularly evaluate the performance of the board and individual directors. The evaluation should specifically address weaknesses in board structure and propose corrective actions (ISS Principles, p.2). • The independent directors should perform regular reviews of the CEO's performance, which should serve as the basis for establishing compensation packages that link CEO pay to company performance (ISS Principles, p.3).
Director selection.*	• A company's corporate governance guidelines must address director qualification standards. These standards should, at a minimum, reflect the independence requirements in proposed Rules 303A(1) (majority independence) and 303(A)(2) (absence of a material relationship; cooling off period). They may also address other substantive qualification requirements, such as policies limiting the number of boards on which directors may serve, and director tenure, retirement and succession (Commentary to proposed NYSE Rule 303A(9)).	• Board positions should not be regarded as permanent. Directors should serve only so long as they add value to the board, and a director's ability to continue to contribute to the board should be considered each time the director is considered for renomination (BRT Principles, pp.24-25). • An independent board committee should review the appropriate skills and characteristics required of directors in light of current board membership. The review should cover diversity, experience and skill sets. The principal qualification for any director should be the ability to act on behalf of all stockholders (ISS Principles, p.2).
Term limits/retirement age for directors.*	• Companies may address director tenure, retirement and succession in their corporate governance guidelines (Commentary to proposed NYSE Rule 303A(9)).	• Planning for the departure of directors and the designation of new board members is essential. The board should establish procedures for the retirement or replacement of directors. Such procedures may include, for example, a mandatory retirement age, a term limit, and/or a requirement that directors who change their primary employment tender a board resignation, providing an opportunity for the corporate governance committee to consider the desirability of their continued service on the board (BRT Principles, p.24).
Succession planning.*	• A company's corporate governance guidelines must address management succession. Succession planning should include policies and principles for CEO selection and performance review, and policies on succession in the event of an emergency or the CEO's retirement (Commentary to proposed NYSE Rule 303A(9)).	• The board should have contingency plans to provide for transitional board leadership if questions arise concerning management's conduct, competence, or integrity or if the CEO dies or is incapacitated. An individual director, a small group or directors, or the chairman of a committee may be selected by the board for this purpose (BRT Principles, p.11).

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Board consultation with senior management.	• A company's corporate governance guidelines must address director access to management (Commentary to proposed NYSE Rule 303A(9)).	• Board members should have full access to senior management and to information about the corporation's operations. Generally, the CEO should be advised of significant contacts between board members and senior management (BRT Principles, p.22). • Independent directors should have open access to management at all times (ISS Principles, p.3).
Director compensation.*	• A company's corporate governance guidelines must address director compensation. Director compensation guidelines should include general principles for determining the form and amount of director compensation and for reviewing those principles, as appropriate (Commentary to proposed NYSE Rule 303A(9)).	• A meaningful portion of directors' compensation should be in the form of long-term equity. Corporations may wish to consider establishing a requirement that, for as long as directors remain on the board, they acquire and hold stock in an amount that is meaningful and appropriate to each director (BRT Principles, pp.20-21).
Director education and orientation.*	• A company's corporate governance guidelines must address director orientation and continuing education (Commentary to proposed NYSE Rule 303A(9)). • In conjunction with leading corporate governance authorities, the NYSE will develop a Directors Institute (NYSE Press Release, Aug. 1, 2002).	• Many corporations provide new directors with materials and briefings to permit them to become familiar with the corporation's business, industry, and corporate governance practices. It is appropriate for corporations to provide additional educational opportunities to directors on an ongoing basis to enable them to better perform their duties and recognize and deal appropriately with issues that arise (BRT Principles, p.22).
Auditor independence.	• The Sarbanes-Oxley Act prohibits outside auditors from providing eight categories of non-audit services to their audit clients, including: ➢ bookkeeping and other services related to the company's accounting records or financial statements; ➢ financial information systems design and implementation; ➢ appraisal or valuation services, fairness opinions and contribution-in-kind reports; ➢ actuarial services; ➢ internal audit outsourcing services; ➢ management functions and human resources; ➢ broker-dealer, investment adviser and investment banking	• The audit committee should consider the independence of the outside auditor and should develop policies concerning the provision of non-audit services by the corporation's outside auditor. When making independence judgments, the audit committee should consider the nature and dollar amount of all services provided by the outside auditor when assessing the auditor's independence (BRT Principles, p.14).

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	services; and ➢ legal services and expert services unrelated to the audit. • The Sarbanes-Oxley Act requires that all audit services, and all permissible non-audit services (subject to a *de minimis* exception), be pre-approved by the audit committee and that the pre-approval of non-audit services be disclosed in the company's 10-Ks and 10-Qs (§202). • The audit committee must have sole authority to hire and fire the outside auditor (including sole authority to approve all engagement fees and terms), and to approve significant non-audit relationships/engagements with the outside auditor (Proposed NYSE Rules 303A(7)(a), (b)(ii)(A) & commentary).	
Hiring/firing of outside auditor.	• The Sarbanes-Oxley Act requires the SEC to promulgate rules prohibiting the listing of any security of a company that does not make its audit committee "directly responsible," in its capacity as a committee of the board, for the appointment, compensation, and oversight of the work of the outside auditor (including resolving disagreements between the auditor and management) and requires the outside auditor to report directly to the audit committee (§301). • The audit committee must have sole authority to hire and fire the outside auditor (Proposed NYSE Rules 303A(7)(a) & (b)(iii)(A)).	• The audit committee should make an annual recommendation to the full board about the selection of the outside auditor, based on a due diligence process that includes a review of the auditor's qualifications, work product, independence and reputation (BRT Principles, p.14).
Auditor rotation.	• The Sarbanes-Oxley Act requires rotation of lead audit and review partners every five years (§203). • In addition to assuring regular rotation of the lead audit partner as required by law, the audit committee should consider whether, in order to assure continuing independence, there should be regular rotation of the audit firm itself (Commentary to proposed NYSE Rule 303A(7)(b)(ii)(B)).	• The audit committee should consider whether it would be appropriate for the outside auditor periodically to rotate senior audit personnel or for the corporation periodically to change its outside auditor. The audit committee should base its decisions about selecting and possibly changing the outside auditor on its assessment of what is likely to lead to more effective audits (BRT Principles, pp.13-14).
Hiring former audit personnel.	• The Sarbanes-Oxley Act prohibits an audit firm from providing audit services to a company whose CEO, CFO or chief accounting officer (or any person serving in an equivalent capacity) was employed by the audit firm and participated in the company's audit in any capacity	• The audit committee should consider adopting a "cooling-off" period or other policy restricting the hiring of former auditor personnel; each corporation should consider what policy is appropriate for it (BRT Principles, pp.16).

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	within one year of the audit initiation (§206). • The audit committee must set clear hiring policies for employees or former employees of the outside auditor (Proposed NYSE Rule 303A(7)(b)(ii)(I)).	Principles, pp.16).
Stockholder approval of option plans.*	• Stockholders must vote to approve or disapprove all equity compensation plans (including any material revisions to the terms of a plan and repricing of existing options), except inducement options, plans acquired in mergers or acquisitions, and tax qualified and excess benefit plans. Plans that are not subject to stockholder approval must be subject to approval by the compensation committee (Proposed NYSE Rule 303A(8) & commentary). • Brokers may not vote customer shares on any equity compensation plans unless the broker has the customer's instructions to do so (Commentary to Proposed NYSE Rule 303A(8) & Rule 452). • Both provisions take effect immediately upon SEC approval.	• Corporations should obtain stockholder approval of all option plans (The Business Roundtable Statement on Restoring Investor Trust, July 8, 2002).
Corporate governance principles.	• Companies must adopt and disclose (including by posting on their websites) a set of corporate governance principles (Proposed NYSE Rule 303A(9)). • The principles must address director qualification standards and responsibilities, director access to management and independent advisors, director compensation, director orientation and continuing education, management succession, and annual board evaluations (Commentary to proposed NYSE Rule 303A(9)).	• All corporations should adopt and publicize statements of corporate governance principles (BRT Principles, p.18).
Codes of conduct.	• Companies must adopt and disclose (including by posting on their websites) a code of business conduct and ethics for directors, officers, and employees. The code must: ➢ require that any waivers of the code for directors or executive officers can be made only by the board or a board committee and that such waivers be promptly disclosed to stockholders; and ➢ contain compliance standards and procedures that ensure prompt	• Corporations should have a code of conduct with effective reporting and enforcement mechanisms. Employees should have a means of alerting management and the board to potential misconduct without fear of retribution, and violations of the code should be addressed promptly and effectively (BRT Principles, p.8).

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Issue	Sarbanes-Oxley Act of 2002 and New York Stock Exchange	BRT Principles of Corporate Governance (2002) and ISS Corporate Governance Principles
	and consistent action against violations (Proposed NYSE Rule 303A(10) & commentary). • At a minimum, a code of conduct should address conflicts of interest; corporate opportunities; confidentiality; fair dealing with the company's customers, suppliers, competitors and employees; protection and proper use of company assets; compliance with laws, rules and regulations, including laws on insider trading; and reporting illegal or unethical behavior (Commentary to proposed NYSE Rule 303A(10)).	
Disclosure of corporate governance practices on company website.	• Companies must post on their websites copies of their corporate governance principles, the charters of their most important committees (including, at a minimum, the charters of the audit, nominating/ corporate governance and compensation committees), and their code of business conduct and ethics. Companies must indicate in their annual reports that these materials are available on their websites and that the information is available in print to any stockholder that requests it (Commentary to proposed NYSE Rule 303A(9)).	• Recommends that corporations publicize statements of their corporate governance principles (BRT Principles, p.18).
Compliance with corporate governance listing standards.	• The CEO of each listed company must certify to the NYSE annually that he or she is not aware of any violation by the company of the NYSE's corporate governance listing standards. The NYSE certification, and any CEO/CFO certifications required to be filed with the SEC regarding the quality of the company's public disclosure, must be disclosed in the company's annual report (Proposed NYSE Rule 303A(12) & commentary).	•

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PRELIMINARY REPORT OF THE AMERICAN BAR ASSOCIATION TASK FORCE ON CORPORATE RESPONSIBILITY*

July 16, 2002

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PRELIMINARY REPORT OF THE ABA TASK FORCE ON CORPORATE RESPONSIBILITY

July 16, 2002

On March 28, 2002, Robert Hirshon, President of the American Bar Association, appointed a task force with the following charge:

> The Task Force on Corporate Responsibility shall examine systemic issues relating to corporate responsibility arising out of the unexpected and traumatic bankruptcy of Enron and other Enron-like situations which have shaken confidence in the effectiveness of the governance and disclosure systems applicable to public companies in the United States. The Task Force will examine the framework of laws and regulations and ethical principles governing the roles of lawyers, executive officers, directors, and other key participants. The issues will be studied in the context of the system of checks and balances designed to enhance the public trust in corporate integrity and responsibility. The Task Force will allow the ABA to contribute its perspectives to the dialogue now occurring among regulators, legislators, major financial markets and other organizations focusing on legislative and regulatory reform to improve corporate responsibility.

The Task Force respectfully submits this preliminary report in response to that charge. The report is the product of extended meetings of the full Task Force, numerous formal and informal meetings of various subgroups of the Task Force, and the fund of professional experience and judgment that the members of the Task Force bring to bear.[1]

This preliminary report is intended to serve as a vehicle to elicit comments from interested observers, within the ABA and elsewhere, through a written comment

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[1] The Task Force also notes with particular gratitude the contributions of Mary Ann Jorgenson, Chair of the ABA Section of Business Law Committee on Corporate Laws, and Stanley Keller, Chair of the ABA Section of Business Law Committee on Federal Regulation of Securities, special advisers to the Task Force.

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process and one or more public hearings to be scheduled this fall. With such input, the Task Force intends to generate a final report before the end of 2002.

The Task Force's recommendations are set out and explained below. They are recited in summary outline form in Exhibit A to this report. Not all members of the Task Force endorse each recommendation and view expressed in this report, but the report taken as a whole reflects a consensus of the members of the Task Force.

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I. INTRODUCTION AND OVERVIEW

A. Background of Recent Failures of Corporate Responsibility

Few events in business history since the Great Depression have had the public impact of the stunning collapse of Enron Corp. and other major companies in the past year. Although President Hirshon's charge to the Task Force specifically refers to Enron, that company is merely one of the most notorious in a disturbing series of recent lapses at large corporations involving false or misleading financial statements and alleged misconduct by executive officers.[2] Investor confidence in the quality and

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[2] Among the more notable recent disclosures:

- After months of questioning of its financial statements, WorldCom announced on June 25, 2002 that it had overstated its earnings before interest, taxes, depreciation and amortization (EBITDA) by over $3.8 billion in the five previous quarters. *See* WorldCom press release dated June 25, 2002, exhibit to Form 8-K dated June 25, 2002. This huge overstatement apparently arose in significant part due to a strategy of treating operating costs such as maintenance as capital investments instead. As it announced the accounting errors, WorldCom also announced that it would eliminate 20% of its work force. Over $115 billion in mid-1999, WorldCom's market capitalization is now less than $1 billion. *See* Simon Romero and Alex Berenson, "WorldCom Says It Hid Expenses, Inflating Cash Flow $3.8 Billion," New York Times, June 26, 2002, p. A1.

- On June 25, 2002, Adelphia Communications filed for protection under Chapter 11 of the bankruptcy laws, some three months after revealing that it had guaranteed loans of $2.3 billion to members of the Rigas family, Adelphia's controlling shareholders. Joseph B. Treaster, "Adelphia Files for Bankruptcy," New York Times, June 26, 2002, p. C2. Adelphia's common stock, which had reached a high of nearly $28 per share just last December, is now essentially worthless. Peter Lauria, "Adelphia Bottoms Out," The Daily Deal, June 27, 2002.

- The market capitalization of the stock of Tyco International has fallen by some $100 billion this year, driven by the indictment of its former chief executive officer on charges of state sales tax evasion, and by concerns about the use of

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integrity of public company corporate governance is compromised, and the pace of calls by the President, Congress, the SEC, stock markets and other interested groups for regulatory reform has quickened dramatically.[3]

Given the charge to the Task Force to examine "systemic issues relating to corporate responsibility," the threshold consideration in evaluating recent failures in "corporate responsibility" is defining that term. At the very least, "corporate responsibility" should be understood to include behavior by the executive officers and

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corporate funds for the personal benefit of the chief executive officer and the general counsel of the company. *See* Alex Berenson, "Ex-Tyco Chief, a Big Risk Taker, Now Confronts the Legal System," New York Times, June 10, 2002, p. C1.

- Gary Winnick, the former head of now bankrupt Global Crossing Ltd., sold over $700 million of his stock in that company from 1999, when the price reached $60 per share, through the end of 2001, soon before its bankruptcy filing following allegations that the company's revenues were inflated due to swaps without economic substance. *See* Jill Stewart, "Master of Disaster: How L.A.'s Super-rich Gary Winnick is Trying to Wash Blood from the Global Crossing Implosion off his Hands -- and Make More Money in the Bargain," New Times Los Angeles, April 25, 2002.

At least until the collapses that put some of these companies, as well as Enron, into bankruptcy, the common stock of all of these companies had been traded on the New York Stock Exchange or the Nasdaq National Market.

[3] The chairman and chief executive officer of the investment banking firm of Goldman Sachs recently remarked publicly that, "I cannot think of a time when business over all has been held in less repute." Patrick McGeehan, "Goldman Chief Urges Reforms in Corporations," New York Times, June 6, 2002, p. A1; *see also* Gretchen Morgenson, "What If Investors Won't Join the Party?," New York Times, June 2, 2002, p. C4 (reporting a May UBS/Gallup poll indicating that "84 percent feel that [the accounting impropriety] issue is punishing stock prices, ranking it ahead of conflict in the Middle East and terrorism."). *See also* The Business Roundtable Statement on Restoring Investor Trust, July 8, 2002, *available at* http://www.brt.org/press.cfm/728; Statement of the Chairs of the Conference Board Commission on Public Trust and

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directors of the corporation that conforms to law and results from the proper exercise of the fiduciary duties of care and loyalty to the corporation and its shareholders. In the Task Force's view, moreover, the term "corporate responsibility" also embraces ethical behavior beyond that demanded by minimum legal requirements.[4] Participants in the

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Private Enterprise, July 10, 2002, *available at* http://www.conferenceboard.org/economics/press.cfm?pressid=3000.

The responses of public officials to these concerns include: Remarks by the President on Corporate Responsibility, delivered on July 9, 2002, *available at* http://www.whitehouse.gov/news/releases/2002/07/20020709-4.html; "President Outlines Plan to Improve Corporate Responsibility," Remarks by the President at Malcolm Baldrige National Quality Award Ceremony (March 7, 2002) *available at* http://www.whitehouse.gov/news/releases/2002/03/20020307-3.html; H.R. 3763, the Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002, sponsored by Representative Oxley and approved by the House of Representatives on April 24, 2002; S. 2673, sponsored by Senator Sarbanes and approved (as H.R. 3763) by the Senate on July 15, 2002; and H.R. 5118, sponsored by Representative Sensenbrenner and approved by the House of Representatives on July 16, 2002. The SEC has proposed a number of regulatory reforms, including the formation of a Public Accountability Board, CEO certification of financial reports, and the approval of New York Stock Exchange and NASD rules affecting the conduct of security analysts. Release Nos. 33-8109; 34-46120; 35-27543; IA-2039; IC-25624, June 26, 2002, *available at* http://www.sec.gov/rules/proposed/33-8109.htm; Certification of Disclosure in Companies' Quarterly and Annual Reports, SEC Release No. 34-46079, June 17, 2002, *available at* http://www.sec.gov/rules/proposed.shtml; SEC Release No. 34-45908; File No. SR-NASD-2002-21; SR-NYSE-2002-09 (May 10, 2002), *available at* http://www.sec.gov/rules/sro/34-45908.htm.

[4] Section 2.01 of the American Law Institute's Principles of Corporate Governance expresses the consensus of the legal and business community that:

> (a) Subject to subsection (b) ... , a corporation should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain.
>
> (b) Even if corporate profit and shareholder gain are not thereby enhanced, the corporation, in the conduct of its business:

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corporate governance process require a fresh recognition that executives are employees, and that corporate responsibility can only be achieved when officers and directors both recognize that they are obliged to advance the interests of others. In their roles as corporate fiduciaries, the corporation does not belong to them.

Judged by this concept of corporate responsibility, the system of corporate governance at many public companies has failed dramatically. It is a clear failure of corporate responsibility, for example, if a corporation belatedly and precipitously discloses that the equity on its balance sheet has been overstated by *billions* of dollars. It is a clear failure of corporate responsibility if employees whose retirement accounts are heavily invested in the corporation's stock are assured by management of the

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> (1) Is obliged, to the same extent as a natural person, to act within the boundaries set by law;
> (2) May take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business; and
> (3) May devote a reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic purposes.

This language expresses a balance in which corporations are generally entitled, and indeed obligated, to seek to maximize their wealth for the benefit of their shareholders. That entitlement is tempered, on the other hand, by the corporation's obligation to act within the bounds of the law, and its power to engage in charitable activities and follow reasonable ethical considerations even if doing so fails to maximize the corporation's wealth.

While some state statutes (so-called "constituency statutes") purport to embrace a hierarchy in which shareholders are entitled to no greater consideration than employees or communities or other corporate constituencies, those statutes tend to have no different practical impact than the law in states that follow the American Law Institute approach. *See* Committee on Corporate Laws, *Other Constituencies Statutes: Potential for Confusion,* 45 BUS. LAW. 2253, 2271 (1990) ("Those statutes that merely empower directors to consider the interests of other constituencies are best taken as a legislative affirmation of what courts would be expected to hold, in the absence of a statute."). In

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corporation's financial prospects and then discover that the value of that stock has promptly vanished as a result of earnings misstatements and self-dealing by corporate officers. It is a clear failure of corporate responsibility if executive officers aware of potential accounting irregularities sell millions of dollars of stock to public investors who are unaware of such information. It is a clear failure of corporate responsibility for insiders to borrow enormous amounts from their companies without adequate security beyond inflated stock of the company itself. And it is a clear failure of corporate responsibility when outside directors, auditors and lawyers, who have important roles in our system of independent checks on the corporation's management, fail to avert or even discover – and sometimes actually condone or contribute toward the creation of – the grossest of financial manipulations and fraud.

At least with the benefit of hindsight, the 1990's can be seen to have created a potent recipe for failures of corporate responsibility. Among other things:

- Stock prices grew enormously and almost continuously, leading many investors to expect double digit annual returns on investment as a matter of course.[5] Executive officers were expected to meet growth expectations of Wall Street analysts that became increasingly unrealistic. The only hope for meeting expectations was a willingness to undertake significant risk or to manipulate data so that they would indicate the desired results.

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all states, shareholder interests have primacy as a practical matter because only shareholders are entitled to vote in the election of corporate directors.

[5] *See* Harris Collingwood, "The Earnings Cult," New York Times Magazine 68 (June 9, 2002).

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- Aided by dramatic stock price growth, equity-based executive compensation – particularly in the form of stock options – as a means intended to align the interests of managers and shareholders became increasingly prevalent and lucrative. There were unanticipated consequences. Executive officers were endowed with powerful personal incentives to meet near term Wall Street earnings expectations and to avoid any negative impact upon current stock market prices.[6] Directors faced significant pressures to produce executive compensation and benefit packages that were attractive in an ever-escalating executive compensation marketplace. The reasonableness of compensation and its structure, as well as the motivations being created, may not have received sufficient independent consideration.
- Outside professionals hired by the corporation – particularly its accountants and lawyers – faced increasing pressures of consolidation and global competition, and they found it necessary to compete more keenly to identify ways to enhance their relationships with their corporate clients. As accounting and law firms grew larger, the need increased to put in place internal controls that would allow those firms to assure the necessary quality controls and independent judgment. Corporate executives' self-interest in assuring a rising corporate stock price, and the frequent need to be aggressive in accounting matters and in assuming business risks were not tempered by the checks and balances which the general

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[6] David Wessel, "Why Boardroom Bad Guys Have Emerged en Masse: The 1990's Magnified Shifts in Business Mores as Watchdogs Napped," Wall Street Journal

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corporate governance scheme expected from outside directors and professional firms engaged by the corporation to provide independent review and advice. Questionable treatment of financial information evaded audit screens, and important disclosures were not made. Unfortunately, judgments at all levels of the governance system were compromised and, in too many instances, seriously flawed.

B. Identifying Critical Causes of Failures of Corporate Responsibility

The Task Force believes that most executive officers, directors and professional advisers act honestly and in good faith. Direct operational control of American public companies is and must remain primarily in the hands of their executive officers. It has always been recognized, however, that executive officers and other employees of public companies may succumb to the temptation to serve personal interests in maximizing their own wealth or control at the expense of long-term corporate well-being. To check such temptation, and to focus the corporation on the interests of the shareholders, our system of corporate governance has long relied upon the active oversight and advice of independent participants in the corporate governance process, such as the outside directors, outside auditors and outside counsel. Corporate responsibility and sound corporate governance thus depend upon the active and informed participation of independent directors and advisers who act vigorously in the best interests of the corporation and are empowered effectively to exercise their responsibilities.

(June 20, 2002).

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The core conclusion of the Task Force, however, is that, as evidenced by recent failures of corporate responsibility, the exercise by such independent participants of active and informed stewardship of the best interests of the corporation has in too many instances fallen short. Unless the governance system is changed in ways designed to encourage such active and informed stewardship, the Task Force believes that public trust and investor confidence in the corporate governance system will not be restored.

No set of legal rules or guidelines can guarantee that such active care will be achieved in practice.[7] Even the most stringent definition of independence will not generate the backbone to act independently and objectively which the Task Force believes is necessary to an effective system of corporate governance. And certainly, no reasonable amount of active care will invariably prevent fraud or other misconduct by corporate management. The Task Force nonetheless believes that its recommendations would significantly enhance corporate governance practices and ethical principles to make it more likely that the system of checks and balances involving outside directors, auditors and corporate counsel will work effectively to help ensure that the corporation is ethically and legally responsible and managed in the long run best interests of the corporation and its shareholders.

C. Subjects of the Task Force's Recommendations

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[7] The Business Roundtable's May 2002 Principles of Corporate Governance (p. 2) acknowledge that "[e]ven the most thoughtful and well-drafted policies and procedures are destined to fail if directors and management are not committed to enforcing them in practice."

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Effective reform of the corporate governance process will require comprehensive changes. In some areas in need of such change, the Task Force has not at this time formulated specific recommendations.[8] There are two principal areas, however, in which the Task Force believes that the ABA can meaningfully contribute to the current public policy debate on corporate responsibility. The first area involves internal corporate governance, particularly the composition and processes of the board of directors and its core committees. The ABA, particularly through its Business Law Section, has long been an important source of guidance in the formulation of internal rules of corporate governance.[9] The Task Force benefits from the collective experience

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[8] There are three significant limitations on the scope of this report. First, the Task Force has not attempted to determine the legal, ethical or moral responsibility of any individual person or organization associated with any particular failure of corporate governance. Second, the Task Force has also not at this time formulated recommendations on specific policy initiatives relating directly to public company audits, executive compensation and benefit plans, security analysts or employee retirement benefit plans. It is nevertheless the sense of the Task Force that meaningful reforms in these areas are necessary to complement the reforms it is proposing with respect to boards of directors and corporate lawyers. In particular, the Task Force supports the formation of a new, independent public oversight board for the accounting profession (although the Task Force has not reached any conclusion regarding specific attributes – composition or powers, for example – of such a board). The Task Force also believes that executive compensation practices, including the provisions and accounting for stock options, need to be carefully considered in reviewing reform necessary to enhancing corporate responsibility. Third and finally, the Task Force's recommendations concerning internal corporate governance standards are limited to corporations having publicly traded stock. In part, this limitation arises from the charge to the Task Force, which explicitly addresses "public companies." This limitation to public companies is appropriate in any event because the greatest risk to investors involves public companies; most large companies are publicly held; and the existing pattern of regulation through federal securities law and securities trading markets facilitates prompt reform.

[9] ABA Business Law Section Committee on Corporate Laws, Corporate Director's Guidebook (3rd ed. 2001).

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of its members whose professional careers have involved deep practical experience with, and broad study of, public corporations and the legal and ethical framework within which those corporations carry on their activities. The Task Force recommends that the ABA consider and endorse a series of corporate governance initiatives that are intended to enhance the likelihood that key corporate actors and advisers will act to further the interests of the corporation and its shareholders. These initiatives are set forth and explained in part II of this report.

The second area in which this report of the Task Force offers recommendations involves the ethical and governance framework within which the corporate lawyer can advance corporate responsibility. For many years the ABA has studied and formulated policies designed to encourage lawyers to promote corporate responsibility. Recent criticism of lawyers' conduct demonstrates that this study and formulation of policy has not yet achieved its objective and must be a continuing effort. The Task Force proposes that the ABA's Standing Committee on Ethics and Professional Responsibility consider a number of modifications to the ABA's Model Rules of Professional Conduct, and the Task Force also recommends a governance process designed to establish effective channels for chief legal officers and outside corporate counsel to communicate with independent directors. These recommendations, which are set forth and explained in part III of this report, are designed to make more effective the contributions of lawyers to corporate responsibility.

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II. RECOMMENDATIONS REGARDING INTERNAL CORPORATE GOVERNANCE

A. Introductory Perspective

Although the model for outside directors today posits an attitude of independence from senior management in carrying out their oversight function, in practice many aspects of the outside directors' role have reflected a dependence on senior management. Typically, senior management plays a significant part in the selection of directors, in proposing the compensation for directors, in selecting their committee assignments, in setting agendas for their meetings, and in evaluating their performance. In addition, directors often defer to management for the selection of the key advisers to the board and its committees (*e.g.*, compensation consultants), as well as the outside auditors for the company.

Recommendations to create active independent oversight must address these realities and bring about actual change. More specifically, such recommendations should serve four subsidiary purposes: (1) encourage qualified individuals to serve as independent directors; (2) create expectations and attitudes on the part of such individuals that establish active, informed and objective oversight as a behavioral norm; (3) create mechanisms that empower those individuals to exercise such oversight; and (4) reinforce those mechanisms with appropriate public disclosure obligations.

In developing such recommended standards of internal corporate governance, there is no shortage of models to review, and the Task Force has been greatly assisted by the wide range of industry organizations that have recently made corporate

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governance recommendations.[10] In many respects, those various organizations have urged standards of governance that reflect a developing consensus that we believe will materially improve the responsible conduct of corporate business.

Most of the recommendations below relating to internal corporate governance contemplate implementation through listing standards of the principal United States securities trading markets such as the New York Stock Exchange and the Nasdaq Stock Market. The Task Force is concerned, however, that the two principal trading marketplaces will not adopt substantially similar listing standards relating to corporate governance and that the other SRO's, such as the American Stock Exchange, the Midwest Stock Exchange and the Pacific Stock Exchange, may adopt none. The Task Force believes that substantial uniformity of governance standards applicable to public companies is desirable and would have the greatest impact on reliable corporate responsibility. Among the alternatives discussed by the Task Force to produce uniformity is to amend Section 19(c) of the Securities Exchange Act to empower the SEC to amend the rules of a self-regulatory organization to assure uniformity in listing

[10] We refer, for example, to: (1) the Report of the New York Stock Exchange Corporate Accountability and Listing Standards Committee dated June 6, 2002; (2) May 24, 2002 announcement by the Nasdaq Stock Market, Inc.; (3) May 2002 Business Roundtable Principles of Corporate Governance, and its related July 2002 statement, *available at* http://www.brt.org/press.cfm/728 ; (4) March 2002 Financial Executives International, Observations and Recommendations Improving Financial Management, Financial Reporting and Corporate Governance; (5) Council of Institutional Investors Corporate Governance Policies, *available at* http://www.cii.org/corp_governance.htm. The Task Force has also been guided by the Corporate Director's Guidebook (3rd ed. 2001) prepared by the Committee on Corporate Laws of the ABA Business Law Section, and by the ALI Principles of Corporate Governance.

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standards with respect to corporate governance matters.[11] The Task Force believes, however, that the most practical approach for adopting the proposed listing standards promptly – an approach that avoids direct federal regulation of matters of corporate governance historically governed by state law -- is for the self-regulatory organizations, acting with the support of the SEC or under the auspices of a jointly appointed Blue Ribbon Commission,[12] to adopt standards of governance that reflect the necessary improvements to the system of corporate checks and balances applicable to the largest public companies. If the desired uniformity is not achieved through this approach, however, serious consideration of alternatives such as amending Section 19(c) may be appropriate if other means are not found to avoid trading marketplace arbitrage.

The Task Force is not at this time addressing possible changes in state corporation law. State laws apply to a wide range of corporate entities, including closely held family businesses, and therefore the flexibility to accommodate different rules may be important. It is difficult in any event to coordinate state action on a uniform basis; on

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[11] The SEC currently can amend self-regulatory organization rules as it "deems necessary or appropriate to insure the fair administration of the self-regulatory organization, to conform its rules to requirements of [the Securities Exchange Act] and the rules and regulations thereunder applicable to such organization, or otherwise in furtherance of the purposes of [the Securities Exchange Act]. Securities Exchange Act §19(c), 15 U.S.C.§78s. The leading case construing the SEC's authority under this statute sharply circumscribed, or negated altogether, such authority in regard to the direct adoption of corporate governance listing standards. *The Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990).

[12] An example of such a commission is the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, which was composed of representatives of the New York Stock Exchange, Nasdaq, the SEC and other organizations interested in corporate governance. The 1999 report of that committee is available at http://www.nyse.com/abouthome.html?query=/about/report.html.

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the other hand, there are ongoing mechanisms for improving the ability of state corporate laws to deal with conflicts or interest on the part of corporate directors and officers. For example, the Committee on Corporate Laws of the ABA Business Law Section, which developed and periodically revises the frequently followed Model Business Corporation Act, is expected later this year to propose significant changes to clarify and enhance the role of independent directors in the evaluation of conflict of interest transactions. Moreover, the state courts that review the fiduciary duties of care and loyalty of directors and officers can be expected to identify and give effect to evolving expectations regarding oversight responsibility, conflicts of interest and director independence, and the Task Force believes that such common law development will improve the level of corporate responsibility.

B. Proposed Corporate Governance Recommendations

Having discussed numerous suggestions for change in corporate governance principles, the Task Force has concluded that corporate responsibility of public companies must be materially improved. Such companies should adhere to each of the following standards of internal corporate governance:[13]

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[13] The Task Force recognizes that these recommended standards of internal corporate governance may not be uniformly appropriate for all types of public companies. For certain categories of public companies, such as investment companies governed by the Investment Company Act of 1940 and exchange traded funds (ETF's), compliance with the recommended standards may be unnecessary or unsuitable. In addition, application of certain of the recommended standards to majority owned subsidiaries or similarly controlled public companies, and to foreign private issuers as defined in SEC Rule 3b-4(c), presents complex issues which require further study.

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1. A substantial majority of the members of the Board of Directors should be independent of management, both in fact and in appearance. The independent directors should meet routinely in executive session outside the presence of any senior corporate officer or director who is not independent. While the Task Force is not at this time recommending any particular formulation of the definition of the term "independent," the Task Force supports the concepts of independence recently proposed for adoption by the New York Stock Exchange.[14]

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[14] In its June 6, 2002 report, the New York Stock Exchange Corporate Accountability and Listing Standards Committee addresses the concept of director independence as follows:

> • No director qualifies as "independent" unless the board of directors affirmatively determines that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company). Companies must disclose these determinations.
>
> • In addition:
>
> – No director who is a former employee of the listed company can be independent" until five years after the employment has ended.
> – No director who is, or in the past five years has been, affiliated with or employed by a (present or former) auditor of the company (or of an affiliate) can be "independent" until five years after the end of either the affiliation or the auditing relationship.
> – No director can be "independent" if he or she is, or in the past five years has been, part of an interlocking directorate in which an executive officer of the listed company serves on the compensation committee of another company that employs the director.
> - Directors with immediate family members in the foregoing categories must likewise be subject to the five-year "cooling-off" provisions for purposes of determining "independence."

Report at 6-8. The NYSE Committee's report also observes, and the Task Force agrees, that "[w]e do not view ownership, or affiliation with the owner, of less than a controlling amount of stock as a *per se* bar to an independence finding." *Id.* at 8.

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2. The Board of Directors should appoint a committee (described in these recommendations as the Corporate Governance Committee) composed entirely of independent directors, and which may consist of all of the independent directors. This committee should be responsible for the identification and nomination (or recommendation of nomination) of independent members of the Board of Directors, and for extending invitations to potential independent Board members. This committee should also appoint or recommend to the full Board of Directors the persons to serve on each of the other committees of the Board. The Corporate Governance Committee may consult with the chief executive officer or any other executive officer of the corporation regarding such nominations or recommendations, but the Committee should ultimately determine and approve such nominations and recommendations in executive session outside the presence of any executive officer or director who is not independent.

3. The Audit Committee of the Board of Directors should be composed entirely of independent directors. The Audit Committee should meet routinely outside the presence of any executive officer of the corporation or director who is not independent. The Audit Committee should (a) have the authority either to engage and remove the corporation's outside auditor, or to recommend such engagement or removal to the Board, and the authority to determine the terms of the engagement of the outside auditor; (b) have the authority and resources to engage independent accounting and legal advisers when determined by the Committee to be necessary or appropriate; and (c) recommend or establish

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policies relating to non-audit services provided by the corporation's outside auditor to the corporation and other aspects of the corporation's relationship with the outside auditor that may adversely affect that firm's independence. The resolution of the Board of Directors creating the committee should specify whether the foregoing decisions are to be made exclusively by the Audit Committee, or by the full Board of Directors (or by all of the independent directors on the full Board) upon the recommendation of the committee.[15]

4. The Compensation Committee of the Board of Directors should be composed entirely of independent directors. The Compensation Committee should meet routinely outside the presence of any senior officer of the corporation or director who is not independent. The Compensation Committee should (a) determine, or make a recommendation with respect to, the compensation (including executive benefit plans) of the senior executive officers of the corporation, and (b) have the authority and resources to engage independent executive compensation and legal advisers when determined by the Committee to be necessary or appropriate. The resolution of the Board of Directors creating the committee should specify whether the foregoing decisions are to be made exclusively by the Compensation Committee, or by the full Board

[15] This flexibility of permitting action by the full Board of Directors or all of the independent directors acting as a group is not explicitly contemplated in the recently proposed amendments to the listing standards of the NYSE. The Task Force believes, however, that such flexibility would be valuable as a means to obtain input from all independent directors, rather than just those who are appointed to serve on the Audit Committee. This same point applies as well to the Corporate Governance Committee and the Compensation Committee.

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of Directors (or by all of the independent directors on the full Board) upon the recommendation of the committee.

5. The Corporate Governance Committee (or other committee consisting entirely of independent directors) should recommend for adoption by the full Board of Directors a corporate code of ethics and conduct that includes the establishment of a mechanism (such as a hot line, an ombudsman or compliance certification) through which information concerning violations of law by the corporation or its management personnel, or breaches of duty to the corporation which could have a material effect on the corporation, not appropriately addressed by corporate officers, can be freely transmitted to more senior officers and, if necessary, to the Audit or Corporate Governance Committee. In any investigation by the Board of Directors (or any committee) of such a violation or breach of duty, the Board (or committee) should have the authority to retain independent legal counsel.

6. In addition to approvals required by law, the Corporate Governance Committee, the Audit Committee or some other committee composed exclusively of independent directors and appointed for the purpose by or on the recommendation of the Corporate Governance Committee, should review and approve any material transaction between the corporation and any director or executive officer of the corporation (and any person or entity controlling or controlled by such director or officer, or in which such director or officer has a direct or indirect material financial interest), including a loan or guarantee by the

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corporation. Such review and approval should include (a) an explanation why the transaction is in the best interests of the corporation without regard to the interest or desire of the individual (or related person or entity); (b) a documented rationale for engaging in the transaction with a related party rather than with a third party; (c) a specific determination of the fairness of the transaction; and (d) a review of the public disclosure that may be appropriate for the transaction.

7. The Corporate Governance Committee and the Audit Committee should establish procedures for regular meetings with the corporate officers responsible for implementing the corporation's internal controls, codes of ethics and compliance policies – such as general counsel, the chief internal auditor and the chief compliance officer.[16] At least a portion of such meetings should routinely be outside the presence of any other executive officer or director who is not independent. At such meetings, the responsible officer should report on legal and compliance affairs of the corporation as directed by the committee. The scope and content of such reports should be designed to elicit, at a minimum, information about violations or potential violations of law and breaches of duty by an executive officer or director that could have a material adverse effect on the corporation.[17]

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[16] The areas of internal controls may vary from company to company depending upon the nature of its business; in most cases they would include the internal audit function and compliance with relevant legal requirements (antitrust, insider trading, environmental, employment, etc.), and may include matters such as product safety.

[17] Thus, this recommended standard is closely related to the Task Force's recommendations (in Part IV(C) below) regarding lines of communication through which

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The Task Force further believes that, in addition to the mandatory standards set forth above, best practices of corporate governance should include principles by which the Board of Directors takes the following actions:

1. Consider whether to implement other processes that may encourage active and informed input of the independent directors. Such processes may include (a) the appointment of a "lead" independent director,[18] or an independent director to serve as Chair of the Board of Directors, and (b) the adoption of processes for setting agendas and distributing information.

2. Consider whether to establish term limits or policies governing rotation of the chair and membership of the Board of Directors and its Corporate Governance, Audit and Compensation Committees, and the number of board and committee memberships.

3. Institute and maintain a training and education program for all directors, and particularly independent directors, in regard to (a) their legal and ethical responsibilities as directors, (b) the financial condition, the principal operating risks and the performance factors materially important to the business of the corporation and (c) the operation, significance and effects of compensation incentive programs and related party transactions.

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general counsel and outside counsel can effectively communicate issues relating to violations of law and breaches of fiduciary duty by corporate officers or employees.

[18] For example, the New York Stock Exchange Corporate Accountability and Listing Standards Committee has proposed to require the designation and public identification of the independent director who will preside over regularly scheduled meetings of non-management directors. (NYSE Recommendations p. 7).

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4. Institute procedures for periodic evaluations by the directors of (a) the effectiveness and adequacy of meetings of the Board of Directors and its committees, (b) the adequacy and timeliness of the information provided by management to the Board of Directors, (c) the diversity of experience of individual directors and (d) the contributions of each director.

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III. RECOMMENDATIONS REGARDING THE CONDUCT OF LAWYERS

A. Introductory Perspective

The conduct of inside and outside lawyers representing companies involved in recent failures of corporate responsibility has been the subject of legislative inquiry and public criticism, and those lawyers have been the targets of civil litigation and hints of possible criminal prosecution[19]. Members of Congress and commentators have questioned whether, in light of the events that transpired, the rules of professional conduct governing lawyers adequately serve and protect the public interest in circumstances such as those that were present in such corporate failures.[20]

[19] Illustrative material is available from the Task Force's web site, at: http://www.abanet.org/buslaw/corporateresponsibility/responsibility_relatedmat.html.

[20] Senator Edwards' remarks and his letter to SEC Chairman Harvey Pitt, 148 Cong Rec S 5652 (June 18, 2002) (urging imposition of corporate lawyer responsibilities through federal legislation), as well as the March 7, 2002 letter from Prof. Richard Painter, *et al.*, to Chairman Pitt, are available at the Task Force's web site. The bill passed by the Senate on July 15, 2002 (H.R. 3763) includes the following provision requiring the SEC to prescribe minimum standards of professional conduct for attorneys practicing before the Commission:

> Not later than 180 days after the date of enactment of this section, the Commission shall establish rules, in the public interest and for the protection of investors, setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of public companies, including a rule requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof) and, if the counsel or officer does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation), requiring the attorney to report the evidence to the audit committee of the board of directors or to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the company, or to the board of directors.

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In response to these concerns, the Task Force has reviewed applicable provisions of the ABA Model Rules of Professional Conduct ("Model Rules" or "Rules"), as most recently amended in February 2002.[21] Based on that review, the Task Force believes that the Model Rules should be amended in several important respects. The amendments proposed by the Task Force are designed to help lawyers comply with their duties to an organizational client in circumstances in which corporate officers engage in or countenance criminal, fraudulent or deceptive conduct likely to cause harm to the organization or its shareholders.

The Task Force has also concluded that it would promote corporate responsibility to adopt practices in which both outside and inside counsel to the corporation have a direct line of communication through which counsel may proceed in circumstances in which the lawyer reasonably believes that the corporate client is involved in a violation or potential violation of law or in a breach of duty that will adversely affect in a material manner the interests of the corporation. Finally, the Task Force recommends that the ABA further study and develop recommendations of "best practices" for law firms and corporate legal departments that are designed to promote effective and ethical representation of the corporation. All of these recommendations address the role of counsel for all corporations, and not just those with publicly traded stock.

H.R. 3763 section 602(d).

[21] Controlling rules of professional conduct are usually promulgated by the highest court of the state in which the lawyer practices, and are frequently modeled upon the ABA Model Rules of Professional Conduct. The rules of professional conduct may also be relevant in determining attorney liability. *See* American Law Institute, Restatement (Third) of the Law Governing Lawyers, §52(2)(c) and cmt. f.

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B. Proposed Amendments to the Model Rules of Professional Conduct

The Model Rules encourage lawyers to embrace and observe moral and ethical considerations beyond legally required minimum standards. For example, the Preamble to the Model Rules states that "a lawyer is also guided by personal conscience." Likewise, the Scope of the Rules declares that "[t]he Rules do not . . . exhaust the moral and ethical considerations that should inform a lawyer, for no worthwhile human activity can be completely defined by legal rules. The Rules simply provide a framework for the ethical practice of law." Model Rule 2.1 provides that, in rendering advice, "a lawyer may refer not only to law but to other considerations such as moral, economic, social and political factors, that may be relevant to the client's situation." The Comments to Model Rule 2.1 state that "[a]lthough a lawyer is not a moral advisor as such, moral and ethical considerations impinge upon most legal questions and may decisively influence how the law will be applied."

These broad and aspirational principles, while of profound importance, do not afford a sufficient guide to the corporate lawyer confronted with aberrant conduct by corporate officers and insiders. Such guidance should be given, in the view of the Task Force, by clear and precise direction in the Model Rules.[22] The amendments proposed by the Task Force to be considered by the Standing Committee on Ethics and Professional Responsibility reflect this objective. The background and content of the proposed amendments follow.

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Model Rule 1.13. Rule 1.13 ("Organization as Client") states that a lawyer employed or retained by an organization represents the entity ("the organization acting through its duly authorized constituents"). If confronted with corporate misconduct, the lawyer must consider whether, among other alternatives, to present the lawyer's concerns about that misconduct to a higher level of authority within the organization. Rule 1.13 provides that the lawyer shall proceed "as is reasonably necessary in the best interest of the organization" if the lawyer knows that

> an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law which reasonably might be imputed to the organization, and is likely to result in substantial injury to the organization

The premise of Rule 1.13 is that the organization is the lawyer's client and that the lawyer owes that client an obligation of protection from harm. Harm can result when an officer breaches a duty to the corporation (*e.g.*, wastes or misappropriates corporate assets), when the corporation will be caused to injure a third party who will then have a claim against the corporation or when the corporation will be exposed to a fine or penalty. In any such case, the lawyer's duty to protect the corporate client from harm requires the lawyer to serve the interests of the corporation and its shareholders rather than the interests of the individual officers or employees who are acting for the corporation.

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[22] The Task Force's recommendations address Model Rules 1.2, 1.6, 1.13, 1.16 and 4.1. Those Rules, in their current form, are reproduced in Exhibit B to this report.

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The range of actions open to the lawyer under Rule 1.13 includes asking for reconsideration of the matter, taking the matter to higher authority in the organization or, in an extreme case, where higher authority fails to act, resigning from the representation in accordance with Rule 1.16 or disclosing confidential client information to a third party in accordance with Rule 1.6.[23]

Under existing Rule 1.13, only misconduct that is "related to the [lawyer's] representation" triggers the lawyer's obligation. In addition, the tone of Rule 1.13 (including its Comments) tends to discourage action by the lawyer to prevent or rectify corporate misconduct. Thus, for example, Rule 1.13(b) requires that any measure taken by the lawyer "be designed to minimize disruption of the organization and the risk of revealing information relating to the representation to persons outside the organization." The Task Force believes that this wording unduly emphasizes the avoidance of "disruption" of the organization while playing down the more important goal of minimizing <u>harm</u> resulting from the misconduct. Likewise, the Comments to Rule 1.13 state that "[c]lear justification should exist for seeking review over the head of the constituent normally responsible for it." This wording discourages a lawyer from seeking review by higher corporate authority.

The Task Force accepts that it is the appropriate role of corporate officers and employees to make business decisions involving substantial degrees of risk, such as entering into a largely untested new line of business or building new facilities in

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23 Disclosure of client confidences to higher authority *within* the corporation is not prohibited by Rule 1.6, and Rule 1.13 should make this clear.

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anticipation of projected business growth, and certainly the lawyer is not expected to go over the head of the individual with whom the lawyer is dealing unless he or she has reason to believe that the officer or employee is acting illegally or fraudulently, or in breach of a duty to the corporation. When the lawyer knows or reasonably should know of such misconduct, however, the lawyer should be encouraged to act promptly to protect the interests of the corporation.

The Task Force therefore recommends that Rule 1.13 be amended to make clear that it requires the lawyer to pursue the measures outlined in Rule 1.13(c)(1) through (3) (including referring the matter to higher corporate authority), in a matter either related to the lawyer's representation (as currently provided) *or* that has come to the lawyer's attention through the representation, where the misconduct by a corporate officer, employee or agent involves crime or fraud, including violations of federal securities laws and regulations.[24] Rule 1.13(b) could also be amended to emphasize in the text of the Rule itself that the list of potential remedial measures need not be pursued in sequential order, and that in circumstances involving potentially serious misconduct with significant risk to the corporation, an effort to seek reconsideration by a particular officer or employee that is unlikely to succeed should be bypassed in favor of referral to a higher

[24] Where the misconduct is unrelated to the lawyer's representation, however, the requirement to pursue the measures outlined in Rule 1.13(c)(1) should apply only where the lawyer knows of the misconduct, since there should be no obligation on the part of the lawyer to inquire into matters unrelated to the lawyer's representation. *See* discussion below, text at note 34, proposing to amend Rule 1.13, among others, to reach matters of which the lawyer "reasonably should know."

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authority in the corporation.[25] Finally, the Task Force recommends that both the text of and comments to Rule 1.13 should be revised to avoid unduly discouraging action by counsel to prevent or rectify corporate misconduct, and to encourage lawyers to take the action required by the rule.

Model Rule 1.6. Rule 1.6 prohibits (with limited exceptions) a lawyer from disclosing information relating to the representation of a client except with the client's informed consent. The protections of Rule 1.6 apply to communications to the lawyer by a corporate officer when acting in that capacity. It is not clear, however, what the Rules permit the lawyer to disclose upon learning of corporate misconduct through confidential consultation with a corporate officer. The Comments to Rule 1.13 state that even if the lawyer is unable through other courses of action to protect the corporation and its shareholders, the lawyer's duty to safeguard confidential communications under Rule 1.6 remains in force.

The ABA Commission on Evaluation of the Rules of Professional Conduct ("Ethics 2000") proposed in February of this year, consistent with the Restatement (Third) of the Law Governing Lawyers, that three exceptions be added to Model Rule

[25] The existing commentary to Rule 1.13(b) correctly notes that referral to a higher corporate authority may occur without prior presentation to the officer or employee whose conduct is in question: "If that [presentation to the officer or employee] fails, *or* if the matter is of sufficient seriousness and importance to the organization, it may be reasonably necessary for the lawyer to take steps to have the matter reviewed by a higher authority in the organization." Rule 1.13, Comment [3] (emphasis added).

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1.6 to permit the lawyer to disclose client confidences to third parties.[26] The ABA House of Delegates approved one of those exceptions, permitting disclosure when necessary to prevent reasonably certain death or substantial bodily harm. It rejected the other two Ethics 2000 proposals to expand permissive disclosure under Rule 1.6. Those proposals would have permitted disclosure to prevent or rectify the consequences of a crime or fraud in which the client had used or was using the lawyer's services and that was reasonably certain to result, or had resulted, in substantial injury to the financial interests or property of another.[27]

The Task Force recommends that the House of Delegates reconsider and adopt these Ethics 2000 proposals. We endorse the following articulation in the Ethics 2000 report of the rationale for those proposals:

> The Commission recommends that a lawyer be permitted to reveal information relating to the representation to the extent necessary to prevent the client from committing a crime or fraud reasonably certain to result in substantial economic loss, but only when the lawyer's services have been or are being used in furtherance of the crime or fraud. Use of the lawyer's services for such improper ends constitutes a serious abuse of the client-lawyer relationship. The client's entitlement to the protection of the Rule must be balanced against the prevention of the injury that would otherwise be suffered and the interest of the lawyer in being able to prevent the misuse of the lawyer's services.
>
> Moreover, with respect to future conduct, the client can easily prevent the harm of disclosure by refraining from the wrongful conduct. …
>
> The rationale for [permitting disclosure to prevent, mitigate or rectify substantial economic loss resulting from client crime or fraud in which client has used

[26] American Bar Association, Commission on Evaluation of the Rules of Professional Conduct, Report with Recommendation to the House of Delegates (August 2001), *available at* http://www.abanet.org/cpr/e2k-report_home.html.

[27] *See* http://www.abanet.org/cpr/e2k-rule16.html.

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> lawyer's services] is the same …, the only difference being that the client no longer can prevent disclosure by refraining from the crime or fraud. See also Comment [8]. The Commission believes that the interests of the affected persons in mitigating or recouping their substantial losses and the interest of the lawyer in undoing a wrong in which the lawyer's services were unwittingly used outweigh the interests of a client who has so abused the client-lawyer relationship.

The Task Force further recommends amendment of Rule 1.6 to make disclosure mandatory, rather than permissive, in order to prevent client conduct known to the lawyer to involve a crime, including violations of federal securities laws and regulations, in furtherance of which the client has used or is using the lawyer's services, and which is reasonably certain to result in substantial injury to the financial interests or property of another.

Forty-one states either permit or require disclosure to prevent a client from perpetrating a fraud that constitutes a crime,[28] and eighteen states permit or require disclosure to rectify substantial loss resulting from client crime or fraud in which the client used the lawyer's services.[29] If existing Rule 1.6 was "out of step with public policy" a year ago, as Ethics 2000 concluded,[30] it is even more out of step today, when

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[28] Alaska, Arizona, Arkansas, Colorado, Connecticut, Florida, Georgia, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Massachusetts, Maryland, Maine, Michigan, Minnesota, Mississippi, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, South Carolina, Tennessee, Texas, Utah, Vermont, Virginia, Washington, Wisconsin, West Virginia and Wyoming (permit); Florida, New Jersey, Virginia and Wisconsin (require).

[29] Connecticut, Hawaii, Maryland, Massachusetts, Michigan, Minnesota, Nevada, New Jersey, North Carolina, North Dakota, Ohio, Oklahoma, Pennsylvania, South Dakota, Texas, Utah, Virginia and Wisconsin (permit); Hawaii and Ohio (require).

[30] *See* Reporter's Explanation of Changes to Rule 1.6, *available at* http://www.abanet.org/cpr/e2k-rule16rem.html

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public demand that lawyers play a greater role in promoting corporate responsibility is almost certainly much stronger. The Ethics 2000 proposals are an important part of an effective response to the problems that have provoked public criticism of the bar.

Model Rules 1.2 and 4.1. Rules 1.2 and 4.1 prohibit active participation in a client's criminal or fraudulent conduct. Rule 1.2(d) provides that a lawyer "shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent." Rule 4.1 provides that, in the course of representing a client, a lawyer "shall not knowingly . . . make a false statement of material fact or law to a third person." Rule 4.1 also provides that a lawyer shall not knowingly "fail to disclose a material fact when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client."

Both of these Rules refer to "knowing" conduct. Similarly, the mandate of Rule 1.13 applies only if the lawyer "knows" that a person associated with an organization is engaging in or intends to engage in misconduct. The Model Rules define "knows" as "actual knowledge of the fact in question." While a person's knowledge "may be inferred from the circumstances," this term presumably does not reach conduct covered by the term "reasonably should know," which is also defined in the Model Rules.

In recent corporate failures, some legal advisers have been criticized for accepting management's instructions and limiting their advice and/or services to a narrowly defined scope, ignoring the context or implications of the advice they are

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giving.[31] This criticism is similar to that generally directed at lawyers giving tax opinions on hypothetical facts in circumstances in which the opinions served to facilitate fraudulent transactions.[32] The ABA has long advised that lawyers providing transactional opinions that may be relied upon by third parties cannot blindly accept facts posited by the client; they must question and investigate the factual predicate for their advice, at least to some extent and in some circumstances.[33]

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[31] *See, e.g.,* Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp. by William C. Powers, Jr., Chair, dated February 1, 2002, at 25-26, available at http://news.findlaw.com/hdocs/docs/enron/sicreport/.

[32] *See* ABA Standing Committee on Ethics and Professional Responsibility, Formal Opinion No. 346, "Tax Law Opinions in Tax Shelter Investment Offerings," 68 A.B.A.J. 471 (1982).

[33] *Id.* ("The lawyer who accepts as true the facts which the promoter tells him, when the lawyer should know that a further inquiry would disclose that these facts are untrue, also gives a false opinion."). Quoting an earlier opinion (A.B.A. Formal Opinion No. 335 (1974), the 1982 ABA opinion explains the lawyer's duty to investigate as follows:

> [T]he lawyer should, in the first instance, make inquiry of his client as to the relevant facts and receive answers. If any of the alleged facts, or the alleged facts taken as a whole, are incomplete in a material respect; or are suspect; or are inconsistent; or either on their face or on the basis of other known facts are open to question, the lawyer should make further inquiry. The extent of this inquiry will depend in each case upon the circumstances; for example, it would be less where the lawyer's past relationship with the client is sufficient to give him a basis for trusting the client's probity than where the client has recently engaged the lawyer, and less where the lawyer's inquiries are answered fully than when there appears a reluctance to disclose information.
>
> Where the lawyer concludes that further inquiry of reasonable nature would not give him sufficient confidence as to all the relevant facts, or for any other reason he does not make the appropriate further inquiries, he should refuse to give an opinion. However, assuming that the alleged facts are not incomplete in a material respect, or suspect, or in any way inherently inconsistent, or on their

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There has also been criticism of corporate lawyers for turning a blind eye to the natural consequences of what they observe and claiming that they did not "know" that the corporate officers they were advising were engaged in misconduct. The Task Force believes that, while lawyers should not be subject to discipline for simple negligence, they should not be permitted to ignore the obvious. Instead, lawyers should be held to the "reasonably should know" standard, defined in the Model Rules as denoting "that a lawyer of reasonable prudence and competence would ascertain the matter in question."[34]

In summary, the Task Force believes that the problems and criticisms it has described are legitimate concerns that require a corrective response. Accordingly, the

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> face or on the basis of other known facts open to question, the lawyer may properly assume that the facts as related to him by his client, and checked by him by reviewing such appropriate documents as are available, are accurate. . . .
>
> The essence of this opinion . . . is that, while a lawyer should make adequate preparation including inquiry into the relevant facts that is consistent with the above guidelines, and while he should not accept as true that which he should not reasonably believe to be true, he does not have the responsibility to 'audit' the affairs of his client or to assume, without reasonable cause, that a client's statement of the facts cannot be relied upon.

See also 31 CFR §10.33(a)(1), which requires tax practitioners who give tax shelter opinions to "make inquiry as to all relevant facts," and precludes such practitioners from

> (ii) ... accept[ing] as true asserted facts pertaining to the tax shelter which he/she should not, based on his/her background and knowledge, reasonably believe to be true. However, a practitioner need not conduct an audit or independent verification of the asserted facts, or assume that a client's statement of the facts cannot be relied upon, unless he/she has reason to believe that any relevant facts asserted to him/her are untrue.

[34] Some members of the Task Force preferred limiting this expansion of Rules 1.2(d), 1.13 and 4.1 to matters that should have been obvious to a lawyer of reasonable prudence and competence given the facts actually known to the lawyer.

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Task Force concludes that the Model Rules should be amended so as better to protect the public from criminal or fraudulent conduct using a lawyer's services, better to serve the interests of organizational clients, and better to guide lawyers in complying with their ethical obligations when serving organizational clients.

C. Reporting by Counsel of Potential Violations of Law and Other Concerns Relating to the Welfare of the Corporate Client

In addition to the foregoing recommendations of amendments to the Model Rules, the Task Force recommends the adoption of two corporate governance policies that would facilitate and encourage independent oversight of potential violations of law and breaches of duty to the corporation. First, the Board of Directors should establish a practice of regular, executive session meetings between the general counsel[35] and the Audit Committee or other appropriate committee of the Board of Directors. Second, all retentions of outside counsel to the corporation should establish two things at the outset of the engagement: (1) a direct line of communication between outside counsel and the corporation's general counsel; and (2) the understanding that outside counsel are obliged to apprise the general counsel, through that direct line of communication, of violations or potential violations of law by the corporation or of violations or potential

[35] Reference to the general counsel includes, where appropriate, the general counsel's staff and, where no office of general counsel has been established, outside counsel performing a similar role with respect to corporate governance, compliance or disclosure. The Task Force recommends that if a public company has no internal corporate general counsel, the Audit Committee (or other committee of independent directors) of the Board of Directors should identify and designate a lawyer or law firm to act as general counsel, or designate an executive officer to have executive responsibility for the legal affairs of the corporation.

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violations of duties to the corporation. The reasons for these recommended practices are set forth below.

1. Communication Between General Counsel and Independent Directors

The general counsel of a corporation works day to day with senior management and typically reports to the CEO or another senior officer. Although such interaction is with individual members of management, the general counsel's client is the corporation. That creates a tension whose resolution demands a number of practical steps.

Where the general counsel knows or has reason to know that an officer or employee to whom counsel reports will breach a duty to the corporation or violate a law, counsel may have to confront the issue of going over the head of that individual if the officer or employee cannot be persuaded to alter such conduct. If the relevant officer or employee is a member of senior management or most difficult, the CEO, general counsel must determine whether to go up the corporate ladder to the Board or a Board committee.

The general counsel's consideration, under Model Rule 1.13, of whether to go over the head of the CEO depends upon a number of factors: the basis for and strength of counsel's concerns about the conduct; the severity of possible harm to the corporation as a consequence of the conduct, and the level of disruption within the corporation from raising the issue to the board level. In any event, the general counsel will expect to pay a substantial price for going over the head of the CEO and will be reluctant to do so. At a minimum, such action will disturb the relationship of the CEO

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and the general counsel.

Suppose on the other hand that the general counsel, as a matter of routine, periodically meets privately with the Chair of the Audit Committee. Suppose further that the Chair of the Audit Committee had instructed general counsel to use those occasions to report on violations or potential violations of law, breaches of duty to the corporation and other substantial legal concerns relating to the welfare of the corporation that have come to general counsel's attention since their last meeting. The Chair also expects to know what investigation of the facts has been made, what steps have been taken to deal with the violations or breaches, and the steps taken to make sure such violations or breaches do not reoccur. Under such a procedure, the general counsel would not easily be able to avoid reporting to the Chair of the Audit Committee the concerns about the particular conduct. Moreover, the fact that the general counsel would have to make such disclosure probably makes it easier for the general counsel to persuade the CEO to raise the issue with the Chair of the Audit Committee.

If the CEO agrees to raise the issue with the Chair of the Audit Committee, does the general counsel have any duty to see whether the CEO has done so? This possible duty is relatively easy for the general counsel to discharge, by saying: "I understand the CEO has already discussed with you the issue raised by..."

Suppose the Chair of the Audit Committee responds to the general counsel by agreeing with the CEO's position that the corporation must take the business risk of engaging in the conduct worrying the general counsel because if the corporation does not do so it will have enormous problems with its business and lose a substantial

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amount of money. Must the general counsel take the issue to the rest of the Board? If the general counsel concludes that there is a reasonable likelihood that this action contravenes the Board adopted Code of Conduct or is illegal, counsel must at a minimum strongly urge that the Board be informed. If the Board is nevertheless prepared in effect to amend the Code to permit a violation of law and the conduct would create substantial risks of physical harm to third parties, it would implicate duties under Model Rule 1.6 to consider disclosure of the conduct, and under Rule 1.16 to consider withdrawal. In addition, under Rule 1.2(d) counsel cannot participate in any act that violates the law.

The Task Force believes that it would facilitate the general counsel's ability to assure that critical issues, including all issues of potential law and fiduciary duty violations, be raised to the Board level if routine, periodic private meetings (designed to elicit specific information) between the general counsel and appropriate independent directors were part of the governance process adopted by the Board. An important virtue of such a process is that it provides leverage for the general counsel to persuade senior management itself to raise those issues with appropriate members of the Board and thus allows the general counsel to avoid the painful and possibly disruptive process of having to go over the head of senior management.

2. Communication Between Outside Counsel and General Counsel

The corporation is commonly served by a number of outside counsel who interact with specific corporate employees. Outside counsel may or may not have regular contact with the corporation's senior management (including the CEO) and typically do

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not interact with the Board of Directors or independent members of the Board. In the absence of such contact, outside counsel who becomes concerned that a duty to the corporation has been breached or that the corporation may be violating or potentially violating the law is unlikely to have either the mandate or access to the corporation's resources to permit an appropriate investigation to be made.

In these circumstances, present Model Rule 1.13 probably does not require the outside counsel to take any action. There are frequently significant practical obstacles, moreover, to outside counsel bringing potential misconduct to the attention of appropriate corporate authorities. In many situations operational personnel will hire outside counsel and be responsible for future hires of counsel. Consequently, a pattern can easily develop where outside counsel does not fully appreciate that counsel's responsibility is to the corporation, not to the employee or department who retains counsel.

In many well run corporations, however, the general counsel will have made clear to outside counsel that in circumstances where outside counsel believes that an officer or employee is violating the law or a duty to the company, outside counsel should communicate that belief to the general counsel. General counsel may have additional information and, if needed, typically has the resources to make appropriate investigations and is charged with responsibility to pursue such inquiries in appropriate situations. In those corporations, outside counsel will have an invitation to make known his or her concerns at a place in the corporate structure where appropriate action can be taken.

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Particularly in circumstances where operational personnel select (or are perceived as selecting) counsel, general counsel should take an early opportunity to meet with outside counsel and stress that outside counsel represents the corporation and that general counsel wants to be informed of situations where outside counsel is concerned that the law is being violated or there is a breach of duty that adversely affects the interests of the corporation.[36] General counsel will also follow up by periodically meeting with outside counsel to talk about the representation.

Creation of this routine path of communication helps outside counsel to take appropriate steps where counsel knows or has reason to believe that officers or employees are engaging in conduct which will cause the corporation to violate the law or otherwise suffer serious harm. These steps tend to put the problem in the hands of the general counsel who usually has better tools to get the problem properly resolved within the corporate governance process.

This procedure will not solve the problem where outside counsel knows or has reason to believe that general counsel will not handle the problem properly either because of a disabling conflict of interest or because of weakness or incompetence. In those cases outside counsel is remitted to the guidance in Model Rule 1.13, discussed above, dealing with presenting concerns about corporate misconduct to higher levels of authority within the corporation.

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[36] Since outside counsel does not want the raising of this information to prejudice unnecessarily an ongoing working relationship with the employee, general counsel must be sensitive in dealing with the information communicated by outside counsel.

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Many public corporations have no internal corporate general counsel with whom outside counsel can communicate. If an outside law firm serves as the corporate general counsel, the Chair of the Audit Committee or Corporate Governance Committee of the Board of Directors will want to meet regularly and privately with the appropriate member or members of such outside law firm. In addition, the Chair may want to arrange for that firm to perform the general counsel role described above with respect to other outside firms retained to represent the corporation. In some cases that process would not be appropriate and outside counsel would be remitted to the guidance in Model Rule 1.13, discussed above. In general, however, the Task Force believes that the Audit Committee (or other committee of independent directors) should identify and designate a single lawyer or law firm to perform the general counsel role.

D. Issues for Further Study

The foregoing recommendations, if adopted and implemented, should by no means represent the last word in the development of standards of conduct for corporate lawyers in the interest of promoting corporate responsibility. There have been enormous changes in the legal profession in recent years, including the growth of very large law firms, whose offices are widely scattered, not only in the United States but also abroad. This development heightens the need for thoughtful evaluation of how the rules of professional conduct and best practices can be effectively implemented.

Growth in size, geographical dispersion and increasing emphasis on economic results compel law firms to focus attention on internal quality and risk management controls. These controls should assure that difficult issues of client relations are

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surfaced at appropriate levels of the firm, are thoroughly examined in discussions, which include partners who are not intimately involved with the client, and decided by the firm. In addition, senior management of law firms and corporate law departments should make special efforts to educate all their colleagues about their responsibilities to their corporate clients and their other professional responsibilities.

The Task Force recommends that the appropriate committee of the Business Law Section of the ABA, and such other groups as the ABA considers appropriate, promptly take up these important issues of internal law firm and law department governance.

Finally, the Task Force notes that the corporate lawyer should be sensitive to the potential conflicts of interest arising out of business and investment relationships with his or her client. While ethically permitted under current principles, accepting securities in a client company in exchange for legal services, serving on the board of directors of a client for which legal services are performed by the firm, and entering into business arrangements with the client raise potential conflicts of interest with the client and may adversely affect the attorney's independence and judgment.[37] The Task Force has not had the time fully to consider these difficult issues. It expects to do so prior to the issuance of its final report following comments and testimony on these issues.

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[37] *See* Model Rule 1.8(a); American Law Institute, Restatement (Third) of the Law Governing Lawyers §126; ABA Standing Committee on Ethics and Professional Responsibility Formal Opinion No. 00-418, Acquiring Ownership in a Client in Connection with Performing Legal Services (July 7, 2000); The Lawyer-Director:

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EXHIBIT A

SUMMARY OF RECOMMENDATIONS[38]

Recommendations Relating to Internal Corporate Governance

Recommended Standards for Public Companies

1. A Board of Directors should include a substantial majority of independent directors, with independence being defined in a manner consistent with recent listing standard proposals for the New York Stock Exchange.

2. A corporate governance (or equivalent) committee composed entirely of independent directors should be responsible for identifying and contacting potential independent directors.

3. The audit committee should consist entirely of independent directors, and should have authority to recommend or take action with respect to engaging and removing the outside auditor, engaging independent accounting and legal advisers when deemed necessary or appropriate, and establishing policies relating to non-audit services by the outside auditor and other matters that may affect the outside auditor's independence.

4. The compensation committee should consist entirely of independent directors, and should have authority to recommend or take action with respect to determining senior executive officer compensation and engaging independent executive compensation and legal advisers when deemed necessary or appropriate.

5. The corporate governance committee should recommend a corporate code of ethics and conduct including establishing a mechanism for communication to independent directors of information about material violations of law and breaches of duty to the corporation.

6. A committee of independent directors should approve all material transactions with a director or executive officer, upon specific

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Implications for Independence, ABA Section of Litigation Task Force on the Independent Lawyer (April 1998).

[38] This summary is solely intended to facilitate comment, and is in all respects qualified by the full text of the recommendations in the body of the report.

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determinations of fairness, rationale for dealing with a related party rather than a third party, and appropriate public disclosure.

7. The Board should adopt procedures for routine held, executive session meetings between the corporate governance and/or audit committees and the corporate officers (*e.g.*, general counsel, chief internal auditor, chief compliance officer) responsible for implementing internal controls.

Recommended Governance Enhancements for Boards of Directors of Public Companies

1. Consider use of "lead" independent director or independent Board chair, and adoption of processes for agenda setting and information distribution.

2. Consider policies establishing term limits or rotating chair/membership of corporate governance, audit and compensation committees, and the number of board and committee memberships.

3. Maintain a program of director training and education.

4. Adopt procedures for evaluating effectiveness of meetings, information flow, diversity of director experience and contributions of individual directors.

Recommendations Relating to Lawyer Responsibilities and Conduct

Proposals to Amend the Model Rules of Professional Responsibility:

1. Amend Rule 1.13 to require the lawyer to pursue remedial measures for misconduct whether the problem is related to the representation or learned through the representation and to communicate with higher corporate authority where other efforts fail to prevent or rectify the problem, to make clear that disclosure of confidential client information to higher authority within the corporation does not violate Rule 1.6, and to revise language that discourages lawyers from communicating with higher corporate authorities.

2. Extend permissible disclosure under Rule 1.6 to reach conduct that has resulted or is reasonably certain to result in substantial injury to the financial interests or property of another, and require disclosure under Rule 1.6 to prevent felonies or other serious crimes, including violations of the federal securities laws, where such misconduct is known to the lawyer.

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3. Expand Rules 1.2(d), 1.13 and 4.1 to reach beyond actual knowledge to circumstances in which the lawyer reasonably should know of the crime or fraud.

4. Improve the linkage among the Model Rules relating to the obligations of a lawyer faced with illegal conduct or breach of fiduciary duty in representing a corporate client.

Proposals for Establishing Lines of Communication by General Counsel and Outside Counsel

1. Corporations should adopt a practice whereby general counsel meets routinely and periodically, privately, with one or more independent directors, to facilitate Board attention to potential violations of law by and breaches of duty to the corporation.

2. All engagements of outside counsel should establish at the outset a direct line of communication with general counsel through which outside counsel should inform the general counsel of violations/potential violations of law and duty to the corporation.

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EXHIBIT B

SELECTED MODEL RULES OF PROFESSIONAL CONDUCT

SCOPE OF REPRESENTATION

RULE 1.2 ABA MODEL RULES OF PROFESSIONAL CONDUCT

(a) Subject to paragraphs (c) and (d), a lawyer shall abide by a client's decisions concerning the objectives of representation and, as required by Rule 1.4, shall consult with the client as to the means by which they are to be pursued. A lawyer may take such action on behalf of the client as is impliedly authorized to carry out the representation. A lawyer shall abide by a client's decision whether to settle a matter. In a criminal case, the lawyer shall abide by the client's decision, after consultation with the lawyer, as to a plea to be entered, whether to waive jury trial and whether the client will testify.

(b) A lawyer's representation of a client, including representation by appointment, does not constitute an endorsement of the client's political, economic, social or moral views or activities.

(c) A lawyer may limit the scope of the representation if the limitation is reasonable under the circumstances and the client gives informed consent.

(d) A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent, but a lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law.

CONFIDENTIALITY OF INFORMATION

RULE 1.6 ABA MODEL RULES OF PROFESSIONAL CONDUCT

(a) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted by paragraph (b).

(b) A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:

(1) to prevent reasonably certain death or substantial bodily harm;

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(2) to secure legal advice about the lawyer's compliance with these Rules;

(3) to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved, or to respond to allegations in any proceeding concerning the lawyer's representation of the client; or

(4) to comply with other law or a court order.

ORGANIZATION AS CLIENT

RULE 1.13 ABA MODEL RULES OF PROFESSIONAL CONDUCT

(a) A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents.

(b) If a lawyer for an organization knows that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law which reasonably might be imputed to the organization, and is likely to result in substantial injury to the organization, the lawyer shall proceed as is reasonably necessary in the best interest of the organization. In determining how to proceed, the lawyer shall give due consideration to the seriousness of the violation and its consequences, the scope and nature of the lawyer's representation, the responsibility in the organization and the apparent motivation of the person involved, the policies of the organization concerning such matters and any other relevant considerations. Any measures taken shall be designed to minimize disruption of the organization and the risk of revealing information relating to the representation to persons outside the organization. Such measures may include among others:

(1) asking for reconsideration of the matter;

(2) advising that a separate legal opinion on the matter be sought for presentation to appropriate authority in the organization; and

(3) referring the matter to higher authority in the organization, including, if warranted by the seriousness of the matter, referral to the highest authority that can act on behalf of the organization as determined by applicable law.

(c) If, despite the lawyer's efforts in accordance with paragraph (b), the highest authority that can act on behalf of the organization insists upon action, or a refusal to act, that is clearly a violation of law and is likely to result in substantial injury to the

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organization, the lawyer may resign in accordance with Rule 1.16.

(d) In dealing with an organization's directors, officers, employees, members, shareholders or other constituents, a lawyer shall explain the identity of the client when the lawyer knows or reasonably should know that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing.

(e) A lawyer representing an organization may also represent any of its directors, officers, employees, members, shareholders or other constituents, subject to the provisions of Rule 1.7. If the organization's consent to the dual representation is required by Rule 1.7, the consent shall be given by an appropriate official of the organization other than the individual who is to be represented, or by the shareholders.

DECLINING OR TERMINATING REPRESENTATION

RULE 1.16 ABA MODEL RULES OF PROFESSIONAL CONDUCT

(a) Except as stated in paragraph (c), a lawyer shall not represent a client or, where representation has commenced, shall withdraw from the representation of a client if:

(1) the representation will result in violation of the rules of professional conduct or other law;

(2) the lawyer's physical or mental condition materially impairs the lawyer's ability to represent the client; or

(3) the lawyer is discharged.

(b) Except as stated in paragraph (c), a lawyer may withdraw from representing a client if:

(1) withdrawal can be accomplished without material adverse effect on the interests of the client;

(2) the client persists in a course of action involving the lawyer's services that the lawyer reasonably believes is criminal or fraudulent;

(3) the client has used the lawyer's services to perpetrate a crime or fraud;

(4) the client insists upon taking action that the lawyer considers repugnant or with which the lawyer has a fundamental disagreement;

(5) the client fails substantially to fulfill an obligation to the lawyer regarding the

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lawyer's services and has been given reasonable warning that the lawyer will withdraw unless the obligation is fulfilled;

(6) the representation will result in an unreasonable financial burden on the lawyer or has been rendered unreasonably difficult by the client; or

(7) other good cause for withdrawal exists.

(c) A lawyer must comply with applicable law requiring notice to or permission of a tribunal when terminating a representation. When ordered to do so by a tribunal, a lawyer shall continue representation notwithstanding good cause for terminating the representation.

(d) Upon termination of representation, a lawyer shall take steps to the extent reasonably practicable to protect a client's interests, such as giving reasonable notice to the client, allowing time for employment of other counsel, surrendering papers and property to which the client is entitled and refunding any advance payment of fee or expense that has not been earned or incurred. The lawyer may retain papers relating to the client to the extent permitted by other law.

TRUTHFULNESS IN STATEMENTS TO OTHERS

RULE 4.1 ABA MODEL RULES OF PROFESSIONAL CONDUCT

In the course of representing a client a lawyer shall not knowingly:

(a) make a false statement of material fact or law to a third person; or

(b) fail to disclose a material fact when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client, unless disclosure is prohibited by Rule 1.6.

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Principles of Corporate Governance

A White Paper from The Business Roundtable

© May 2002

THE BUSINESS ROUNDTABLE
AN ASSOCIATION OF CHIEF EXECUTIVE OFFICERS COMMITTED TO IMPROVING PUBLIC POLICY

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FOREWORD AND INTRODUCTION

The Business Roundtable is recognized as an authoritative voice on matters affecting American business corporations and, as such, has a keen interest in corporate governance. The Business Roundtable is an association of chief executive officers of leading corporations with a combined workforce of more than 10 million employees in the United States and $3.5 trillion in revenues. The chief executives are committed to advocating public policies that foster vigorous economic growth, a dynamic global economy, and a well-trained and productive U.S. workforce essential for future competitiveness.

Past publications of The Business Roundtable that have addressed corporate governance include our Statement on Corporate Governance (September 1997); Executive Compensation/Share Ownership (March 1992); Corporate Governance and American Competitiveness (March 1990); Statement on Corporate Responsibility (October 1981); and The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation (January 1978). We are pleased to note that, in the five years since our 1997 Statement was published, many of the practices we suggested at that time have become common.

The United States has the best corporate governance, financial reporting, and securities markets systems in the world. These systems work because of the adoption of best practices by public companies within a framework of laws and regulations. While there have been exceptions to the overall record of success, generally the systems have worked very well.

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Given the accelerated nature of change, innovation and progress in the U.S. and global markets, and in light of notable exceptions to a system that has generally worked well, The Business Roundtable believes it is appropriate to restate our guiding principles of corporate governance. These principles, we believe, should help to guide the continual advancement of corporate governance practices, and so advance the ability of U.S. public corporations to compete, create jobs and generate economic growth.

The Business Roundtable supports the following guiding principles:

First, the paramount duty of the board of directors of a public corporation is to select a Chief Executive Officer and to oversee the CEO and other senior management in the competent and ethical operation of the corporation on a day-to-day basis.

Second, it is the responsibility of management to operate the corporation in an effective and ethical manner in order to produce value for stockholders. Senior management is expected to know how the corporation earns its income and what risks the corporation is undertaking in the course of carrying out its business. Management should never put personal interests ahead of or in conflict with the interests of the corporation.

Third, it is the responsibility of management, under the oversight of the board and its audit committee, to produce financial statements that fairly present the financial condition and results of operations of the corporation, and to make the

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timely disclosures investors need to permit them to assess the financial and business soundness and risks of the corporation.

Fourth, it is the responsibility of the board and its audit committee to engage an independent accounting firm to audit the financial statements prepared by management and to issue an opinion on those statements based on Generally Accepted Accounting Principles. The board, its audit committee and management must be vigilant to ensure that no actions are taken by the corporation or its employees that compromise the independence of the outside auditor.

Fifth, it is the responsibility of the independent accounting firm to ensure that it is in fact independent, is without conflicts of interest, employs highly competent staff, and carries out its work in accordance with Generally Accepted Auditing Standards. It is also the responsibility of the independent accounting firm to inform the board, through the audit committee, of any concerns the auditor may have about the appropriateness or quality of significant accounting treatments, business transactions that affect the fair presentation of the corporation's financial condition and results of operations, and weaknesses in internal control systems. The auditor should do so in a forthright manner and on a timely basis, whether or not management has also communicated to the board or the audit committee on these matters.

Sixth, the corporation has a responsibility to deal with its employees in a fair and equitable manner.

These responsibilities, and others, are critical to the functioning of the modern public corporation and the integrity of the public markets. No law or regulation alone can be a substitute for the

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voluntary adherence to these principles by corporate directors and management and by the accounting firms retained to serve American corporations.

The Business Roundtable continues to believe that the most effective way to enhance corporate governance is through conscientious and forward-looking action by a business community that focuses on generating long-term stockholder value with the highest degree of integrity.

The principles discussed here are intended to assist corporate management and boards of directors in their individual efforts to implement best practices of corporate governance, and also to serve as guideposts for the public dialogue on evolving governance standards.

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I. KEY CORPORATE ACTORS

Effective corporate governance requires a clear understanding of the respective roles of the board and of senior management and their relationships with others in the corporate structure.

Effective corporate governance requires a clear understanding of the respective roles of the board and of senior management and their relationships with others in the corporate structure. The relationships of the board and management with stockholders should be characterized by candor; their relationships with employees should be characterized by fairness; their relationships with the communities in which they operate should be characterized by good citizenship; and their relationships with government should be characterized by a commitment to compliance.

Senior management, led by the Chief Executive Officer, is responsible for running the day-to-day operations of the corporation and properly informing the board of the status of such operations. Management's responsibilities include strategic planning, risk management, and financial reporting.

The board of directors has the important role of overseeing management performance on behalf of stockholders. Its primary duties are to select and oversee a well qualified and ethical CEO who, with senior management, runs the corporation on a daily basis, and to monitor management's performance and adherence to corporate standards. Effective corporate directors are diligent monitors, but not managers, of business operations.

Stockholders necessarily have little voice in the day-to-day management of corporate operations, but have the right to elect representatives (directors) to look out for their interests, and to receive the information they need to make investment and voting decisions.

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Effective corporate governance requires a proactive, focused state of mind on the part of directors, the CEO and senior management, who all must be committed to business success through maintenance of the highest standards of responsibility and ethics. Good governance is far more than a "check-the-box" list of minimum board and management policies and duties. Even the most thoughtful and well-drafted policies and procedures are destined to fail if directors and management are not committed to enforcing them in practice. A good corporate governance structure is a working system for principled goal-setting, effective decision-making and appropriate monitoring of compliance and performance. Through such a vibrant and responsive structure, the CEO, the management team and the board of directors can interact effectively and respond quickly to changing circumstances, within a framework of solid corporate values, to provide enduring value to the stockholders who invest in the enterprise.

II. THE ROLES OF THE BOARD OF DIRECTORS AND MANAGEMENT

An effective system of corporate governance provides the framework within which the board and management address their respective responsibilities.

The Board of Directors

- The business of a corporation is managed under the direction of the corporation's board. The board delegates to the CEO, and through him or her to other senior management, the authority and responsibility for managing the everyday affairs of the corporation.

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Directors monitor management on behalf of the corporation's stockholders.

The selection, compensation and evaluation of a well qualified and ethical CEO is the single most important function of the board.

- The selection, compensation and evaluation of a well qualified and ethical CEO is the single most important function of the board. The board also appoints or approves other members of the senior management team.
- Directors bring to the corporation a range of experience, knowledge and judgment. Directors should not represent the interests of particular constituencies.
- Effective directors maintain an attitude of constructive skepticism; they ask incisive, probing questions and require accurate, honest answers; they act with integrity; and they demonstrate a commitment to the corporation, its business plans and long-term stockholder value.
- In performing its oversight function, the board is entitled to rely on the advice, reports and opinions of management, counsel, auditors and expert advisors. The board should assess the qualifications of those it relies on and hold managers and advisors accountable. The board should ask questions and obtain answers about the processes used by managers and advisors to reach their decisions and recommendations and about the substance of the advice and reports received by the board.
- Given the board's oversight role, stockholders and other constituencies can reasonably expect that directors will

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exercise vigorous and diligent oversight over a corporation's affairs. However, they should not expect the board to micromanage the corporation's business by performing or duplicating the tasks of the CEO and the senior management team.

- The board's oversight function carries with it a number of specific responsibilities in addition to that of selecting the CEO. These include responsibility for:

  - *Planning for management succession.* The board should plan for CEO and senior management succession and, when appropriate, replace the CEO or other members of senior management.

  - *Understanding, reviewing and monitoring implementation of the corporation's strategic plans*. The board has responsibility for overseeing and understanding the corporation's strategic plans from their inception through their development and execution by management. Once the board reviews a strategic plan, the board should regularly monitor implementation of the plan to determine whether it is being implemented effectively and whether changes are needed.

  - *Understanding and reviewing annual operating plans and budgets*. The board has responsibility for overseeing and understanding the corporation's annual operating plans and for reviewing the annual budgets presented by management. The board should monitor implementation of the annual plans to assess whether they are being implemented

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effectively and within the limits of approved budgets.

The board and its audit committee should take reasonable steps to be comfortable that the corporation's financial statements and other disclosures accurately present the corporation's financial condition and results of operations to stockholders, and that they do so in an understandable manner.

- *Focusing on the integrity and clarity of the corporation's financial statements and financial reporting*. While financial reports are primarily the responsibility of management, the board and its audit committee should take reasonable steps to be comfortable that the corporation's financial statements and other disclosures accurately present the corporation's financial condition and results of operations to stockholders, and that they do so in an understandable manner. In order to do this, the board, through its audit committee, should have a broad understanding of the corporation's financial statements, including why the accounting principles critical to the corporation's business were chosen, what key judgments and estimates were made by management, and how the choice of principles, and the making of such judgments and estimates, impacts the reported financial results of the corporation.

- *Engaging outside auditors and considering independence issues*. The board, through its audit committee, bears responsibility for engaging an outside auditor to audit the corporation's financial statements and for ongoing communications with the outside auditor. The board, through its audit committee, should periodically consider the independence and continued tenure of the auditor.

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- *Advising management on significant issues facing the corporation*. Directors can offer management a wealth of experience and a wide range of perspectives. They provide advice and counsel to management in formal board and committee meetings and are available for informal consultation with the CEO and senior management.

- *Reviewing and approving significant corporate actions*. As required by state corporate law, the board reviews and approves specific corporate actions, such as the election of executive officers, declaration of dividends and appropriate major transactions. The board and senior management should have a clear understanding of what level or types of decisions require specific board approval.

- *Nominating directors and committee members and overseeing effective corporate governance*. It is the responsibility of the board and its corporate governance committee to nominate directors and committee members and to oversee the composition, structure, practices and evaluation of the board and its committees.

The CEO and Management

- It is the responsibility of the CEO, and of senior management under the CEO's direction, to operate the corporation in an effective and ethical manner.

- The governance model followed by most public corporations in the United States has historically been

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one of individual, rather than group, leadership. U.S. corporations have traditionally vested responsibility in the CEO as the leader of management rather than diffusing high-level responsibility among several individuals. The Business Roundtable believes that this model has generally served corporations well.

The CEO and senior management run the corporation's day-to-day business operations.

- The CEO should be aware of the major risks and issues that the corporation faces and is responsible for supervising the corporation's financial reporting processes. For example, the CEO is responsible for providing stockholders and others with information that the CEO believes is important to understanding the corporation's business. Of course, the CEO necessarily relies on the expert advice of others on technical questions and legal requirements.

- As part of its operational responsibility, senior management is charged with:

  - *Operating the corporation*. The CEO and senior management run the corporation's day-to-day business operations. With a thorough understanding of how the corporation operates and earns its income, they carry out the corporation's strategic objectives within the annual operating plans and budgets reviewed by the board.

  - *Strategic planning*. The CEO and senior management generally take the lead in strategic planning. They identify and develop strategic plans for the corporation; present those plans to the board; implement the plans once board review is

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completed; and recommend and carry out changes to the plans as necessary.

- *Annual operating plans and budgets*. With the corporation's overall strategic plans in mind, senior management develops annual operating plans and annual budgets for the corporation, and the CEO presents those plans and budgets to the board. Once board review is completed, the management team implements the annual operating plans and budgets.

- *Selecting qualified management and establishing an effective organizational structure*. Senior management is responsible for selecting qualified management and for implementing an organizational structure that is efficient and appropriate for the corporation's particular circumstances.

- *Identifying and managing risks*. Senior management identifies and manages the risks that the corporation undertakes in the course of carrying out its business. It also manages the corporation's overall risk profile.

- *Good financial reporting*. Senior management is responsible for the integrity of the corporation's financial reporting system. It is senior management's responsibility to put in place and supervise the operation of systems that allow the corporation to produce financial statements that fairly present the corporation's financial condition and thus permit investors to understand the business

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and financial soundness and risks of the corporation.

- The CEO and senior management are responsible for operating the corporation in an ethical manner. They should never put individual, personal interests before those of the corporation or its stockholders. In carrying out this function, The Business Roundtable believes that corporations should have:

The CEO should be a person of integrity who takes responsibility for the corporation adhering to the highest ethical standards.

- *A CEO of integrity*. The CEO should be a person of integrity who takes responsibility for the corporation adhering to the highest ethical standards.

- *A strong, ethical "tone at the top*." Senior management, and particularly the CEO, should set a "tone at the top" that establishes a culture of legal compliance and integrity communicated to personnel at all levels of the corporation.

- *Internal controls*. A corporation should have an effective system of internal controls providing reasonable assurance that the corporation's books and records are accurate, that its assets are safeguarded and that it complies with applicable laws. The internal controls system should be periodically evaluated and updated so that it continues to be effective in a changing environment.

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A corporation should have a code of conduct with effective reporting and enforcement mechanisms.

- *Codes of conduct*. A corporation should have a code of conduct with effective reporting and enforcement mechanisms. Employees should have a means of alerting management and the board to potential misconduct without fear of retribution, and violations of the code should be addressed promptly and effectively.

III. HOW THE BOARD PERFORMS ITS OVERSIGHT FUNCTION

Publicly owned corporations employ diverse approaches to board structure and operations, and no one structure is right for every corporation. Nevertheless, The Business Roundtable believes that the corporate governance "best practices" set forth in the following sections provide an effective approach for corporations to follow.

Board Composition and Leadership

- Boards of directors of large, publicly owned corporations vary in size from industry to industry and from corporation to corporation. In determining board size, directors should consider the nature, size, and complexity of the corporation as well as its stage of development. The experience of many Roundtable members suggests that smaller boards are often more cohesive and work more effectively than larger boards.

- The Business Roundtable believes that having directors with relevant business and industry experience is beneficial to the board as a whole. Directors with such

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backgrounds can provide a useful perspective on significant risks and competitive advantages and an understanding of the challenges facing the business. Because the corporation's need for particular backgrounds and experiences may change over time, the board should monitor the mix of skills and experience that directors bring to the board to assess, at each stage in the life of the corporation, whether the board has the necessary tools to perform its oversight function effectively.

- The board of a publicly owned corporation should have a substantial degree of independence from management. Board independence depends not only on directors' individual relationships – personal, employment or business – but also on the board's overall attitude toward management. Providing objective independent judgment is at the core of the board's oversight function, and the board's composition should reflect this principle.

A substantial majority of directors of the board of a publicly owned corporation should be independent of management, both in fact and appearance.

- *Board independence.* A substantial majority of directors of the board of a publicly owned corporation should be independent of management, both in fact and appearance, as determined by the board.

    - *Assessing independence.* An independent director should be free of any relationship with the corporation or its management that may impair, or appear to impair, the director's ability to make independent judgments. The listing standards of the major securities markets relating to audit

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committees provide useful guidance in determining whether a particular director is "independent." These standards focus primarily on familial, employment and business relationships. However, boards of directors should also consider whether other kinds of relationships, such as close personal relationships between potential board members and senior management, may affect a director's actual or perceived independence.

- *Relationships with not-for-profit organizations*. Some observers have questioned the independence of directors who have relationships with non-affiliated not-for-profit organizations that receive support from corporations. The Business Roundtable believes that such relationships and their effect on a director's independence should be assessed by the board or its corporate governance committee on a case-by-case basis, taking into account the size of the corporation's contributions to the not-for-profit organization and the nature of the director's relationship to the organization. Independence issues are most likely to arise where a director is an employee of the not-for-profit organization and where a substantial portion of the organization's funding comes from the corporation. By contrast, where a director merely serves on the board of a not-for-profit organization with broad community representation, there may be no meaningful independence issues.

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Most American corporations are well served by a structure in which the CEO also serves as chairman of the board.

- Most American corporations are well served by a structure in which the CEO also serves as chairman of the board. The CEO serves as a bridge between management and the board, ensuring that both act with a common purpose. Some corporations have found it useful to separate the roles of CEO and chairman of the board to provide continuity of leadership in times of transition. Each corporation should make its own determination of what leadership structure works best, given its present and anticipated circumstances. The board should have contingency plans to provide for transitional board leadership if questions arise concerning management's conduct, competence, or integrity or if the CEO dies or is incapacitated. An individual director, a small group of directors, or the chairman of a committee may be selected by the board for this purpose.

Board Organization

- Virtually all boards of directors of large, publicly owned corporations operate using committees to assist them. A committee structure permits the board to address key areas in more depth than may be possible in a full board meeting.

- Decisions about committee membership should be made by the full board, based on recommendations from a committee responsible for corporate governance issues. The board should designate the chairmen of the various committees, if this is not done by the committees themselves.

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- Committees should apprise the full board of their activities on a regular basis. Processes should be developed and monitored for keeping the board informed through oral or written reports.

- The Business Roundtable believes that the functions generally performed by the audit, compensation and corporate governance committees are central to effective corporate governance. The Business Roundtable does not believe, however, that a particular committee structure is essential for all corporations. What is important is that key issues be addressed effectively by the independent members of the board. Thus, the references below to the functions performed by particular committees are not intended to preclude corporations from allocating these functions differently.

- Other committees, such as executive or finance committees, also may be used. Some corporations find it useful to establish additional committees to examine special problems or opportunities in greater depth than would otherwise be feasible.

- The responsibilities of each committee should be clearly defined and understood. A written charter approved by the board, or a board resolution establishing the committee, is appropriate.

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Audit Committee

Every publicly owned corporation should have an audit committee comprised solely of independent directors.

- *Every publicly owned corporation should have an audit committee comprised solely of independent directors.*
- Audit committees typically consist of 3 to 5 members. The listing standards of the major securities markets require audit committees and require that an audit committee have at least 3 members and that all members of the audit committee qualify as independent under the applicable listing standards, subject to limited exceptions.
- Audit committee members should meet minimum financial literacy standards, and at least one of the committee members should have accounting or financial management expertise, as required by the listing standards of the major securities markets. However, more important than financial expertise is the ability of audit committee members, as with all directors, to understand the corporation's business and risk profile, and to apply their business experience and judgment to the issues for which the committee is responsible with an independent and critical eye.
- The audit committee is responsible for oversight of the corporation's financial reporting process. The primary functions of the audit committee are the following:
  - *Risk profile.* The audit committee should understand the corporation's risk profile and oversee

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the corporation's risk assessment and management practices.

The selection of an outside auditor should involve an annual due diligence process in which the audit committee reviews the qualifications, work product, independence and reputation of the proposed outside auditor.

- *Outside auditors*. The audit committee is responsible for supervising the corporation's relationship with its outside auditor, including recommending to the full board the firm to be engaged as the outside auditor, evaluating the auditor's performance, and considering whether it would be appropriate for the outside auditor periodically to rotate senior audit personnel or for the corporation periodically to change its outside auditor. The selection of an outside auditor should involve an annual due diligence process in which the audit committee reviews the qualifications, work product, independence and reputation of the proposed outside auditor. The audit committee should base its decisions about selecting and possibly changing the outside auditor on its assessment of what is likely to lead to more effective audits. Based on its due diligence, the audit committee should make an annual recommendation to the full board about the selection of the outside auditor.

- *Independence*. The audit committee should consider the independence of the outside auditor and should develop policies concerning the provision of non-audit services by the outside auditor. The provision of some types of audit-related and consulting services by the outside auditor may not be inconsistent with independence

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or the attestation function. In considering whether the outside auditor should provide certain types of non-audit services, the audit committee should consider the degree of review and oversight that may be appropriate for new and existing services. When making independence judgments, the audit committee should consider the nature and dollar amount of all services provided by the outside auditor.

- *Critical accounting judgments and estimates.* The audit committee should review and discuss with management and the outside auditor the corporation's critical accounting policies and the quality of accounting judgments and estimates made by management.

- *Internal controls*. The audit committee should understand and be familiar with the corporation's system of internal controls and on a periodic basis should review with both internal and outside auditors the adequacy of this system.

- *Compliance*. Unless the full board or another committee does so, the audit committee should review the corporation's procedures addressing compliance with the law and important corporate policies, including the corporation's code of ethics or code of conduct.

- *Financial statements*. The audit committee should review and discuss the corporation's annual financial statements with management and the

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outside auditor and, based on these discussions, recommend that the board approve the financial statements for publication and filing. Most audit committees also find it advisable to implement processes for the committee or its designee to review the corporation's quarterly financial statements prior to release.

- *Internal audit function.* The audit committee oversees the corporation's internal audit function, including review of reports submitted by the internal audit staff, and reviews the appointment and replacement of the senior internal auditing executive.

- *Communication.* The audit committee should provide a channel of communication to the board for the outside auditor and internal auditors and may also meet with and receive reports from finance officers, compliance officers and the general counsel.

- *Hiring auditor personnel.* Under audit committee supervision, some corporations have implemented "revolving door" policies covering the hiring of auditor personnel. For example, these policies may impose "cooling off" periods prohibiting employment by the corporation in senior financial management positions of members of the audit engagement team for some period of time after their work as auditors for the corporation. The audit committee should consider whether to adopt such a

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policy. Any policy on the hiring of auditor personnel should be flexible enough to allow exceptions, but only when specifically approved by the audit committee.

Audit committee meetings should be held frequently enough to allow the committee to appropriately monitor the annual and quarterly financial reports.

- Audit committee meetings should be held frequently enough to allow the committee to appropriately monitor the annual and quarterly financial reports. For many corporations, this means four or more meetings a year. Meetings should be scheduled with enough time to permit and encourage active discussions with management and the internal and outside auditors. The audit committee should meet with the internal and outside auditors, without management present, at every meeting and communicate with them between meetings as necessary. Some audit committees may decide that specific functions, such as quarterly review meetings with the outside auditor or management, can be delegated to the audit committee chairman or other members of the audit committee.

Corporate Governance Committee

- *Every publicly owned corporation should have a committee that addresses corporate governance issues.* A corporate governance committee (often combined with, or referred to as, a nominating committee) is central to the effective functioning of the board. Traditionally, the corporate governance/nominating committee's role was to recommend director nominees to the full board and the corporation's stockholders. Over time, the committee's role has expanded so that,

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today, it typically provides a leadership role in shaping the corporate governance of a corporation.

A corporate governance committee should be comprised solely of independent directors.

- *A corporate governance committee should be comprised solely of independent directors.* While the CEO typically works closely with the corporate governance committee, a committee made up exclusively of independent directors reinforces the idea that the governance processes of the corporation are under the control of the board, as representatives of the stockholders.

- *A corporate governance committee performs the core function of recommending nominees to the board. The committee also recommends directors for appointment to committees of the board.* These responsibilities include establishing criteria for board and committee membership, considering rotation of committee members, reviewing candidates' qualifications and any potential conflicts with the corporation's interests, assessing the contributions of current directors in connection with their renomination, and making recommendations to the full board. The committee also should develop a process for considering stockholder suggestions for board nominees. While it is appropriate for the CEO to meet with potential director nominees, the final responsibility for selecting director nominees rests with the board.

- *A corporate governance committee should monitor and safeguard the independence of the board*. The Business Roundtable believes that an important function of a

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corporate governance committee, related to its core function of recommending nominees to the board, is to ensure that a substantial majority of the directors on the board are, in both fact and appearance, independent of management.

- *A corporate governance committee should oversee and review the corporation's processes for providing information to the board.* A corporate governance committee should assess the reporting channels through which the board receives information, and the quality and timeliness of information received, so that the board obtains appropriately detailed information in a timely fashion.

- *A corporate governance committee should develop and recommend to the board a set of corporate governance principles applicable to the corporation.* These principles should be communicated to the corporation's stockholders and should be readily available to prospective investors and other interested persons.

- *A committee comprised of independent directors should oversee the evaluation of the board and management.* Specifics concerning the evaluation process are discussed below under "Board and Management Evaluation."

Compensation Committee

- *Every publicly owned corporation should have a committee comprised solely of independent directors that addresses compensation issues.* A compensation

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committee has two interrelated responsibilities: overseeing the corporation's overall compensation programs, and setting CEO and senior management compensation.

A compensation committee should look . . . at the overall compensation structure of the enterprise to determine that it establishes appropriate incentives for management and employees at all levels.

- *Overall compensation structure*. In addition to reviewing and setting compensation for management, a compensation committee should look more broadly at the overall compensation structure of the enterprise to determine that it establishes appropriate incentives for management and employees at all levels. In doing so, the committee should understand that incentives are industry-dependent and are different for different categories of people. All incentives should further the corporation's long-term strategic plan and should be consistent with the culture of the corporation and the overall goal of enhancing enduring stockholder value.

- *A diverse mix of compensation for the board and management can foster the right incentives and prevent a short-term focus or a narrow emphasis on particular aspects of the corporation's business*.

  - *Trend toward equity compensation for directors and management*. In recent years, many corporations have increasingly moved toward compensating directors and management with stock options and other equity compensation geared to the corporation's stock price. While this trend may align director and management interests with stockholder value, equity compensation should be carefully designed to avoid unintended incentives

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such as an undue emphasis on short-term market value changes.

- *Management compensation.* Management compensation practices will necessarily differ for different corporations. Generally, however, an appropriate compensation package for management includes a carefully determined mix of long- and short-term incentives. Management compensation packages should be designed to create a commensurate level of risk and opportunity based on business and individual performance. The structure of management compensation should directly link the interests of management, both individually and as a team, to the long-term interests of stockholders.

- *Management benefits*. A compensation committee should consider whether the benefits provided to senior management, including post-employment benefits, are proportional to the contributions made by management.

Board Operations

- Serving on a board requires significant time and attention on the part of directors. Directors must participate in board meetings, review relevant materials, serve on board committees, and prepare for meetings and for discussions with management. They must spend the time needed and meet as frequently as necessary to properly discharge their responsibilities.

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The appropriate number of hours to be spent by a director on his or her duties and the frequency and length of board meetings depend largely on the complexity of the corporation and its operations. Longer meetings may permit directors to explore key issues in depth, whereas shorter but more frequent meetings may help directors stay up-to-date on emerging corporate trends and business and regulatory developments. When arranging a meeting schedule for the board, each corporation should consider the nature and complexity of its operations and transactions, as well as its business and regulatory environment.

Directors should be incentivized to focus on long-term stockholder value.

- Directors should be incentivized to focus on long-term stockholder value. Including equity as part of directors' compensation helps align the interests of directors with those of the corporation's stockholders. Accordingly, a meaningful portion of a director's compensation should be in the form of long-term equity. Corporations may wish to consider establishing a requirement that, for as long as directors remain on the board, they acquire and hold stock in an amount that is meaningful and appropriate to each director.
- The Business Roundtable does not endorse a specific limitation on the number of directorships an individual may hold. However, service on too many boards can interfere with an individual's ability to perform his or her responsibilities. Before accepting an additional board position, a director should consider whether the acceptance of a new directorship will compromise the ability to perform present responsibilities. It also is

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good practice for directors to notify each board on which they serve before accepting a seat on the board of another business corporation, in order to avoid potential conflicts. Similarly, the corporation should establish a process to review senior management service on other boards prior to acceptance.

- Independent directors should have the opportunity to meet outside the presence of the CEO and any other management directors.

Independent directors should have the opportunity to meet outside the presence of the CEO and any other management directors.

- Many board responsibilities may be delegated to committees to permit directors to address key areas in more depth. Regardless of whether the board grants plenary power to its committees with respect to particular issues or prefers to take recommendations from its committees, committees should keep the full board informed of their activities. Corporations benefit greatly from the collective wisdom of the entire board acting as a deliberative body, and the interaction between committees and the full board should reflect this principle.
- The board's agenda must be carefully planned, yet flexible enough to accommodate emergencies and unexpected developments. The chairman of the board should be responsive to individual directors' requests to add items to the agenda, and open to suggestions for improving the agenda. Importantly, the agenda and meeting schedule must permit adequate time for discussion and a healthy give-and-take between board members and management.

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- Management presentations should be scheduled to allow for question-and-answer sessions and open discussion of key policies and practices. Board members should have full access to senior management. Generally, the CEO should be advised of significant contacts between board members and senior management.

- The board must have accurate, complete information to do its job; the quality of information received by the board directly affects its ability to perform its oversight function effectively. Directors should be provided with, and review, information from a variety of sources, including management, board committees, outside experts, auditor presentations, and analyst and media reports. The board should be provided with information before board and committee meetings with sufficient time to review and reflect on key issues and to request supplemental information as necessary.

- Many corporations provide new directors with materials and briefings to permit them to become familiar with the corporation's business, industry and corporate governance practices. The Business Roundtable believes that it is appropriate for corporations to provide additional educational opportunities to directors on an ongoing basis to enable them to better perform their duties and to recognize and deal appropriately with issues that arise.

- From time to time, it may be appropriate for boards and board committees to seek advice from outside advisors

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independent of management with respect to matters within their responsibility. For example, there may be technical aspects of the corporation's business – such as risk assessment and risk management – or conflict of interest situations for which the board or a committee determines that additional expert advice would be useful. Similarly, a compensation committee may find it useful to engage separate compensation consultants. The Business Roundtable believes that board and committee access to outside advisors in such cases is an important element of an effective corporate governance system.

Board and Management Evaluation

The board should have an effective mechanism for evaluating performance on a continuing basis.

- *The board should have an effective mechanism for evaluating performance on a continuing basis.* Meaningful board evaluation requires an assessment of the effectiveness of the full board, the operations of board committees and the contributions of individual directors.

  - *The performance of the full board should be evaluated annually, as should the performance of its committees.* The board should conduct periodic – generally annual – self-evaluations to determine whether it and its committees are following the procedures necessary to function effectively.

  - *The board should have a process for evaluating whether the individuals sitting on the board bring the skills and expertise appropriate for the corporation and how they work as a group.* Board

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positions should not be regarded as permanent. Directors should serve only so long as they add value to the board, and a director's ability to continue to contribute to the board should be considered each time the director is considered for renomination.

Planning for the departure of directors and the designation of new board members is essential.

- *Planning for the departure of directors and the designation of new board members is essential.* The board should establish procedures for the retirement or replacement of board members. Such procedures may, for example, include a mandatory retirement age, a term limit, and/or a requirement that directors who change their primary employment tender a board resignation, providing an opportunity for the corporate governance committee to consider the desirability of their continued service on the board.

- *Planning for management succession is also critical.* The board or its corporate governance committee should identify, and periodically update, the qualities and characteristics necessary for an effective CEO. With these principles in mind, the board or committee should periodically monitor and review the development and progression of potential internal candidates against these standards. Advance planning for contingencies such as the departure, death or disability of the CEO or other top executives is also critical so that, in the event of an untimely vacancy, the corporation has in place an emergency succession plan to facilitate the transition to both interim and longer-term leadership.

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- *Under the oversight of a committee comprised of independent directors, the board should annually review the performance of the CEO and should participate with the CEO in the evaluation of members of senior management.* All non-management members of the board should participate with the CEO in senior management evaluations. The results of the CEO's evaluation should be promptly communicated to the CEO by representatives of the non-management directors.

IV. RELATIONSHIPS WITH STOCKHOLDERS AND OTHER CONSTITUENCIES

Corporations are often said to have obligations to stockholders and to other constituencies, including employees, the communities in which they do business, and government, but these obligations are best viewed as part of the paramount duty to optimize long-term stockholder value. The Business Roundtable believes that stockholder value is enhanced when a corporation treats its employees well, serves its customers well, maintains good relationships with suppliers, and has a reputation for civic responsibility and legal compliance.

Stockholders and Investors

- Corporations have a responsibility to communicate effectively and candidly with stockholders. The goal of stockholder communications should be to help stockholders understand the business, risk profile, financial condition, and operating performance and trends of the corporation.

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The goal of stockholder communications should be to help stockholders understand the business, risk profile, financial condition, and operating performance and trends of the corporation.

- Corporations communicate with investors and other constituencies not only in proxy statements, annual and other reports and formal stockholder meetings, but in many other ways. All of these communications should provide consistency, clarity and candor.
- In planning communications with stockholders and investors, corporations should consider:
  - *Candor*. Directors and management should never mislead or misinform stockholders about the corporation's operations or financial condition.
  - *Need for timely disclosure*. In an age of instant communication, there is an increasing need for corporations to disclose significant information closer to the time when it arises and becomes available. The Business Roundtable supports the beneficial trend toward prompt disclosure of significant developments, while recognizing that a current disclosure regime must allow time to reasonably assure accuracy and should not be a basis for new liabilities.
  - *Ultimate goal of stockholder communications*. Whatever the substance of the communication, the corporation's ultimate goal should be to furnish information that is honest, intelligible, meaningful, timely and broadly disseminated, and that gives investors a realistic picture of the corporation's financial condition and results of operations through the eyes of management.

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Corporations should obtain stockholder approval of new stock option and restricted stock plans in which directors or executive officers participate.

- Because stockholders have a particular interest in the amount and nature of equity compensation paid to directors and senior management, corporations should obtain stockholder approval of new stock option and restricted stock plans in which directors or executive officers participate.

Employees

- It is in a corporation's best interest to treat employees fairly and equitably.
- Corporations should have in place policies and practices that provide employees with compensation, including benefits, that is appropriate given the nature of the corporation's business and employees' job responsibilities and geographic locations.
- When corporations offer retirement, healthcare, insurance and other benefit plans, employees should be fully informed of the terms of those plans.
- Corporations should have in place mechanisms for employees to alert management and the board to allegations of misconduct without fear of retribution.
- Corporations should communicate honestly with their employees about corporate operations and financial performance.
- Technology makes communicating with employees quicker, easier and less expensive. Corporations should

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take advantage of technological advances to enhance dissemination of information to employees.

Communities

- Corporations have obligations to be good citizens of the local, national and international communities in which they do business. Failure to meet these obligations can result in damage to the corporation, both in immediate economic terms and in longer-term reputational value.
- A corporation should be a good citizen and contribute to the communities in which it operates by making charitable contributions and by encouraging its directors, managers and employees to form relationships with those communities. A corporation also should be active in promoting awareness of health, safety and environmental issues, including any issues that relate to the specific types of business in which the corporation is engaged.

Government

- Corporations, like all citizens, must act within the law. The penalties for serious violations of law can be extremely severe, even life-threatening, for corporations. Compliance is not only appropriate; it is essential. Management should take reasonable steps to develop, implement and maintain effective legal compliance programs and the board should periodically review such efforts to gain reasonable assurance that they are effective.

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- Corporations have an important perspective to contribute to the public policy dialogue and should be actively involved in discussions about the development, enactment and revision of the laws and regulations that impact their businesses and that affect the communities in which they operate and their employees reside.

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Sarbanes-Oxley Act

Interpretive Issues Under § 402 – Prohibition of Certain Insider Loans

Section 402 of the Sarbanes-Oxley Act of 2002 was enacted to prohibit publicly-traded companies from providing personal loans to directors and executive officers. Among the reasons identified were concerns over the use of company funds to provide personal financing to insiders. In the absence of legislative or regulatory guidance, private practitioners are in the position of having to interpret the statutory provisions in order to advise companies on compliance. This involves determining which arrangements should be considered prohibited by the statute and which arrangements should not be considered prohibited because they do not present the concerns the statute was designed to address.

INTRODUCTION

This Outline describes a variety of interpretive issues that practitioners are addressing under § 402 of the Sarbanes-Oxley Act of 2002. The purpose of the Outline is to prepare a blueprint for a consensus among practitioners on these issues. There is no implication as to the status under § 402 of matters beyond those addressed in this outline (such as split dollar life insurance arrangements). Instead, this outline represents an initial list of issues for consensus.[1]

Section 402 is a component of a very recent statute that was enacted quickly and as to which there is only limited legislative history. Section 402 contains substantial ambiguities and has not been the subject of any official guidance. Subject to that context, a conclusion below that an activity is "permissible" means that in our view, in the absence of contrary official guidance, the activity should not be considered a violation of § 402.

GENERAL PRINCIPLES

Principles of statutory construction. Section 402 should be interpreted in accordance with customary principles of statutory construction. For example, while the same words used in different provisions of a statute are ordinarily given the same meaning, there are recognized circumstances when the context requires different meanings, particularly when the provisions are enacted at different times and address separate subjects with different policy considerations. See "Relationship to margin regulations" below. Also, the apparent breadth of a provision's coverage without benefit of definition of key terms (see "Meaning of personal loan" and "Meaning of

[1] Throughout this Outline the grandfather exclusion may be available even though not specifically referred to.

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arrange" below) permits greater reliance on the underlying policies and purposes of the statutory provision in interpreting its meaning. The absence of legislative or regulatory guidance also leaves room for reasonable good faith interpretations.

Relationship to margin regulations. While the words "extension of credit" and "arrange" in § 402 (adding new § 13(k) to the Exchange Act) are the same as those used in Exchange Act §§ 7 (margin) and 11(d) (credit on new securities in distribution), the policies behind §§ 7 and 11(d) are fundamentally different from the policy underlying § 402.

The policy underlying the margin provisions is to protect the securities markets, customers and broker-dealers from the risks of over-leveraging and to limit speculation, and the policy underlying § 11(d) is to deter share pushing. The policy underlying § 402 appears intended to protect against improper behavior of directors and executive officers and to ensure the proper use of corporate assets by issuers not otherwise in the business of making personal loans.[2] Accordingly, § 402 does not necessarily require the same reading of the concepts of "extension of credit" and "arrange" as used under the margin regulations and § 11(d).

Meaning of "personal loan." The prohibitions of § 402 apply only to an extension of credit "in the form of a personal loan." This suggests that only certain extensions of credit are subject to the prohibition of § 402 and that they must meet two separate requirements.

First, the transaction must take the form of a loan, not merely be an extension of credit. In the absence of a statutory definition or controlling legislative history, terms are given their ordinary meaning. The term "loan" is commonly understood to be narrower than "extension of credit." As a result, the fact that a transaction may, for example, be deemed for margin regulation or other regulatory purposes to involve an extension of credit is not sufficient to trigger the § 402 prohibition. Where a transaction involves actual or potential credit exposure, there will still be situations in which the transaction is not "in the form of a … loan." An example of this would be

[2] The title of § 402 is "enhanced conflict of interest provisions," indicating that conflicts of interest are the policy behind the prohibition. The operative words of § 402 that an issuer shall not, "directly or indirectly, … extend or maintain credit, [or] arrange for the extension of credit, … in the form of a personal loan" are identical to those of the Senate bill (the Act added "including through any subsidiary" and the express prohibition on renewing an extension of credit). The accompanying Report of the Senate Committee on Banking, Housing, and Urban Affairs describes an earlier version of § 402, which required only 8-K reporting within 7 days of the making of covered loans and of "conflicts of interest," to be defined by the SEC. It cites as examples of problematic loans certain personal loans made to executives of identified companies, describing the concern in some cases as lack of disclosure about these loans to investors or the board of directors. The Senate adopted an amendment to proposed § 402 sponsored by Senators Schumer and Feinstein eliminating the disclosure approach and instead creating the prohibition appearing in the bill passed by the Senate and appearing in the Act. In her remarks on the Senate floor, Sen. Feinstein noted conflicts of interest that limit the ability of outside directors, in particular, to voice their criticism of the issuer.

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indemnification advances discussed below in item 6. In other cases, a transaction may involve an element of extension of credit, but be primarily intended to confer an immediate or deferred compensation benefit on the individual for services rendered, analogous to salary or bonus, and not requiring repayment of fixed amounts. An example of this would be the tax indemnity payments discussed below in item 9.

Second, the loan must be a "personal loan." We believe that a loan is not a "personal loan" if the primary purpose of the loan, from the perspective of the issuer, is to advance the business of the issuer (other than merely through benefiting employees and directors of the issuer). Where an extension of credit is made in the ordinary course of business primarily for business purposes, but involves limited ancillary personal credit, it should not be considered "in the form of a personal loan." For example, business travel advances and use of company credit cards and company cars, as discussed below in items 1-3, may involve limited ancillary personal use (*e.g.*, personal items included in hotel room charges) but should not be subject to the § 402 prohibition because the arrangements are primarily for the benefit of the issuer, not the employee, and they are not personal loans within the ordinary meaning of that term.

Meaning of "arrange." The concept of "arranging" necessarily requires some level of issuer involvement in the loan by a third party. While certain limited facilitation of a "personal loan," such as providing information or confirming that the issuer will comply (as well as the method by which the issuer will comply) with its existing obligations, should not constitute "arranging," more substantial levels of facilitation or participation by the issuer may be deemed to be "arranging." Given the conflict of interest-oriented policy of § 402, the use of company assets or facilitation by the issuer of an arrangement that would affect the behavior of directors or executive officers is more likely to involve an "arranging." There also may be circumstances in which an issuer is "arranging" but in which the issuer should not be viewed as "arranging" a "personal loan." For example, an issuer could develop a broadly based employee benefit program involving incidental loans that are available on the same terms to all participants. While the issuer may have arranged the benefit program, it should not be viewed as having arranged "personal loans" because of the incidental nature of the loan feature. An example of this would be loans from 401(k) plans discussed below in item 11.

SITUATIONS INVOLVING "PERSONAL LOAN" ISSUES

1. Travel and similar advances

Permissible – Advances of cash, in accordance with company policy, to cover reimbursable travel and similar expenses incurred while performing executive responsibilities. The advances should be reasonable in relation to the anticipated expenses and settled by the employee with the employer through documentation to show the extent of the reimbursable expenses incurred and a reimbursement to the company of any unused advance. No interest would be charged, and the period of the

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advance should be in accordance with typical cycles of documentation of these types of expenses within the company. (not personal loan because primarily for business purpose)

2. **Personal use of company credit card, required to be reimbursed**

   Permissible – If company policy permits only business use and limited ancillary personal use (*e.g.*, personal items included in hotel room charges) and requires settlement within a reasonable period (*e.g.*, monthly). Personal items should be paid by the employee within a reasonable period after such charges have been presented. (not a personal loan because primarily for business purpose)

3. **Personal use of company car, required to be reimbursed**

   Permissible – If personal use of company car is limited and ancillary to business use and reimbursement is required to be settled within a reasonable period without interest. (not a personal loan because primarily for business purpose)[3]

4. **Relocation payments subject to reimbursement**

   Permissible – Advancement of reimbursable relocation expenses (costs ultimately to be borne by the issuer) if treated the same as travel and similar advances. (not a personal loan because primarily for business purpose)

5. **"Stay" and "retention" bonuses subject to repayment**

   Permissible – Employment, severance and retention plans and agreements commonly providing for the payment of a sum of money to an employee that is contingent upon a stated length of employment or similar condition, with a provision requiring the employee to repay the issuer if he or she terminates employment before the designated date or otherwise fails to meet the conditions of the payment. The obligation is not represented by a note. (not loans because they are primarily for compensation purposes reportable for federal income tax purposes and with no expectation of the issuer at the time made that a portion will be required to be reimbursed)

6. **Indemnification advances**

   Description: Indemnification advances may occur under charter, by-laws or indemnification agreements or D&O policies, where repayment is required under some circumstances (*e.g.*, if ultimately determined not to have acted with the standard of care required to receive indemnification under state law or the contract).

   Permissible – Reasons considered persuasive include the following:

[3] If personal use is permitted without reimbursement, there is still no § 402 issue because it is compensation not involving any extension of credit.

i. Well-developed and longstanding state policy interest in providing indemnification advances (unrelated to insider conflicts of interest). Neither the text of § 402 nor the limited legislative history suggests that Congress intended to limit historic state authority in this area. The prospect of indemnification becoming unavailable could significantly discourage service as an executive officer or director, to the detriment of public companies.

ii. Not "in the form of a … loan" because at the time a commitment arises (*e.g.*, at outset of employment), and presumably even at time advancement occurs, the indemnified party is only contingently required to repay the issuer and the contingency makes the likelihood of such repayment reasonably uncertain.

iii. Not "personal" because expenses are incurred in connection with services to the issuer that constitute a business purpose regardless of whether ultimately these amounts need to be repaid. The repayment obligation contemplated by the arrangement and triggered by external events does not change the business nature of the arrangement.

7. Deferred compensation

Description: Deferred compensation in which executive officers make an "investment" (through deferring compensation) in an index or notional assets with terms giving them a favorable "return" (*e.g.*, more upside than downside; no recourse to officer beyond amount of investment), but the right to a "return" is merely an unsecured payment obligation of the issuer and the amount of the return is based on a formula (which in some cases deducts the amount of deemed company leverage from the gross return). There is no separate investment vehicle in which the executive officer invests or actual amount loaned by the issuer to the executive officer. The "return" may be measured by reference to an investment vehicle to which the issuer has made a loan or for which it has arranged a loan. In some cases, there are forfeiture provisions that apply to employee's "investment," the company's "contribution" or both for a period of time.

Permissible – Regardless of any forfeiture period and any individual variation of the leverage factor among participating employees (no extension of credit by the issuer; compensation). In fact, the executive officer is extending credit to the issuer, represented by the deferred compensation obligation.

8. Leveraged co-investment

Description: Issuer or subsidiary sponsors an investment limited partnership or other entity that will own actual investment assets. The sponsor lends money, or arranges for a third party to lend money, to the entity or a subsidiary of the entity or acquires a fixed income preferred partnership interest (not having substantial equity characteristics such as sharing of loss) in the entity, all as part of the sponsor's ordinary course of business. The proceeds of the loan or preferred partnership interest are used by the entity or subsidiary to make leveraged purchases of assets. Investors in the entity include directors and executive officers.

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a. Should be permissible – If there is a substantial majority in dollar value and a significant number of outside (non-employee) investors, directors and executive officers participate on the same terms as the outside investors, the loan is made on commercial terms, the loan is not contingent on, and is made irrespective of, director or executive officer participation, and investor capital commitments are not pledged to the lender and do not otherwise provide for recourse by lender or issuer against investor (business loan to the partnership, not a personal loan to the director or executive officer).

b. Increased Risk of § 402 Violation – Same as a. above but director or executive officer capital commitment or partnership interest is pledged to lender or lender otherwise has recourse to director or executive officer.

9. Tax indemnity payments to overseas-based executive officers

Description: The issuer agrees to pay the excess of the higher overseas income tax over what the US-only tax would have been. In some cases, settlement is in a lump sum following the close of the tax year after all amounts can be calculated. In other cases, settlement is on a gross basis, with the issuer paying the executive officer the full amount of the non-US taxes on their due dates, and the officer paying the issuer the full amount of the US taxes on their due dates. A similar arrangement could exist for non-US executives who relocate to the United States.

Permissible – Not in the nature of a loan; primarily compensation in the form of a tax swap.

SITUATIONS INVOLVING "ARRANGING" ISSUES

10. Parent/shareholder loans to executive officer of "issuer" subsidiary (who is not also executive officer or director of parent)

a. Parent is non-US 12g3-2(b)-exempt public company (*i.e.*, not an "issuer"), or loan is from non-issuer shareholder, and subsidiary is wholly-owned § 15(d)-reporting "issuer":

i. *Traditional loan.* Depends on whether subsidiary has "arranged."

- Permissible – If there is clear evidence the loan is made by reason of service to the parent, not the subsidiary. It is helpful if similar loans are also offered to similarly situated employees of the lender who are not directors or executive officers of the subsidiary.
- Permissible – If it can otherwise be clearly shown that the subsidiary has not "arranged."

In both cases, factors to be considered include director and executive officer interlocks and the relative size of the parent and the subsidiary.

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ii. *Cashless option exercise for parent stock.* May well be permitted under 13. below; if not, depends on whether subsidiary has arranged and mechanics of cashless exercise in foreign markets.

b. Same scenario as above, but subsidiary is a majority-owned § 13(a)-reporting issuer with publicly traded common stock – same conclusion as above. (Cashless option exercises for subsidiary stock should be analyzed under 13. below.)

c. Same scenario as above, but parent is also an "issuer" (US public company or SEC-registered non-US company) – same conclusion as above, unless the director or executive officer is also a director or executive officer of the parent (in which case there is a presumptive risk of a § 402 violation for traditional loans; cashless option exercise should be analyzed under 13. below).

11. Loans from 401(k) plan

Permissible –

i. In most cases, economic consequence is effectively executive officer borrowing from himself or herself. The principal of such a loan could have been contributed by an executive over many years of employment with the issuer (subject to a variety of limits under both the Internal Revenue Code and the terms of the plan) and through multi-year returns in any number of possible investments in the plan. The loan principal may even have been substantially accumulated through another employer's qualified plan and only recently rolled over to the issuer's 401(k) plan, and thus have no connection whatsoever to employment with the issuer let alone any connection to current compensation.

ii. Loan is from 401(k) plan, not issuer. Loans may be taken only against vested balances. These plans are non-discriminatory between higher- and lower-paid employees and not established with a principal purpose of providing credit. Loan features are ubiquitous and exist to encourage participation in the plan. Current IRS regulations limit loans to $50,000.

iii. Not a loan arranged by issuer. This is the case even if the plan fiduciaries are issuer employees and must approve loan, given ERISA responsibilities of plan fiduciaries to act in interests of participants not those of employer. Payroll deductions for loan repayments and adoption of plan with loan feature are not a sufficient type or degree of issuer involvement to change the conclusion.

iv. No need for additional limitations. In general, any conflict-of-interest considerations in connection with 401(k) plans are already addressed by ERISA's extensive fiduciary responsibility and prohibited transaction rules.

v. ERISA exemption that permits loans to "rank and file" requires that all participants be permitted to borrow.

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12. Loans from annuities and other broad-based employee benefit programs

Assume the programs are written by third parties, are made available to a broad base of employees on similar terms, are not principally for the purpose of establishing a loan facility and the employees (not the issuer) pay for the program benefits.

Permissible –

i. Loan is from annuity writer or program, not issuer.

ii. Issuer should not be regarded as having arranged the loan, because purpose of the program was to confer employee benefits and the loan is merely an ancillary feature.

SITUATIONS INVOLVING BOTH "PERSONAL LOAN" AND "ARRANGING" ISSUES

13. "Cashless" option exercise[4]

Description: These transactions involve the broker paying the issuer the exercise price on the date required by the plan (on T or T+3) and selling (on T) at least enough of the stock to be acquired on exercise of the option to pay for the exercise price and related tax withholding, in each case for the benefit of the insider. The broker uses the proceeds of sale to pay the exercise price (or reimburse itself if it has paid the exercise price before settlement of the sale) and to remit applicable withholding taxes to the issuer and remits the balance to the insider. If the issuer fails to deliver (or is late in delivering) the stock on T+3, the broker may borrow stock to settle the trade and repay the borrowed stock with stock received from the issuer. In order for the broker to execute the transaction in a cash account (or utilize the stock issuable upon exercise as collateral in a margin account) and to avoid net capital charges, Section 220.3(e)(4) of Regulation T and SEC interpretations of Rule 15c3-1 require the broker to obtain an acknowledgment from the issuer that it will deliver the stock promptly. It is assumed the broker observes these requirements. Generally, for tax purposes the exercise date (T) is considered the purchase date for the stock issuable upon exercise and the sale date for that stock. The issuer incurs on that date an obligation to pay related withholding taxes on the issuer's next withholding tax payment date. (The analysis in this document does not extend to the situation where a margin account is established in connection with the exercise and the insider subsequently begins trading in that account on a leveraged basis.)

a. *General analysis*. Some versions of "cashless" exercise are properly analyzed as not involving a personal loan by either the issuer or broker or as not involving

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[4] The following are not prohibited by § 402: (a) use of other stock to pay the exercise price pursuant to the terms of the plan (no extension of credit); (b) the company simply issuing a smaller number of shares (the net version of (a)), and (c) use of insider's other credit sources, including margin borrowing secured by other securities, to pay the cash exercise price, assuming the issuer is not involved in arranging the credit (no arranging).

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arranging by the issuer. Although some versions of "cashless" exercise involve short-term incidental extensions of credit to the executive officer or director by the issuer or the broker, thereby raising credit and arranging issues under the margin regulations, and possibly § 402, the apparent policy of § 402 should permit the conclusion that "cashless" exercise in general does not involve the type of personal loan intended to be prohibited by § 402. Supporting arguments include:

i. These arrangements are generally available to all participants in the option plan on the same terms and, therefore, do not introduce issues of discriminatory access to preferential terms.

ii. Internal technicalities of the various versions – such as whether the issuer facilitates the "cashless" exercise by appointing the broker, whether the issuer delivers stock before payment or whether the broker advances the exercise price before receipt of stock – should not result in different answers under § 402. In the end they all have the same purpose of facilitating realization by the optionee of the value of his or her option by bridging the practical problems of attempting to settle two transactions at or about the same time. In addition, all achieve the same result – permitting a simultaneous or nearly simultaneous exercise of the option and sale of the underlying stock. In economic reality, all forms of "cashless" exercise are equivalent to a sale of the option itself (which is a fully-paid-for instrument) for its in-the-money value by the optionee to the broker, similar to the sale of a warrant to the underwriter by a selling stockholder in an underwriting of the underlying stock.

iii. The fact that the issuer incurs a withholding tax obligation to the government on T, but in some scenarios may not receive cash until T+3, should not be considered an extension of credit to the employee, because although the obligation arises because of the employee's option exercise, the withholding tax obligation is under tax law that of the issuer itself, not an obligation of the employee being satisfied by the issuer.[5]

iv. Any extension of credit is not in the form of a personal loan, but is instead ancillary to the principal purposes of the program, which are bridging logistical settlement issues and simplifying for all employees the mechanics of exercising options. The broker is looking to the stock issuable on exercise, not to the individual credit of the optionee or other assets in the optionee's

---

[5] Note also that if the employee had paid for the stock and reimbursed the amount of the withholding taxes on T by check, it is very possible that even more time would have elapsed before the issuer was actually in funds for the amount it incurred as a withholding obligation on T. Just as we do not examine the actual facts underlying the settlement of a payment by check to determine whether there has been some hypothetical extension of credit, we should not look at the mechanical steps that underlie a commercially normal three-day stock purchase settlement procedure.

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account, as the source of proceeds to cover the exercise price and applicable withholding tax.

v. While the margin and net capital analyses do not drive the § 402 analysis, it should be noted that Section 220.3(e)(4) of Regulation T and SEC interpretations of Rule 15c3-1 expressly permit "cashless" option exercises on the same basis as cash transactions not involving extensions of credit.

b. Because some versions of cashless exercise involve longer than intraday extensions of credit by the issuer or broker (and may involve other credit characteristics such as interest charges), or active arrangement of a cashless exercise program by the issuer, the level of comfort that can be attained with respect to a particular cashless exercise program may depend on the mechanics used to execute the cashless exercise.

Assuming there is no advancement of stock by the issuer before payment of the exercise price, the greatest level of comfort can be attained under those scenarios involving the absence of any advance of cash by the broker before settlement of the related sale transaction (usually T+3), or the absence of the issuer's arranging of the broker used. In these scenarios the analysis is, respectively, that any extension of credit is for the shortest practicable period and purely a function of the practical inability to settle both the exercise and the trade simultaneously, or that there is no "arranging" by the issuer.

c. Description of scenarios

i. Plan provides for payment of exercise price against delivery of stock at the time of settlement of the related sale transaction (often T+3):

- Permissible – Issuer appoints broker and has previously agreed with broker to deliver stock at the time of settlement of the related sale transaction, and in fact can assure that it does so (*e.g.*, through pre-delivery of treasury shares to issuer account at broker or through use of DTC's DWAC system). (no personal loan)
- Permissible – (A) Issuer has not previously agreed with broker, (B) broker is selected by insider with no involvement by issuer, and (C) all issuer does is perform the ministerial act of acknowledging to broker upon broker's request that issuer will deliver stock promptly, whether or not the plan terms so require. (no personal loan and no arranging)
- Permissible – Issuer distributes to employees a list of several brokers experienced in these types of transactions. (no personal loan and no arranging)

ii. Plan provides for payment of exercise price *prior* to settlement of the related sale transaction:

- Permissible – (A) Issuer has not previously agreed with broker, (B) broker is selected by insider with no involvement by issuer, and (C) broker

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advances the exercise price and withholding taxes to the issuer on the exercise date, but (D) all issuer does is perform the ministerial act of acknowledging to broker upon broker's request that issuer will deliver stock promptly, whether or not the plan terms so require. (no arranging)

- Permissible – Issuer distributes to employees a list of several brokers experienced in these types of transactions. (no arranging)
- Should be permissible based on the apparent policy of § 402 – Issuer appoints broker and has previously agreed with broker that broker will advance the exercise price to the issuer on the exercise date, and issuer will deliver stock promptly on T+3.

iii. Plan provides for delivery of treasury shares by company prior to payment of the exercise price:

- Should be permissible based on the apparent policy of § 402.

iv. The above conclusions are not affected by the fact that the issuer contracts with an administrative agent to administer the stock option plan and process exercises of stock options (including "cashless" exercises) and pays the agent annual administrative and per exercise fees.

SITUATIONS INVOLVING EXCEPTIONS AND GRANDFATHER

14. Securities-related loans other than margin loans subject to the specific exemption

The specific clause in § 402 exempting certain margin loans subject to § 7 of the Exchange Act should not be read to preclude other lending that is for the purpose of purchasing securities or that is secured by securities if the other lending is a "consumer credit" satisfying the three conditions and is not used to purchase stock of the issuer.

a. Most of the categories of permitted credit in § 402 overlap.

b. Given the specific limit on loans to purchase issuer stock in the margin loan exception, it seems prudent to apply this limit to other securities-related loans.

c. Examples of permissible loans include loans from issuers that are non-US broker-dealers and issuers that are US broker-dealers to non-employee directors (assuming the three conditions are satisfied and they are not used to purchase issuer stock).

15. Drawdowns on committed lines and maintaining demand loans after July 30, 2002

a. *Drawdowns on committed credit lines*. Permissible – as long as issuer is legally committed before July 30, 2002, without issuer having discretion or a termination right (grandfather).

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b. *Maintenance of demand loans*. Permissible – if extended before July 30, 2002 (grandfather).

16. Forgiveness of grandfathered loans

a. The issue is whether complete or partial forgiveness, after July 30, 2002, of a grandfathered loan would be a "material modification to any term" of the loan. Forgiveness constitutes a discharge of the loan obligation or part of it and not a modification. Even if considered a material modification, the effect of that modification should be tested when it occurs. In the case of full forgiveness, no loan is outstanding and, in the case of partial forgiveness, there is no modification of the remaining obligation. Additionally, forgiveness would be equivalent to the issuer's granting a bonus to repay the loan. A similar analysis should apply to both the forgiveness and the bonus situations.

   i. Permissible – If forgiveness or bonus/repayment in full.

   ii. Permissible – If partial forgiveness or bonus/repayment in part, to the extent partial prepayment is not prohibited and no other term of the loan is changed.

b. Of course, there may well be other issues, including those relating to disclosure, fiduciary duty and investor relations, that should be considered in the context of granting a bonus to repay or forgiving of an executive officer or director loan.

17. Modification favorable to the issuer

Permissible – Given the purpose of the statute, any modification of a grandfathered loan that is clearly adverse to the insider and beneficial to the issuer should not constitute a "material modification" of the loan, and the loan, as amended, should retain its status as a grandfathered loan. For example, an increase in interest rate, acceleration of scheduled principal payment dates or amounts and/or addition of collateral are not material.

The undersigned firms concur in the above conclusions (recognizing that there is limited legislative history and a lack of official guidance and that advice in any situation is dependent on the particular facts and circumstances). By concurring in the conclusions, the undersigned do not necessarily agree on all aspects of the analysis or give them equal weight. None of the firms subscribing to this document intends thereby to give legal advice to any person. Any person subject to § 402 should consult with an attorney in any situation in which there may be an issue as to

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the meaning or scope of § 402, including situations that may appear to be identical or similar to those described herein.

October 15, 2002

Alston & Bird LLP
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Cahill Gordon & Reindel
Cleary, Gottlieb, Steen & Hamilton
Clifford Chance US LLP
Cravath, Swaine & Moore
Davis Polk & Wardwell
Dewey Ballantine LLP
Fried, Frank, Harris, Shriver & Jacobson
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(new text is underlined)

Amended and Restated

Charter
Corporate Governance Committee

Status

The Corporate Governance Committee is a committee of the Board of Directors.

Membership.

The Corporate Governance Committee shall consist of directors all of whom in the judgment of the Board of Directors shall be independent in accordance with New York Stock Exchange listing standards.

Responsibilities

The Corporate Governance Committee is responsible for considering and making recommendations to the Board concerning the appropriate size, function and needs of the Board. This responsibility includes:

establishing the criteria for Board membership;

considering, recommending and recruiting candidates to fill new positions on the Board;

reviewing candidates recommended by shareholders;

conducting the appropriate and necessary inquiries into the backgrounds and qualifications of possible candidates; and

recommending the Director nominees for approval by the Board and the shareholders.

The Committee's additional functions are:

to consider questions of possible conflicts of interest of Board members and of our senior executives;

to monitor and recommend the functions of the various committees of the Board;

to recommend members of the committees;

to advise on changes in Board compensation;

to make recommendations on the structure of Board meetings;

to recommend matters for consideration by the Board;

to consider matters of corporate governance and to review, periodically, our Corporate Governance Principles;

to review, periodically, our Shareholder Rights Plan;

to establish Director retirement policies;

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to review the functions of the senior officers and to make recommendations on changes;

to review annually with the Chairman and Chief Executive Officer the job performance of elected corporate officers and other senior executives;

to review the outside activities of senior executives;

to review periodically with the Chairman and Chief Executive Officer the succession plans relating to positions held by elected corporate officers, and to make recommendations to the Board with respect to the selection of individuals to occupy these positions; and

to prepare an annual performance evaluation of the Corporate Governance Committee.

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(new text is underlined, deleted text is bracketed)

Amended and Restated
Charter
Executive Compensation Committee

Status

The Executive Compensation Committee is a committee of the Board of Directors.

Membership

The Executive Compensation Committee shall consist of three or more directors all of whom in the judgment of the Board of Directors shall be independent. A person may serve on the Executive Compensation Committee only if the Board of Directors determines that he or she (i) is a "Non-employee Director" for purposes of Rule 16b-3 under the Securities Exchange Act of 1934, as amended [(the "1934 Act")], [and] (ii) satisfies the requirements of an "outside director" for purposes of Section 162(m) of the Internal Revenue Code, and (iii) is "independent" in accordance with New York Stock Exchange listing standards.

Purpose

The purposes of the Executive Compensation Committee are (i) to discharge the responsibilities of the Board of Directors relating to compensation of the Company's CEO and other executives, and (ii) to produce an annual report on executive compensation for inclusion in the Company's annual proxy statement that complies the rules and regulations of the Securities and Exchange Commission, the New York Stock Exchange and any other applicable rules and regulations.

Duties and Responsibilities

The Executive Compensation Committee is responsible for establishing annual and long-term performance goals and objectives for our elected officers. This responsibility includes: (i) [establishing the compensation and] evaluating the performance of the [Chairman and] CEO and other elected officers in light of the approved performance goals and objectives; (ii) setting the compensation level of the CEO and other elected officers based upon the evaluation of the performance of the CEO and the other elected officers, respectively; (iii) making recommendations to the Board of Directors with respect to incentive based compensation plans and equity-based plans; and (v) preparing an annual performance evaluation of the Executive Compensation Committee. In addition, the Executive Compensation Committee:

- determines and certifies the shares awarded under the 2001 Performance-Contingent Share Award Plan;
- grants options and awards under the 2001 Stock and Incentive Plan;

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- advises on the setting of compensation for senior executives whose compensation is not otherwise set by the Committee; and
- monitors compliance by officers with our program of required stock ownership. [; and]
- [publishes an annual Executive Compensation Committee Report for the shareholders.]

In determining the long-term incentive component of the Company's CEO and other elected officers, the Executive Compensation Committee may consider: (i) the Company's performance and relative shareholder return; (ii) the value of similar incentive awards to chief executive officers and elected officers at comparable companies; and (iii) the awards given to the Company's CEO and other elected officers in previous years.

The Executive Compensation Committee may, in its sole discretion, employ a compensation consultant to assist in the evaluation of the compensation of the Company's CEO or other elected officers. The Compensation Committee shall have the sole authority to approve the fees and other retention terms with respect to such a compensation consultant.

Meetings

The [committee] Executive Compensation Committee shall meet at least four times each year and at such other times as it deems necessary to fulfill its responsibilities.

[Report]

[The Executive Compensation Committee shall prepare a report each year concerning its compliance with this charter for inclusion in the Company's proxy statement.]

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(new text is underlined, deleted text is bracketed)

Our Corporate Governance Principles

Role and Composition of the Board of Directors

1. The Board of Directors, which is elected by the shareholders, is the ultimate decision-making body of the Company except with respect to those matters reserved to the shareholders. It selects the senior management team, which is charged with the conduct of the Company's business. Having selected the senior management team, the Board acts as an advisor and counselor to senior management and ultimately monitors its performance.

2. The Board also plans for succession to the position of Chairman of the Board and Chief Executive Officer as well as certain other senior management positions. To assist the Board, the Chairman and CEO annually provides the Board with an assessment of senior managers and of their potential to succeed him or her. He or she also provides the Board with an assessment of persons considered potential successors to certain senior management positions.

3. It is the policy of the Company that the positions of Chairman of the Board and Chief Executive Officer be held by the same person, except in unusual circumstances. This combination has served the Company well over a great many years. The function of the Board in monitoring the performance of the senior management of the Company is fulfilled by the presence of outside Directors of stature who have a substantive knowledge of the business.

4. It is the policy of the Company that the Board consist of a majority of outside Directors and that the number of Directors not exceed a number that can function efficiently as a body. The Corporate Governance Committee, in consultation with the Chairman and CEO, considers and makes recommendations to the Board concerning the appropriate size and needs of the Board. The Corporate Governance Committee considers candidates to fill new positions created by expansion and vacancies that occur by resignation, by retirement or for any other reason. When a Director's principal occupation or business association changes substantially during his or her tenure as a Director, that Director shall tender his or her resignation for consideration by the Corporate Governance Committee. The Corporate Governance Committee will recommend to the Board the action, if any, to be taken with respect to the resignation. Candidates are selected for their character, judgment, business experience and acumen. Scientific expertise, prior government service and familiarity with national and international issues affecting business are among the relevant criteria. Final approval of a candidate is determined by the full Board. The Corporate Governance Committee annually reviews the compensation of Directors. All Directors are expected to own stock in the Company in an amount that is appropriate for them.

5. It is the general policy of the Company that all major decisions be considered by the Board as a whole. As a consequence, the committee structure of the Board is limited to those committees considered to be basic to or required for the operation of a publicly owned company. Currently these committees are the Executive Committee, Audit Committee, Executive Compensation Committee and Corporate Governance Committee. The members and

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chairs of these committees are recommended to the Board by the Corporate Governance Committee in consultation with the Chairman and CEO. The Audit Committee, Executive Compensation Committee and Corporate Governance Committee are made up of only outside Directors. The membership of these three committees is rotated from time to time.

6. In furtherance of its policy of having major decisions made by the Board as a whole, the Company has a full indoctrination <u>and continuing education</u> process for [new] Board members that includes extensive materials, meetings with key management and visits to Company facilities.

7. It is the policy of the Company that the chairs of the Audit, Executive Compensation and Corporate Governance committees of the Board each act as the chair at meetings or executive sessions of the outside Directors at which the principal items to be considered are within the scope of the authority of his or her committee. Experience has indicated that this practice, which has been in place on an informal basis, provides for leadership at all of the meetings or executive sessions of outside Directors without the need to designate a lead Director.

8. The Executive Compensation Committee is responsible for setting annual and long-term performance goals for the Chairman and CEO and for evaluating his or her performance against such goals. The Committee meets annually with the Chairman and CEO to receive his or her recommendations concerning such goals. Both the goals and the evaluation are then submitted for consideration by the outside Directors of the Board at a meeting or executive session of that group. The Committee then meets with the Chairman and CEO to evaluate his or her performance against such goals. The Executive Compensation Committee also is responsible for setting annual and long-term performance goals and compensation for the direct reports to the Chairman and CEO. These decisions are approved or ratified by action of the outside Directors of the Board at a meeting or executive session of that group.

9. The Chairman and CEO is responsible for establishing effective communications with the Company's stakeholder groups, i.e., shareholders, customers, company associates, communities, suppliers, creditors, governments and corporate partners. It is the policy of the Company that management speaks for the Company. This policy does not preclude outside Directors from meeting with shareholders, but it is suggested that any such meetings be held with management present.

Functioning of the Board

1. The Chairman of the Board and Chief Executive Officer sets the agenda for Board meetings with the understanding that certain items pertinent to the advisory and monitoring functions of the Board be brought to it periodically by the Chairman and CEO for review and/or decision. For example, the annual corporate budget is reviewed by the Board. Agenda items that fall within the scope of responsibilities of a Board committee are reviewed with the chair of that committee. Any member of the Board may request that an item be included on the agenda.

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2. Board materials related to agenda items are provided to Board members sufficiently in advance of Board meetings where necessary to allow the Directors to prepare for discussion of the items at the meeting.

3. At the invitation of the Board, members of senior management recommended by the Chairman and CEO attend Board meetings or portions thereof for the purpose of participating in discussions. Generally, presentations of matters to be considered by the Board are made by the manager responsible for that area of the Company's operations. In addition, Board members have free access to all other members of management and employees of the Company and, as necessary and appropriate, Board members may consult with independent legal, financial and accounting advisors to assist in their duties to the Company and its shareholders.

4. Executive sessions or meetings of outside Directors without management present are held at least once each year to review the report of the outside auditors, the criteria upon which the performance of the Chairman and CEO and other senior managers is based, the performance of the Chairman and CEO against such criteria, and the compensation of the Chairman and CEO and other senior managers. Additional executive sessions or meetings of outside Directors may be held from time to time as required. Executive sessions or meetings are held from time to time with the Chairman and CEO for a general discussion of relevant subjects.

Functioning of Committees

1. The Audit, Executive Compensation and Corporate Governance committees consist of only outside Directors.

2. The frequency, length and agenda of meetings of each of the committees are determined by the chair of the committee. Sufficient time to consider the agenda items is provided. Materials related to agenda items are provided to the committee members sufficiently in advance of the meeting where necessary to allow the members to prepare for discussion of the items at the meeting.

3. The responsibilities of each of the committees are determined by the Board from time to time.

4. Each committee is responsible for preparing an annual performance self-evaluation.

Periodic Review

These principles are reviewed by the Board from time to time.

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(new text is underlined, deleted text is bracketed)

Amended and Restated
Charter
Audit Committee

Status

The Audit Committee is a committee of the Board of Directors.

Membership

The Audit Committee shall consist of three or more directors all of whom in the judgment of the Board of Directors shall be independent in accordance with the rules and regulations of the Securities and Exchange Commission and New York Stock Exchange listing standards. Each member shall in the judgment of the Board of Directors have the ability to read and understand the Company's basic financial statements or shall at the time of appointment undertake training for that purpose. At least one member of the Audit Committee shall in the judgment of the Board of Directors [have accounting or] be a financial [management expertise] expert in accordance with the rules and regulations of the Securities and Exchange Commission and at least one member (who may also serve as the financial expert) shall in the judgment of the Board of Directors have accounting or related financial management expertise in accordance with the New York Stock Exchange listing standards.

Purpose

The Audit Committee will assist the board of directors with the oversight of (a) the integrity of the company's financial statements, (b) the company's compliance with legal and regulatory requirements, (c) the independent auditors' qualifications and independence and (d) the performance of the company's internal audit function and the independent auditors.

Responsibilities

1. Appoint the public accounting firm for the purpose of preparing or issuing an audit report or to perform related work and set their compensation.

2. Pre-approve all audit and permitted non-audit services to be performed by the public accounting firm; or delegate the authority to pre-approve such services to one or more members of the Audit Committee, who shall report any decision to preapprove any services to the full Audit Committee at its regularly scheduled meetings.

3. Report the pre-approval of any permitted non-audit services to management for disclosure in the Company's periodic reports.

4. Review with members of the public accounting firm selected by the Audit Committee as outside auditors for the Company, the scope of the prospective audit, the estimated fees

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therefor and such other matters pertaining to such audit as the Audit Committee may deem appropriate.

5. Receive and review:

(a) a report by the outside auditor describing (i) the outside auditor's internal quality-control procedures; (ii) any material issues raised by the most recent internal quality-control review, or peer review, of the firm, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, respecting one or more independent audits carried out by the firm, and any steps taken to deal with any such issues; and (iii) in an effort to assess the auditors' independence, all relationships between the auditors and the company

(b) all other reports from the outside auditors, including the annual comments from the outside auditors on accounting procedures and systems of control;

6. [1.] [Review with members of the public accounting firm selected as outside auditors for the Company, the scope of the prospective audit, the estimated fees therefor and such other matters pertaining to such audit as the Audit Committee may deem appropriate and receive copies of the annual comments from the outside auditors on accounting procedures and systems of control; review] Review and consider whether the provision by the outside auditors of [information technology and other] any permitted non-audit services is compatible with maintaining their independence; review and approve the non-audit fees of the outside auditors; and review with them any questions, comments or suggestions they may have relating to the internal controls, accounting practices or procedures of the Company or its subsidiaries, and any audit problems or difficulties and management's response.

7. [2.] Review, at least annually, the then current and future programs of the Company's Internal Audit Department, including the procedure for assuring implementation of accepted recommendations made by the auditors; and review any issues that arise regarding the performance of the Company's internal audit function and the significant matters contained in these Internal Audit Department reports.

8. [3.] Make or cause to be made, from time to time, such other examinations or reviews as the Audit Committee may deem advisable with respect to the adequacy of the systems of internal controls and accounting practices of the Company and its subsidiaries and with respect to current accounting trends and developments, and take such action with respect thereto as may be deemed appropriate.

[4.] [Recommend annually the public accounting firm to be outside auditors for the Company, for approval by the Board of Directors and set their compensation.]

9. [5.] Review with management and the public accounting firm selected as outside auditors for the Company the annual and quarterly financial statements of the Company, including the Company's disclosures under "Management's Discussion and Analysis of Financial Condition and Results of Operations" and any material changes in accounting principles or practices used in preparing the statements prior to the filing of a report on

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Form 10-K or 10-Q with the Securities and Exchange Commission. Such review to include the items required by SAS 61 as in effect at that time in the case of the annual statements and SAS 71 as in effect at that time in the case of the quarterly statements. During such review, or otherwise, the Audit Committee shall work to resolve any disagreements between management and the outside auditors regarding financial reporting.

10. Review earnings press releases, as well as financial information and earnings guidance provided to analysts and rating agencies and discuss Company policies with respect to risk assessment and risk management.

11. [6.] Receive from the outside auditors the report required by Independence Standards Board Standard No. 1 as in effect at that time and discuss it with the outside auditors.

12. [7.] Review the status of compliance with laws, regulations, and internal procedures, contingent liabilities and risks that may be material to the Company, the scope and status of systems designed to assure Company compliance with laws, regulations and internal procedures, through receiving reports from management, legal counsel and other third parties as determined by the Audit Committee on such matters, as well as major legislative and regulatory developments which could materially impact the Company's contingent liabilities and risks.

13. Establish and maintain procedures for the confidential and anonymous receipt, retention and treatment of complaints regarding the Company's accounting, internal controls or auditing matters and establish clear hiring policies for employees or former employees of the Company's outside auditor.

14. Obtain the advice and assistance, as appropriate, of independent counsel and other advisors or necessary to fulfill the responsibilities of the Audit Committee.

15. Report regularly to the Board of Directors as to the Audit Committee's accomplishments of its purposes and responsibilities.

16. Conduct an annual performance evaluation of the Audit Committee.

Meetings

The Audit Committee shall meet at least six times each year and at such other times as it deems necessary to fulfill its responsibilities. The Audit Committee shall meet regularly in executive session without management present. In addition, the Audit Committee shall periodically meet with management, internal auditors and outside auditors to oversee and review their respective performance.

Report

The Audit Committee shall prepare a report each year concerning its compliance with this charter for inclusion in the Company's proxy statement relating to the election of directors.

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DIRECTOR'S QUESTIONNAIRE

Regarding Independence and Financial Expertise

I. Questions to be Answered by all Directors:

1. Please list any relationships that you have with Pfizer, Inc. (the "Company") (either directly or as a partner, shareholder or officer of an organization that has a relationship with the Company), including, but not limited to, commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships:

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2. Have you or an immediate family member* been an employee of the Company within the past five years? If so, please list the position(s) held and the date(s) such position was so held.

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3. Within the past five years, have you or an immediate family member* been affiliated with or employed by an auditor (present or former) of the Company (or an affiliate of the Company)? If so, please describe the affiliation of, and/or position(s) held by, you or your immediate family member and the date(s) of such affiliation and/or date(s) such position was held.

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* "Immediate family members" include spouses, parents, children, siblings, mothers- and fathers-in-law, daughters- and sons-in-law, sisters- and brothers-in-law and anyone (other than employees) who share your home.

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4. Are you or an immediate family member*, or have you or an immediate family member* been, employed during the past five years by another company while an executive officer of the Company concurrently serves, or has served, on the other company's compensation committee? If so, please list the company or companies and the applicable executive officer of the Company.

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5. Do you or an immediate family member* have any significant relationships or affiliations with any charitable or not-for-profit organizations (including, but not limited to, status as a trustee, member of the board of directors or significant benefactor of such organization)? If so, please list the organization(s) and the relationship(s) or affiliation(s) therewith.

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II. Questions to be Answered by Current or Prospective Audit Committee Members of the Company:

1. Have you, or are you currently, accepting any consulting, advisory or other compensatory fees from the Company? If so, please state the amount of the fees and the services provided to the Company in consideration of such fees.

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2. Please state whether or not you have an understanding of financial statements in general and of Generally Accepted Accounting Principles ("GAAP"), particularly in connection with the accounting for estimates, accruals and reserves. If so, please briefly discuss the extent of your understanding of financial statements and GAAP and the basis for such understanding.

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3. Please state whether or not you have any experience in preparing or auditing financial statements of companies comparable to the Company. If so, please discuss the extent of your experience.

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4. Please state whether or not you have any experience with internal accounting controls and an understanding of audit committee functions. If so, please discuss the extent of your experience and understanding.

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5. Please state any experience or education during the past five years that would contribute to your general understanding of financial statements.

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