909 Best of ACCA '97 The Changing Role of the Director in Today's Corporation

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Faculty Biographies

Daniel Cooperman

Daniel Cooperman is senior vice president, general counsel, and secretary of Oracle Corporation in Redwood Shores, CA. Mr. Cooperman's responsibilities include worldwide legal policies, corporate governance and securities compliance, strategic transactions, commercial licensing, intellectual property, employment law, litigation, patent law, and legal support for Oracle's various business units.

Prior to joining Oracle, Mr. Cooperman was a partner with the San Francisco-based law firm of McCutchen, Doyle, Brown & Enersen, and served as chair of McCutchen's 65-lawyer business and transactions group and managing partner of the firm's San Jose office. Prior to joining McCutchen, he was a consultant in strategic planning with McKinsey & Company's San Francisco office.

Currently, Mr. Cooperman is the vice chair of the Software & Information Industry Association, the largest trade association in the software industry, and a member of NASDAQ's Listing and Hearing Review Council. He is also a member of the ABA's Committee of Corporate General Counsel and the Advisory Council for the Law, Science, and Technology Program at Stanford Law School.

Mr. Cooperman graduated summa cum laude with highest distinction from Dartmouth College. He received his MBA and JD from Stanford University's Graduate School of Business and School of Law.

Justin L. Johnson

Justin L. Johnson is vice president, general counsel, and secretary of Atlanta Life Financial Group, Inc. He has over 16 years of experience in corporate, litigation, finance, employment, and regulatory law.

Prior to joining Atlanta Life, Mr. Johnson served as an assistant city attorney for the City of Atlanta, Georgia, staff attorney for the Resolution Trust Corporation, counsel for Turner Broadcasting Systems, Inc., associate with Alston & Bird, and as an associate with Klett Lieber Rooney & Schorling. Mr. Johnson also served as a commissioner on the City of Pittsburgh Civil Service Commission.

Mr. Johnson is the immediate past president of ACCA's Georgia Chapter and a member of the ABA, National Bar Association, Minority Corporate Counsel Association, and Laws and Legislation Committee of the Life Insurers Council. He is also a participant in the United Way Volunteer Involvement Program, and director of the Jones/Carver Boys & Girls Clubs, Sweet Auburn Business and Improvement Association, Atlanta Children's Shelter, and The Chicago Challenge.

Mr. Johnson received his BA with honors from the University of Chicago and JD from Harvard Law School. He was a member of the Leadership Atlanta Class of 2001.

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Gail A. Lione

Gail A. Lione is vice president, general counsel, and secretary of Harley-Davidson Motor Company and its holding company, Harley-Davidson, Inc. in Milwaukee. She also served as the acting vice president of human resources. Harley-Davidson Motor Company, the only major U.S. based motorcycle manufacturer, produces heavy weight motorcycles and a complete line of motorcycle parts, accessories, apparel, and general merchandise.

Prior to joining Harley-Davidson, Ms. Lione was general counsel and secretary of U.S. News & World Report and its affiliates, The Atlantic Monthly Company, Applied Graphics Technologies, Inc., and Applied Printing Technologies. Her first general counsel position was with Sun Life Group of America in Atlanta, where she managed the legal affairs and all regulatory activities of five insurance companies licensed in 50 states and their affiliates, totaling in excess of $5.3 billion in assets. Ms. Lione started her legal career with Morgan, Lewis & Bockius in Philadelphia.

Ms. Lione is a member of the Board of Trustees of the University of Rochester and the University School of Milwaukee. She is currently serving as a member of the Board of Directors of the YMCA of Milwaukee and the United Way of Greater Milwaukee.

Ms. Lione graduated with a BA magna cum laude and phi beta kappa from the University of Rochester, and she received her JD from the University of Pennsylvania Law School.

Roger W. Raber

Roger W. Raber is president and chief executive officer of the National Association of Corporate Directors (NACD). Founded in 1977, NACD provides educational, publishing, and advisory services for boards of corporations ranging from Fortune 100 and NASDAQ companies to smaller OTC, private, and closely held firms. This professional association of 10,000 members and customers promotes high professional board standards and conducts research, educational seminars and "in-house" customized programs on governance best practices for directors and senior management.

Formerly, Mr. Raber was director of member services and president of the Center for Financial Studies for America's Community Bankers (ACB). ACB is the national trade association for 2,000 savings and community banks and related business firms, based in Washington, DC. Mr. Raber directed education, membership, state relations, publications, and information services for ACB.

Mr. Raber serves on corporate and nonprofit boards and delivers presentations at national and international conferences on board issues, strategic planning, and leadership development.

He holds a doctorate from Columbia University and has taught at Fairfield University, Dartmouth College, the University of Virginia, and Johns Hopkins University.

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Executive Summary

To be effective, boards need the right people, the right culture, the right issues, the right information, the right process, and the right follow-through.

A Call to Action

- The evaluation process starts with the board's enthusiastic commitment to be held accountable.
- As evaluation progresses, it must serve one clear objective: to provide guidance that creates superior long-term shareholder value.

The Right People

- A board with the right people will have a substantial majority of independent directors with a wide range of talents, expertise, and occupational and personal backgrounds.
- Outside directors need to be more than independent; they need to be independent-minded as well.
- Courage is the key to excellence: A courageous director will do what is best for the corporation and its shareholders, even in the face of countervailing pressure inside or outside the boardroom.

The Right Culture

- Boards should encourage a culture that promotes candid communication and rigorous decision making.
- Directors and managers must work together to achieve "constructive interaction"—a healthy atmosphere of give and take.

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The Right Issues

- Constant reference to corporate strategy is paramount to conducting an effective evaluation of the board.
- The board, in conjunction with management, should focus on those issues that will help the company maximize long-term shareholder value.

The Right Information

- Directors must obtain, study, and understand relevant information in order to spend their time effectively and make informed decisions.
- Directors' requests for information should be reasonable in amount and time frame, enabling thorough and prompt replies.

The Right Process

- The development of an evaluation process often occurs in stages—building from CEO evaluation to full board evaluation, individual director self-assessment, and, finally, peer evaluations.
- To evaluate itself, a board should compose a description of its specific duties, goals, and objectives, and then set about measuring its performance against those responsibilities.
- Boards should designate an independent committee—usually the nominating or governance committee—to monitor board composition and operations.

The Right Follow-Through

- The right follow-through is critical to an effective evaluation process and its purpose: to enhance corporate performance and, ultimately, long-term shareholder value.
- To be effective, the evaluation should lead to a clearer understanding and stronger sense of what the board must do to become a strategic asset.
- After weighing the results of the evaluation, the full board should agree on and approve actions to address areas in need of improvement.
- The nominating/governance committee can apply basic management principles to its work on board evaluation, initiating action plans with specific time lines for implementing the board's recommendations and for monitoring the process of each stage of the implementation process.

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Summary and Conclusion

Director professionalism begins with directors themselves—independent, qualified individuals who serve the interests of the shareholders they represent through an effective governance process. In determining this process, directors should first recognize the importance of their own autonomy and abilities. They need to explicitly agree that the board has a function independent of management. Directors fulfill this function by offering the best of themselves and by seeking the best in their fellow directors.

As such, director professionalism requires that each board consider and decide for itself what it should do and how it should do it, as well as who directors should be and how they should be evaluated. This Report addresses all four of these challenges.

1. ***Responsibilities: What Boards Should Do.*** Pursuant to the board's broadly defined powers under state law, each board has the authority to determine its own specific role and responsibilities within the corporation. In consultation with the CEO, the board should clearly define its role, considering both its legal responsibilities to shareholders and the needs of other constituencies, provided shareholders are not disadvantaged.

2. ***Processes: How Boards Should Fulfill Their Responsibilities.*** The board is responsible for determining its own governance processes. In determining such processes a board should:

- establish an independent governance committee
- create independent leadership roles for directors
- determine the method for the board's participation in setting board and committee agendas
- determine the method for selecting and compensating directors and the CEO
- determine a level and timetable for stock ownership required for each director
- establish an effective and independent method for periodically evaluating the CEO, the board, and individual directors
- adopt a policy of holding regular executive sessions without management present, and
- take a role in selecting advisors to the board, directly retaining those advising the board alone.

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3. ***Selection: Who Directors Should Be.*** Director selection should be based on the personal qualities sought in all directors and the core competencies the board needs as a whole. Each director should exhibit:

- integrity and accountability
- informed judgment
- financial literacy
- mature confidence, and
- high performance standards.

Areas of core competency that should be represented on the board as a whole include:

- accounting and finance
- business judgment
- management
- crisis response
- industry knowledge
- international markets
- leadership, and
- strategic vision.

Most importantly, the board should:

- have a substantial majority of independent directors
- develop its own definition of independence, and
- seek disclosure of any relationships that would appear to compromise director independence.

In selecting members, the board must assure itself of their commitment to:

- learn the business of the company and the board
- meet the company's stock ownership requirements
- offer to resign on change of employment or professional responsibilities, or under other specified conditions, and
- importantly, devote the necessary time and effort.

In this regard, the board should consider guidelines that limit the number of positions on other boards, subject to individual exceptions—for example, for CEOs and senior executives, one or two; for others fully employed, three or four; and for all others, five or six.

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With these characteristics, competencies, and commitments in mind, consideration should also include:

- balance of director contributions
- director diversity, and
- company status.

4. ***Evaluation: How Boards and Directors Should Be Judged.*** Board effectiveness and credibility depend in part on regular self-evaluation of both the board as a whole and its individual members. The evaluation process should be:

- controlled by the independent directors themselves
- aligned with established evaluation processes and goals
- tailored to meet the needs of the individual company and board
- designed to ensure candor, confidentiality, and trust
- regularly reviewed and improved as necessary, and
- disclosed (process only) to shareholders and the public.

Evaluation of board performance should include consideration of the execution of general board responsibilities as well as:

- delineation of board and management powers
- effective interaction between and among directors, and
- director education and development.

Evaluation of individual director performance should include consideration of the execution of specific board responsibilities as well as:

- personal characteristics, and
- core competencies.

Additional consideration should be given to:

- varying roles for directors, and
- means for removing under-performing directors, if necessary.

* * *

We do not suggest that the Commission's judgment should be adopted whole. The most important result the Commission seeks is board deliberation on the subjects raised and on the judgments expressed in this Report. Each board should debate these issues thoroughly and disclose the results of its deliberations to shareholders. The board's conclusions can and should be amended from time to time as circumstances change.

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Appendix A3

Model Corporate Governance Guidelines

Corporate Governance Principles

In the corporate governance vernacular, there's perhaps no phrase that is used more (or abused more) than "one-size-does-not-fit-all." For most investors and corporations, these words urge flexibility and introspection. Few investors argue that directors should tailor governance garments that don't fit them or that boards should constantly change outfits to reflect every passing fad. Shareholders recognize that directors must have broad discretion to establish rules that meet their particular circumstances.

Shareholders also realize that the process of designing guidelines is of equal importance to the final cut of the governance garment. Indeed, experience has taught investors to be skeptical of boards that appear to have grabbed off-the-rack guidelines that look (on them at least) like what they truly are—cheap knockoffs of the originals.

Unfortunately, some pundits use "one-size-does-not-fit-all" as a form of license. They chant the phrase in belief that its incantation will justify boardroom failures to adhere to the most basic (and widely accepted) norms of governance conduct.

The Boardroom Fabric

Investors generally believe that two attributes—Independence and Accountability—are nonnegotiable. They are the fibers that are spun into the yarn that is woven into the fabric of the board. Investors believe that the twin filaments of independence and accountability provide the fabric with its basic strength.

To guarantee this structural integrity, shareholders insist on the following:

- a majority of Independent Directors* on the board;
- stocking the committees charged with oversight of the audit, executive/board compensation and board governance/nominations functions solely with Independent Directors;
- annual elections of the entire board of directors; and
- providing Independent Directors with opportunities to meet on a regular basis without the CEO or other insiders in attendance.

Broad Discretion

Beyond structural guarantees of independence and accountability, directors should have a substantial amount of discretion in choosing the specific mechanisms that their boards use to fulfill their duties. Among the key responsibilities for directors are selecting and monitoring top management and determining the composition and structure of the board. In fulfilling these functions, some key issues for boards to consider include the following:

CEO Succession. Many shareholders believe that there is no more important job for the board than top management succession. Maintaining a static succession plan is insufficient to meet this responsibility. Instead, the independent directors on the board must establish an ongoing process that regularly assesses the availability of talent both inside and outside of the corporation.

This model was developed by Institutional Shareholder Services (ISS), 1455 Research Blvd., Rockville, MD 20850. http://www.cda.com/iss www.isstf.com

* Note: An "Independent Director" is an individual who has not been a present or former employee of the company and has no significant financial or personal tie to the company other than share ownership and entitlement to director compensation.

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Board Leadership. Shareholders expect boards to establish checks on the power of a CEO/Chairman to control the boardroom agenda. Under some circumstances, shareholders favor the selection of an independent board chairman. When the CEO holds the position of Chairman, however, boards may create a counterbalance by naming one of the independent directors as the "Lead Director."

Guidelines. Although the actual form may vary widely, shareholders expect boards to establish and maintain Corporate Governance Guidelines that set forth the rules for the operation of the board of directors. Such policies should be published in the annual proxy statement.

Board Size. Similar to the porridge served up in the fairy tale, pundits tend to prefer boards that are neither too large nor too small. The recent trend has been in the direction of smaller boards. A decade ago, it wasn't unusual for corporate boards to consist of 20 or more directors. Most observers believed that such boards were too large to function effectively. Today, the typical large-cap company board is in the 10-to-13-seat range. Many observers believe this range is optimal. Boards at smaller firms, however, are composed of five or six directors on average. Some commentators argue that this compact size allows boards to make quick decisions in fast moving markets. These small panels often err, however, by ignoring governance issues. Most of them lack nominating panels. Few, if any, have governance/board guidelines in place.

Limits on Board Memberships. The CEO and senior management of the company should limit outside Directorships to one or two; Nonemployee Directors who are employed on a full-time basis should limit other Directorships to three or four; and retired executives should limit other Directorships to five or six.

Director Selection. An independent board committee should review the appropriate skills and characteristics required of Board members in light of the current board membership. This assessment should include issues related to diversity, experience and skill sets. The principal qualification for any director should be his or her ability to act on behalf of all of the shareowners.

Director Orientation/Continuing Education. New directors must participate in an orientation process that includes reviewing extensive materials regarding the company's business and operations, visits to company facilities and meetings with key personnel. As part of this process, new directors should attend meetings of the Board's committees to acquaint themselves with the work and operations of each.

Board Performance Reviews. A committee of independent directors should be charged with performing a regular evaluation of the performance of the Board and individual directors. The committee's assessment should specifically address weaknesses in board structure and propose actions to be taken to correct them.

CEO Evaluation. The independent directors should perform regular reviews of the performance of the CEO. These evaluations should serve as the basis for establishing compensation packages that link CEO pay to company performance.

Director Access to Company Management. Independent Directors should be provided with open access to corporate management at all times.

Board Advisors. The board should have access to legal or other expert advice from a source that is independent of management.

Compensation of Directors. To better align their interests with those of company shareholders, directors should receive all or a significant portion of their compensation in the form of equity. To encourage stock ownership by directors, the board should establish and maintain stock ownership guidelines for its Non-employee Directors.

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Appendix E4

Sample Issues for Boards to Consider in Self-Evaluation

Board Culture

- The board has a culture and climate that promotes effective communication and decision making.
- Directors and management work together to achieve "constructive interaction" in a healthy atmosphere of give and take.
- Board members feel free to speak out openly and honestly without fear of criticism, even when voicing a minority position.
- Differences of opinion are fully ventilated and accepted gracefully.

Board Composition

- The board is composed of a substantial majority of independent directors who have the requisite background, skills, experiences, and personal characteristics needed to make the board a genuine strategic asset for the corporation.
- Board members have "business savvy."
- All board members are financially literate.
- A continuous process is in place to assure that the combined knowledge and expertise of the board is aligned with the strategic demands of the company, including the need for technical knowledge.
- A procedure exists to evaluate and attract board members who fulfill the present and future needs of the board.
- The board is appropriately diversified with respect to geography and demographics such as race and gender.

Board Structure and Processes

- All board members comprehend their overarching duties, including the duty of care and the duty of loyalty.
- Each board member is properly oriented and integrated through written material and direct contact with the board chair, other board members, and management. This orientation is renewed for each board member at least every five years.
- The board is structured (through committees, board meetings, etc.) to discharge effectively its duties and responsibilities.
- Charters are in existence for the full board and for each committee.
- Committees regularly review performance against their specific responsibilities and goals.
- The board and committees are provided with relevant information in a timely manner prior to each meeting.
- Board members have ready access to all required information and, through the CEO, to principal staff and line mangers.
- Committees report their activities, decisions, and recommendations to the full board in a concise, understandable manner.
- Board meetings are tightly organized to maximize time spent on strategic issues and policy decisions. Time devoted to routine matters is minimized.
- The board demonstrates commitment to upholding its ethical, legal, and fiduciary responsibilities.
- The board has in place mechanisms to ensure that employees act in accordance with a prescribed code of conduct.

Review of Company Operations

- The board is knowledgeable concerning external factors of the businesses in which it is engaged, including information regarding competition.
- The board devotes adequate time to reviewing annual budgets, capital spending, and the financial integrity of the company.

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- The board receives, comments upon, and monitors long-range forecasts of performance.
- The board reviews operating performance of major segments of the company against targets and inquires into the factors contributing to major performance variations.
- Corporate strengths and weaknesses, threats and opportunities, and business risks are well understood and monitored by the board.

Strategy

- The board members agree on a common vision and mission for the company.
- The board spends a sufficient amount of time discussing the long-range future of the company.
- The board engages proactively in reviewing and approving the corporation's strategic initiatives and direction.
- Board members have a good understanding of the company's major strategic issues including competitive factors.
- A significant portion of every board meeting is devoted to discussion of strategic issues.
- Each board member has participated constructively in strategic discussions.
- Management has responded properly to directors' comments, questions, criticisms, and suggestions regarding strategic plans and the actions to carry them out.
- There are processes in place to review the implementation of strategies and to measure their attainment.
- Strategic goals are tied strongly to metrics such as financial goals, market share objectives, quality performance, etc.
- Corporate long-term performance is measured primarily against strategic goals.
- The company's strategies have been improved as a result of board input.

CEO Evaluation

- The board and CEO are aligned with respect to corporate strategies, goals, and objectives.
- Performance criteria against which the CEO is measured are well understood by the CEO and the board.
- The board has sufficient information for comprehensive CEO evaluation.
- Appropriate board processes are in place to set and periodically review CEO performance standards, including:
  - — Performance against specific company-wide metrics.
  - — Review of qualitative aspects of CEO performance.
  - — Regular executive sessions to evaluate CEO performance.
  - — Feedback to the CEO both in writing and verbally.

Succession Planning and Management Development

- The board has a process to review the talent pool critical to the company's long-term performance, including:
  - — Intimate involvement in succession planning for key corporate positions, including provision for crisis situations.
  - — Sufficient visibility of senior managers to measure their performance and potential for future advancement.
  - — Contact with key high-potential personnel below the senior management level.
  - — Review of top-level managers and key high-potential personnel by the CEO.
  - — Sufficient information to review and approve high-level organizational changes, including promotions.
  - — Data regarding the breadth and depth of the talent pool and the process by which the company ensures adequate availability of needed managerial and functional talent over the long term.
- There are compensation and reward systems in place which properly motivate management to achieve excellent long-term performance.

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Board Evaluation

- The board is fully committed to being held accountable for its performance.
- It is agreed that the evaluation process has one clear objective: to make the board a genuinely strategic asset for the corporation in order to maximize long-term shareholder value.
- An evaluation of board effectiveness is performed regularly (*e.g.*, every two years) against its charter, its specific duties and responsibilities, its goals and objectives, and its stated policies and practices.
- An independent committee (*i.e.*, the nominating or governance committee) is designated to monitor board composition, structure, and performance.
- Board self-evaluation is expected to provide information that will lead to ongoing improvement in its performance.
- The board—collectively and individually—is tenacious in its resolve to continuously improve performance and to continue being a valuable strategic asset to the company. ■

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Excerpted from the memo "Recent Proposals for Changes in Corporate Governance, Public Auditing, and the Role of Corporate Counsel: An Update as of July 26, 2002"
Available on ACCA's website at http://www.acca.com/legres/enron/acca_update.pdf

By John K. Villa
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I. Corporate Governance-Accounting Oversight Bill

The publicity surrounding the collapse of Enron and, more recently, the events involving WorldCom, led, quite predictably, to a flurry of action on Capitol Hill. The culmination of this activity was the Sarbanes-Oxley Act of 2002. On July 25, 2002, the House passed the bill 423-3 yesterday afternoon; a few hours later, the Senate approved the bill 99-0. According to the Wall Street Journal, President Bush called the bill "a good piece of legislation" and promised to sign it before the Senate had even voted.[1]

The Sarbanes-Oxley Act will:

- Grant the SEC broad authorization to "promulgate such rules and regulations, as may be necessary or appropriate in the public interest or for the protection of investors, and in furtherance of this Act."

- Establish a new, independent regulatory body, a five-member Public Company Accounting Oversight Board ("Board") "to oversee the audit of public companies that are subject to the securities laws." No more than two of the Board's five members may have worked as certified public accountants. The Board will register auditors; establish or adopt auditing, quality control, ethics, independence, and other standards for auditors; inspect auditors; conduct investigations and disciplinary proceedings; and enforce compliance with the Act and the rules of the Board. Board members are to be appointed by the SEC after consultation with the Fed Chairman and the Secretary of the Treasury. The Board will have jurisdiction to regulate "persons associated with a public accounting firm."[2] The Board will be funded by fees assessed on issuers of publicly traded

[1] Richard B. Schmitt et al., "Corporate-Oversight Bill Passes, Eases Path for Investor Lawsuits, Wall Street Journal, July 26, 2002, at A1.

[2] A "person associated with a public accounting firm" includes a "professional employee of a public accounting firm, or any other independent contractor or entity that, in connection with the preparation or issuance of any audit report . . . receives compensation . . . from, that firm . . . or participates as agent or otherwise on behalf of such accounting firm in any activity of that firm." The ABA strongly but unsuccessfully objected to this broad definition as appearing to give the Board jurisdiction to regulate both in-house attorneys and outside law firms hired by accounting firms. In the ABA's view, "[r]egulation of lawyers should remain the province of the judiciary, not the executive, and any attempt to grant the accounting oversight board or the SEC the power to adopt a set of national rules would violate separation of powers principles." Letter from

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securities.

- Require public auditors to register with the Public Company Accounting Board.

- Require the Public Company Accounting Oversight Board to include in its auditing
standards, requirements 1) that each public auditing firm maintain audit documents for seven years; 2) that each audit report be approved by a partner other than the one in charge of the audit; and 3) that each audit report describe the auditor's testing of
compliance with law.

- Require the Public Company Oversight Accounting Board to include in its quality control standards requirements relating to monitoring of professional ethics and independence, consultation on accounting and auditing questions, supervision of audit work, hiring and development of personnel, the acceptance and continuation of engagements, and internal inspection.

- Require the Public Company Accounting Board to conduct a continuing program of
inspections of auditors.

- Grant the SEC oversight and enforcement authority over the Board.

- Prohibit public auditors from providing most non-audit services to their audit clients. The provision of tax services to audit clients is permitted only if the client's audit committee gives advance approval.

- Require the rotation of the lead auditor and the audit partner responsible for reviewing the audit on each account at least once every five years.

- Require auditors to provide reports to audit committees.

- Prohibit auditors from auditing clients where a top executive came from the auditor and participated in audits within the past year.

- Require the Comptroller General to conduct a study of the effects of requiring mandatory rotation of audit firms.

- Require the SEC to direct national exchanges to prohibit the listing of any firm that does not have an audit committee meeting specified standards.

- Require the CEO and CFO to personally certify the veracity of financial statements.

Robert D. Evans to Hon. Paul S. Sarbanes (July 19, 2002).

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- Require the CEO and CFO to reimburse the company for bonuses and stock profits
  received if the company is required to restate its profits.

- Prohibit corporate insiders from trading during blackout periods.

- Make it unlawful for an officer or director to improperly interfere with an audit.

- Require the SEC to establish rules "setting forth minimum standards of professional conduct for attorneys appearing and practicing before the [SEC] in any way in the representation of public companies." (Emphasis supplied). Such rules shall include a rule requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty by the company or its agent to the chief legal counsel of the company or the CEO of the company, and, if the counsel or officer "does not appropriately respond," requiring the attorney to report the matter to the audit committee or another committee composed solely of outside directors or to the entire board of directors.[3]

- Direct funds obtained by the SEC through disgorgement orders or civil penalties to
  victimized investors.

- Require enhanced financial disclosures.

- Require the SEC to adopt rules to address analyst conflicts of interests and to conduct a study regarding the role and function of credit rating agencies.

- Require the SEC to review and analyze enforcement actions from the past five years.

- Authorize $776 million for the SEC -- a material increase.

- Make it a criminal offense to destroy or alter a document "with the intent to impede,
  obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States or any case filed under title 11 [bankruptcy], or in relation to or contemplation of any such matter or case," with a maximum sentence of 20 years.

- Make it criminal for an auditor to knowingly and willingly fail to maintain all documents sent, received, or created in connection with an audit or review for five

[3] The ABA unsuccessfully opposed this provision. The ABA objected both because this provision could interfere with the attorney client relationship and because this provision could superimpose national ethics rules that may be inconsistent with the current state ethics rules.

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years from the end of the fiscal period for which the audit or review was conducted.

- Make debts incurred because of settlements, judgments, or orders stemming from securities law violations non-dischargeable in bankruptcy.
- Extend the statute of limitations for securities fraud suits.
- Direct the United States Sentencing Commission to review and amend as appropriate the Federal Sentencing Guidelines to ensure that 1) offense levels and enhancements for document destruction or fabrication and for obstruction of justice are adequate; 2) the guidelines for the bill's newly enacted crimes are sufficient; 3) a specific offence enhancement is added for a fraud offense that endangers the solvency or financial security of a substantial number of victims; and 4) the guidelines that apply to organizations are sufficient to deter and punish organizational criminal misconduct.
- Provide protections for whistleblowers employed at publicly traded companies.
- Create a criminal offense of securities fraud similar to the currently-existing offenses of mail fraud, wire fraud, and bank fraud.
- Make attempt and conspiracy relating to certain white-collar crimes offenses subject to the same penalties as the underlying crime.
- Increase the maximum penalties for mail and wire fraud from five to twenty years per violation.
- Increase the maximum penalties for ERISA violations.
- Direct the Sentencing Commission to review the sentencing guidelines applicable to securities and accounting fraud and related offenses.

II. American Bar Association

On July 24, the ABA's Task Force on Corporate Responsibility made available to the public its preliminary report on improving corporate responsibility.[4]

The Task Force's core conclusion is that outside directors, outside auditors, and outside lawyers have "fallen short" in providing "active and informed stewardship of the best interests of the corporation." In other words, these independent advisors have lost their independence, thereby failing to help ensure that corporate boards act in the best interests

[4] See Preliminary Report of the American Bar Association Task Force on Corporate Responsibility (July 16, 2002), available at http://www.abanet.org/buslaw/corporateresponsibility/.

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of shareholders rather than corporate executives.

To restore the independence of such advisors, the Task Force endorses recommendations in two principal areas: strengthening ethical rules for lawyers and reforming the way corporate boards operate. (the following only include s the portion on corporate governance from the memo).

B. Corporate Governance Recommendations

To improve the way Boards of public companies function, the Task Force recommends that Boards adhere to each of the following standards:

- Boards should include a substantial majority of independent directors, with independence defined as recently proposed by the New York Stock Exchange.
- A corporate governance committee composed entirely of independent directors should be formed to identify, contact and recommend to the Board potential independent directors.
- Audit committees should be composed entirely of independent directors, and have authority to (i) recommend or take action regarding the outside auditor's engagement and removal, (ii) engage independent accounting and legal advisers when necessary or appropriate and (iii) establish policies relating to non-audit services by the outside auditor and other matters that may affect the auditor's independence.
- Compensation committees should be composed entirely of independent directors, and have (i) the authority to recommend or take action regarding senior executive compensation and (ii) the authority and resources to hire independent executive compensation and legal advisers when necessary or appropriate.
- Corporate governance committees, or some other committee of independent directors, should recommend a corporate code of ethics and conduct with a mechanism (such as a hot line, an ombudsman or compliance certification) for employees to communicate to independent directors information about violations of law or breaches of duty to the corporation.
- A committee of independent directors should review all material transactions between the corporation and executive officers and directors.
- Corporate governance committees and audit committees should develop procedures for meeting regularly with the corporate officers responsible for internal controls, codes of ethics and compliance policies.

In addition to the "mandatory" standards listed above, the Task Force endorses a number of corporate governance "best practices":

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- Boards should appoint a “lead” independent director or an independent director to serve as Chair of the Board of Directors.
- Boards should adopt processes for setting agendas and distributing information.
- Boards should consider policies establishing term limits for directors and rotation requirements among the independent committees of the Board.
- Training and education programs should be maintained for all directors, particularly independent ones.
- The Board should adopt procedures for evaluating the effectiveness of meetings, information flow, diversity of director experience and contributions of individual directors.

The Task Force sees its preliminary report as serving as a vehicle for eliciting comments from interested observers through a written comment process and public hearings to be scheduled in the fall. The Task Force intends to issue a final report before the end of 2002, which most likely will be submitted to the ABA House of Delegates next February. Because the report has not been approved by the ABA House of Delegates or Board of Governors, it should not be taken as ABA policy.

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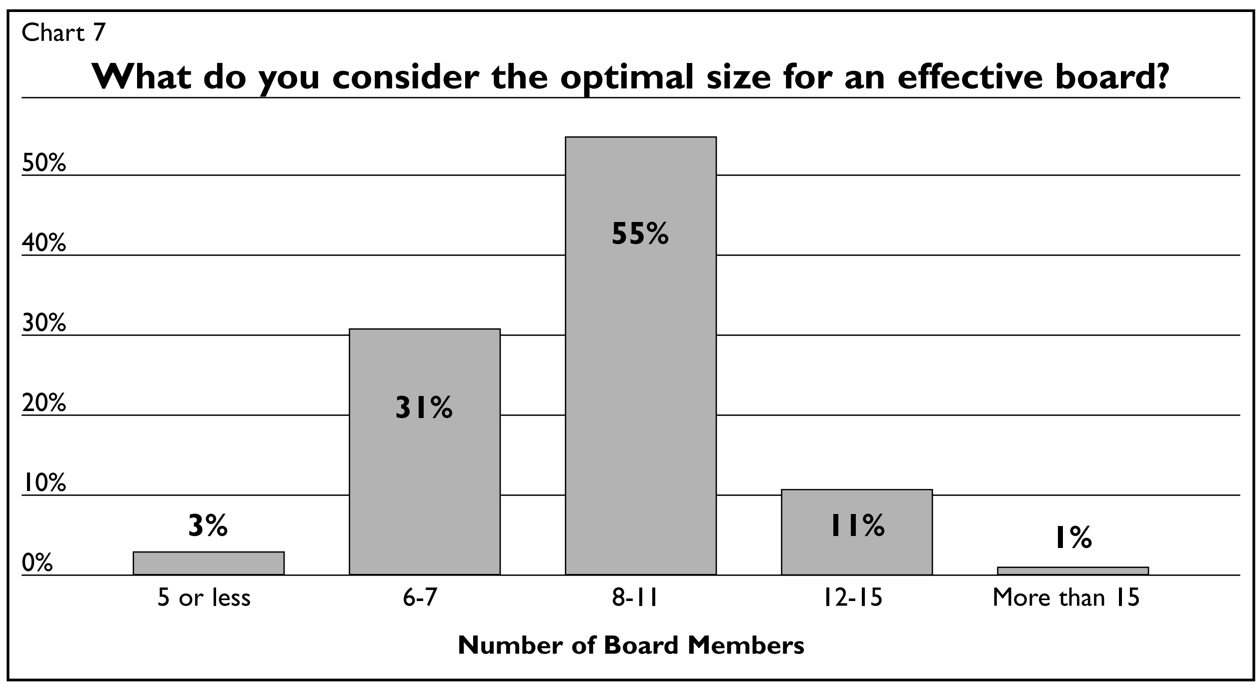
BOARD STRUCTURE AND COMPOSITION

Board Size

Calls for smaller boards, which grew in the wake of the technology stock climb during the late 1990s, lost volume as the technology sector melted down in 2001. Many technology companies had argued that small, insular boards were the wave of the future. These nimble groups were thought to be better at responding to rapidly changing market dynamics. After the market for technology stocks soured, many technology boards looked to expand their ranks by adding seasoned corporate hands.

This change in attitude may explain this year's slight jump in board size.

- In 2001, the typical board had approximately eight seats—up slightly from 2000 when the typical public company board had 7.8 members.
- An eight-member board is at the low end of the range (eight to 11 seats) selected by a majority of the NACD survey respondents as the "optimal board size." (See Chart 7 below.)
- Small boards still have advocates, however. More than three out of every 10 respondents cited six or seven seats as "optimal."



Market Cap and Index Breakdown. Board size varies by market capitalization and market index. The levels are essentially unchanged since 2000. (See Chart 8 on p. 13.)

- Large companies—especially those found in the Standard & Poor's 500 index—tend to have boards that fall within the nine-to-12 seat range.

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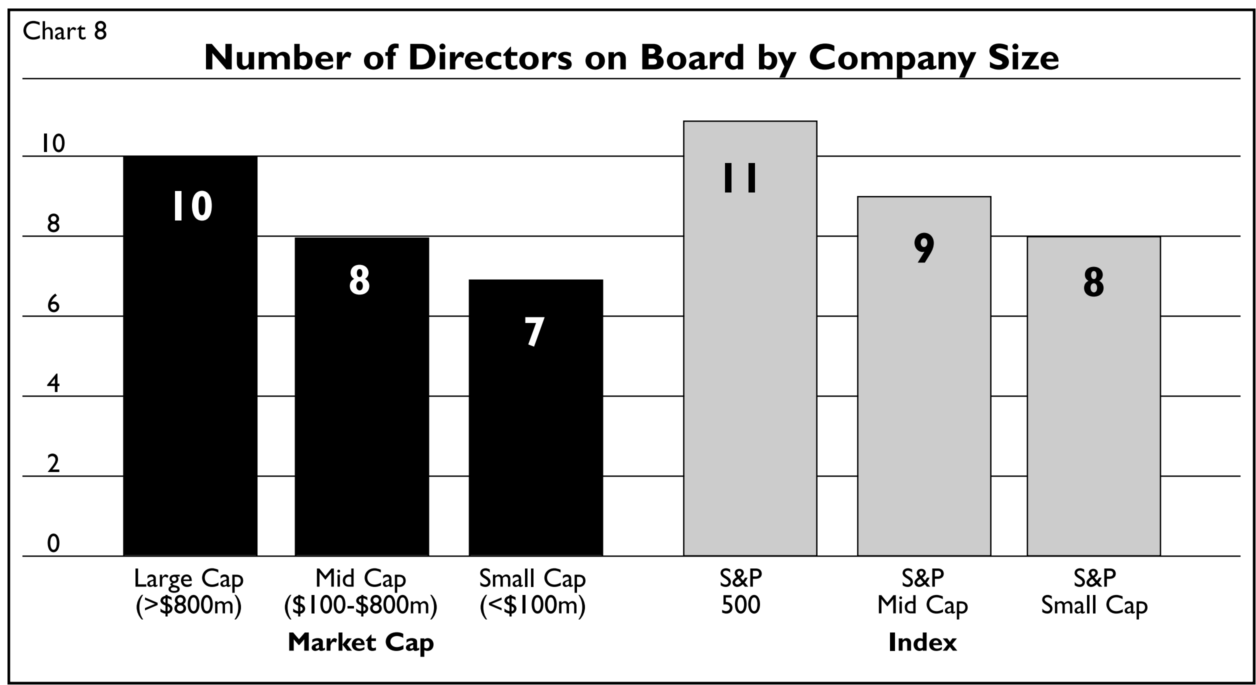
- In sharp contrast, boards at firms falling at the bottom of the market cap scale (<$100m) typically have fewer than seven members.
- Notably, a plurality (47 percent) of the directors in the survey who serve on boards at firms that trade "over the counter" favored boards with just six or seven directors. In contrast, two-thirds of the directors at NYSE-listed firms picked the eight-to-11 seat range as "optimal."



Industry. Board size varies along industry lines. The board size average for all industries is eight members.

- *Larger boards.* Bank boards are the average-busters—12 seats are typical. Utilities also average more than 10 seats per board and savings institutions and credit unions average nine members.
- *Average-sized boards.* Most industries fall in this group with eight board seats:
  - agricultural products
  - chemicals
  - durable consumer goods
  - energy, metal, and mining
  - financial services
  - food, beverages, and tobacco
  - initial public offerings (IPO)*
  - leisure services
  - materials and construction
  - non-durable consumer goods
  - real estate management and investment trusts
  - retail
  - transportation equipment
  - transportation services
  - wholesalers
  - telecommunications
- *Smaller boards.* Boards at start-ups fall at the low-end of the scale with an average of seven seats. Seven-seat boards also are typical in the following industries:
  - computer hardware
  - computer software services and Internet
  - diversified business services
  - electronics and semiconductors
  - healthcare services
  - manufacturing
  - pharmaceutical manufacturing

* A variety of industries are represented in this category.

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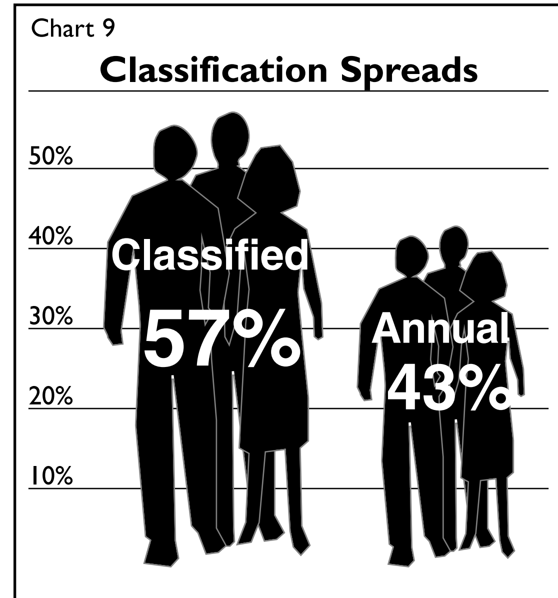
2001-2002 NACD Public Company Governance Survey

Annual Elections/Classified Boards

The lion's share of boards at U.S. companies provide for staggered board terms.

- More than half (57 percent) of the 5,000-plus corporate boards examined during 2001 were classified—slightly up from 53 percent a year earlier. (See Chart 9.)



Market Cap and Index Breakdown. There has been a large migration of companies—across market-cap lines—to staggered boards over the past year. (See Chart 10.)

- Large-cap and S&P 500 firms have long had an affinity for staggered board structures. Classification rates at mid- and small-cap firms, however, are advancing at a faster pace.
- Annual elections are less common at S&P Mid Cap 400 firms, for example, than they are at their larger siblings found on the S&P 500.
- The flight from annual elections is strongest at small-cap firms. Companies in the sub-$100 million category crossed the 50 percent line in 2001.

Chart 10

Percentage of Classified Boards by Company Size

Market Cap	2001	2000
Large Cap (>$800m)	61%	59%
Mid Cap ($100m-$800m)	60%	56%
Small Cap (<$100m)	51%	47%

Index	2001	2000
S&P 500	62%	58%
S&P Mid Cap	66%	65%
S&P Small Cap	59%	58%

Industry. Classification rates also vary widely by industry group (see Chart 11 on p. 15).

- Annual elections are unlikely at savings institutions and credit unions (95 percent are classified), banks (73 percent), and utilities (72 percent). This high rate of staggered elections may be explained, in part, by board size. Notably, these three industries are host to the largest boards as well.
- Newly minted companies may be leading the trend away from annual elections. Nearly three-quarters of the initial public offering (IPO) companies tracked in 2001 had classified boards.

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Shareholder Voting Trends.
Shareholder antipathy toward staggered board structures remains high.

- Thirty-two proposals calling for a return to the annual election of the entire board received majority votes during 2001. A larger number, 35, had reached majority support status the previous year.
- A handful of companies had shareholder proposals to repeal the classified board structure approved at three or more consecutive meetings in 2001.
- A dozen companies have had these proposals approved by shareholders two years in a row.

By and large boards have not given in on the classified board issue, even in the face of some successful shareholder proposals. Note, however, that adopting staggered board terms—other than at the time of incorporation—has become a difficult task.

Chart 11

Percentage Classified Boards by Industry

Industry	Percentage
Savings institutions & credit unions	95%
Banking	73%
Initial public offerings (IPOs)*	72%
Utilities	72%
Real estate management & investment trusts	62%
Computer software services & Internet	59%
Financial services, excluding REITs	57%
Telecommunications	57%
AVERAGE (All Companies)	**57%**
Transportation equipment	56%
Energy, metal, & mining	55%
Diversified business services	53%
Chemicals	53%
Retail	53%
Materials & construction	53%
Durable consumer goods	52%
Non-durable consumer goods	52%
Manufacturing	52%
Leisure services	51%
Computer hardware	50%
Wholesalers	50%
Pharmaceutical manufacturing	47%
Transportation services	47%
Healthcare services	44%
Electronics & semiconductors	43%
Agricultural products, food, beverages, & tobacco	40%

*A variety of industries are represented in this category.

Board Leadership

Boardroom leadership remains a controversial issue at many U.S. companies. Unlike some foreign markets—such as Canada and the United Kingdom—the tradition in the U.S. is to vest a single individual with both the CEO and chairman titles. Many directors at U.S. companies—especially those who serve as chief executives—continue to favor the status quo. Support in boardrooms for separating the two top corporate offices or creating some other form of counterbalance to the CEO/chair is growing.

- A plurality (41 percent) of the survey respondents said they prefer vesting both titles in one person. (See Chart 12 on p. 16.)
- More than one-half of the respondents favor some alternative to title unification. More than one-third of the survey respondents (36 percent) favored separation and nearly one-fifth (19 percent) favor allowing outside directors on each board to select a "lead" director from among their ranks.

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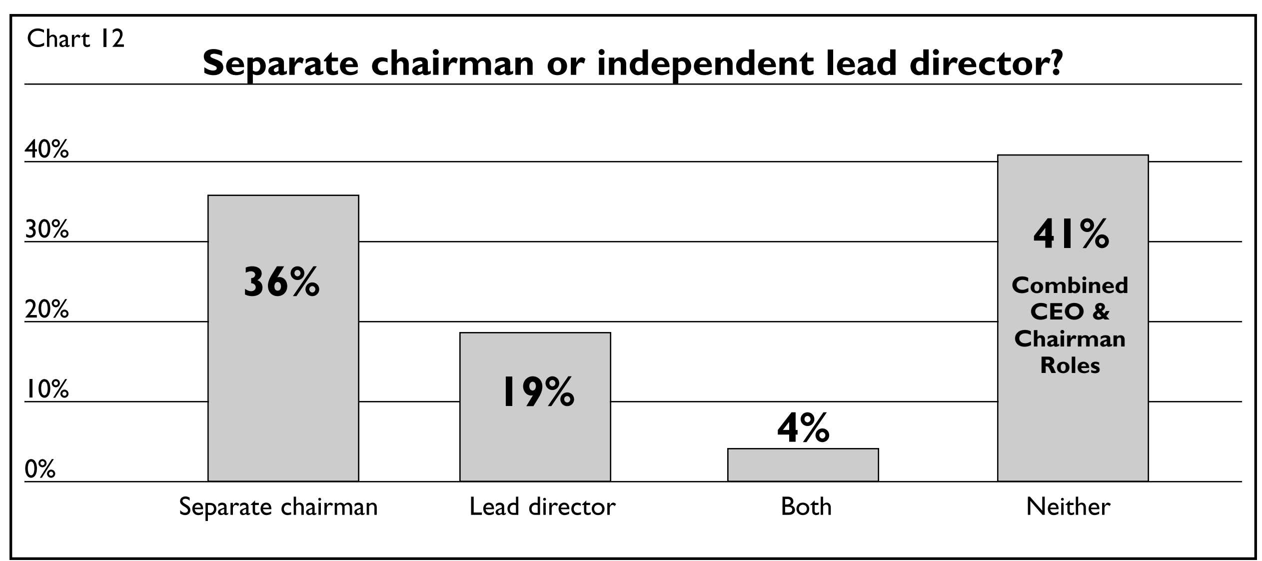

- Most advocates of alternatives to the unitary leadership model see increased board independence as the primary benefit. Others see it purely as an emergency measure—or in the words of one director "when the board distrusts the CEO." (See Chart 13 below.)
- More than three-quarters (78 percent) of the survey respondents said boards should craft a "written description of the roles and responsibilities" for the chairman that are distinct from those given to the CEO.
- A majority (87 percent) of the directors said directors themselves should have a role in setting the board agenda.
- Most (93 percent) of the directors said boards should have the authority to retain outside advisors.

Chart 13

What is the best reason for having a separate chairman or lead director?

Reason	%
Ensures board independence	50%
Helps in succession planning	7%
Improves efficiency of board meetings	5%
Other*	4%
Not applicable	33%

*Other: absence of CEO (1); distrust of the CEO (1); leadership when board faces stalemate or uncertainty (1)

Chart 14

Percentage of Boards with CEO/Chairman Roles Separated by Industry

Industry	%
Savings institutions & credit unions	62%
Initial public offerings (IPOs)*	56%
Banking	56%
Telecommunications	51%
Healthcare services	49%
Diversified business services	48%
Computer hardware	48%
Computer software services & Internet	47%
Financial services, excluding REITs	47%
Durable consumer goods	46%
Real estate management & investment trusts	45%
Electronics & semiconductors	45%
Manufacturing	45%
Materials & construction	44%
Pharmaceutical manufacturing	43%
Wholesalers	40%
Retail	39%
Chemicals	39%
Agricultural products, food, beverages, & tobacco	39%
Transportation equipment	36%
Transportation services	36%
Energy, metal, & mining	35%
Leisure services	34%
Non-durable consumer goods	34%
Utilities	32%

*A variety of industries are represented in this category.

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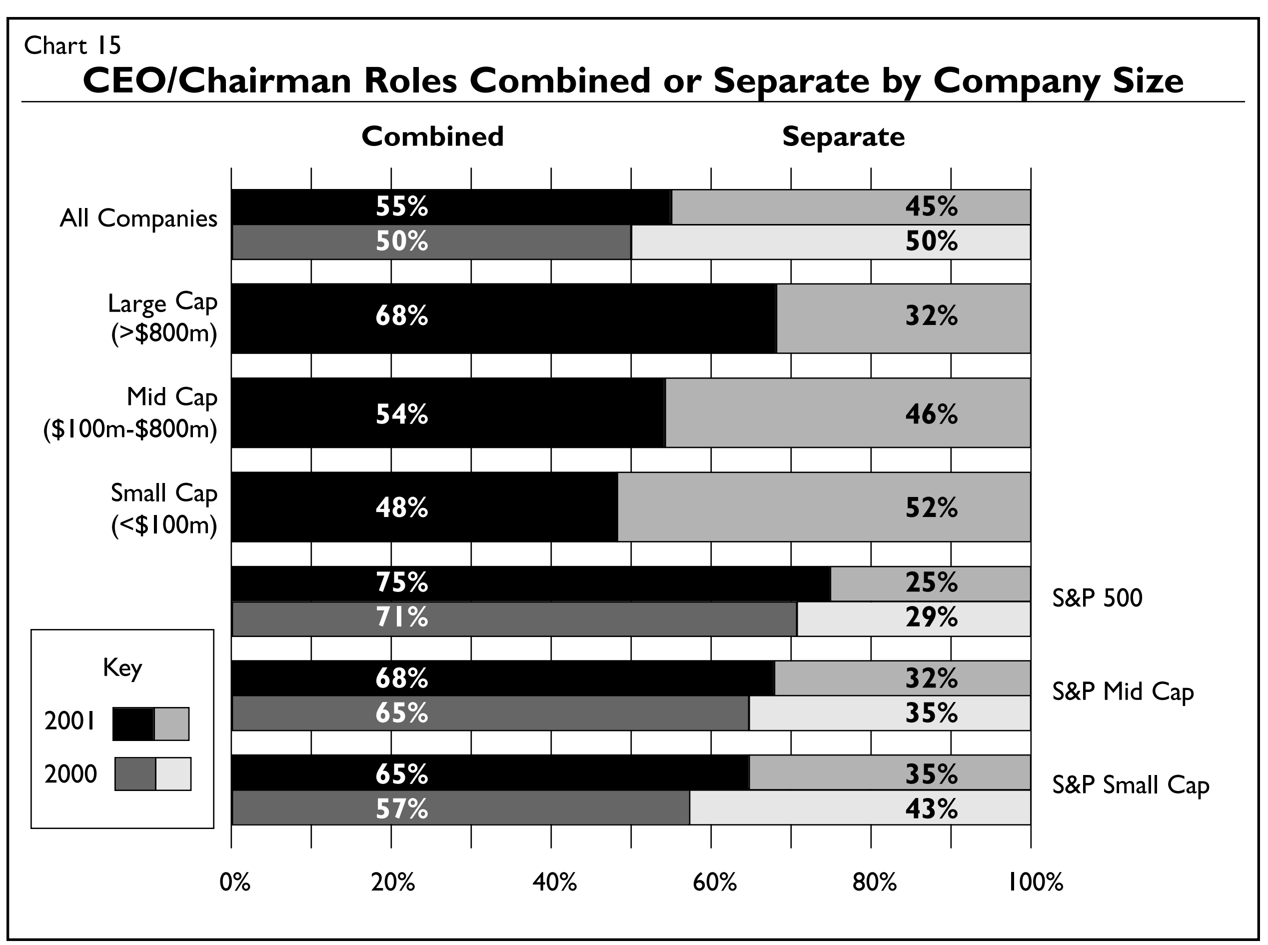
Actual Boardroom Practices. Chart 14 on p. 16 shows industry trends for separating the CEO/chairman roles. Contrary to common wisdom, separation is actually quite common at U.S. companies—especially small- and mid-cap firms. Nearly one-half of the boards reviewed during 2001 (see Chart 15 below) had different individuals carrying each of these titles. In most instances, there is no "independent" board chair. Instead, the separation is transitory in nature.

- At big companies, combination is the rule. But it is not unusual for a CEO/chairman to hand off day-to-day management responsibility to his or her handpicked successor, while the former CEO will often continue for a period of time as chairman.
- Some boards have adopted policies prohibiting a CEO from staying on as a board member after retirement. About 40 percent of the surveyed directors think such mandatory retirement provisions may help avoid any possibility of friction between the retired CEO and his successor.
- At many small-cap firms, company founders often stay on as employee-chairmen after they pass the CEO baton on to a more experienced manager.



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Board Independence*

For the charts throughout this report on director independence, we used the ISS definition of independence. ISS defines an independent outside (IO) director as someone with no connection to company other than his or her board seat. An affiliated outside (AO) director is a former employee of company or its affiliates, a relative of a current employee of the company or its affiliates, a provider of professional services to the company, a director with any transactional relationship with company or its affiliates, a founder of company but not currently an employee, or a director employed by a significant customer or supplier. An inside (I) director is any employee of the company or any individual with beneficial ownership of more than 50 percent of the company's voting power.

Chart 16
Independence of Directors

	2001	2000
75% or more Independent Outsiders	29%	28%
More than 50% Independent Outsiders	61%	54%
50% or more Affiliated Outsiders and Insiders	39%	46%

Average. Boardroom independence levels continue to climb. (See Chart 16 above.)

- In 2001, nearly two-thirds of all boards tracked meet the basic "majority of board seats" independence requirement.
- There was a massive 13 percent surge from 2000 to 2001 in the percentage of companies meeting this threshold—most likely due to the influx of independent directors on boards to meet the new audit committee standards.
- Many boards exceed this standard by a wide margin. Nearly one out of every three boards tracked had "independent outsiders" sitting in at least three-quarters of the seats on the full board.

Market Cap and Index. Independence levels rise along with company size. (See Chart 17 on p. 19.)

- The percentage of large-cap companies with a majority of independent directors on their boards (72 percent) is nearly 10 percentage points higher than the same measure of independence at mid-cap companies (64 percent) and its almost 20 percentage points higher than the same benchmark at small-cap firms (53 percent).
- Inclusion in a widely held stock index appears to lead to higher levels of independence. Independent directors make up a majority of the board at an impressive 88 percent of the companies found in the S&P 500. Three-quarters or more of the directors meet independence standards at 46 percent of the companies in the S&P 500.

* Note: The NACD definition of independence is as follows: A director will be considered independent if he or she has never been an employee of the corporation or any of its subsidiaries; is not a relative of any employee of the company; provides no services to the company; is not employed by any firm providing major services to the company; and receives no compensation from the company, other than director fees.

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Chart 17

Independence of Directors by Company Size

2001	Large Cap (>$800m)	Mid Cap ($100m-$800m)	Small Cap (<$100m)	S&P 500	S&P Mid Cap	S&P Small Cap
75% or more Independent Outsiders	**36%**	**31%**	**24%**	**46%**	**39%**	**36%**
More than 50% Independent Outsiders	73%	64%	53%	88%	80%	76%
50% or more Affiliated Outsiders and Insiders	27%	36%	47%	12%	20%	24%

- The impact of indexes is even more compelling at small-cap firms. More than 76 percent of the firms in the S&P Small Cap 600 have at least a majority of independent directors on their boards compared with just half of the boards for a broader range of small-cap firms.

Industries. Independence levels also vary by industry group. (See Chart 18.)

- Not surprisingly, the highest levels of board-room independence are found in highly regulated business sectors such as utilities, banks, and credit unions.
- Insider domination is most often found at companies in a mix of industries—"leisure" services, durable consumer goods, wholesalers, and retailers.
- The trend is positive. Nearly two-thirds of the boards at recent IPO firms had at least a majority of independent directors on their boards. ■

Chart 18

Independence of Directors by Industry

Industry Group	≥75% IO	>50% IO	>50% AO&I
Agricultural products, food, beverages, & tobacco	20%	62%	38%
Banking	46%	84%	16%
Chemicals	40%	65%	35%
Computer hardware	26%	70%	30%
Computer software services & Internet	22%	66%	34%
Diversified business services	17%	58%	42%
Durable consumer goods	19%	54%	46%
Electronics & semiconductors	28%	66%	34%
Energy, metal, & mining	30%	72%	28%
Financial services, excluding REITs	43%	81%	19%
Healthcare services	29%	70%	30%
Initial public offerings (IPOs)	23%	66%	34%
Leisure services	15%	48%	52%
Manufacturing	31%	65%	35%
Materials & construction	29%	59%	41%
Non-durable consumer goods	26%	64%	36%
Pharmaceutical manufacturing	29%	67%	33%
Real estate management & investment trusts	18%	67%	33%
Retail	19%	57%	43%
Savings institutions & credit unions	42%	79%	21%
Telecommunications	23%	66%	34%
Transportation equipment	29%	67%	33%
Transportation services	24%	63%	37%
Utilities	56%	95%	5%
Wholesalers	25%	55%	45%

IO - Independent outsiders; AO - Affiliated outsiders; I - Insiders.

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DM Extra!

July 2, 2002
Alert Edition

Timely Commentary on Critical Events and Regulatory Developments

WorldCom: Six Questions for Directors

Director Summary

On June 26, 2002, the world woke up to headlines about the discovery of a $3.8 billion accounting misstatement at **WorldCom**. This misstatement, like other troubling financial disclosures in the past several months (at **Enron**, **Global Crossing**, **Tyco**, **ImClone**, **Xerox**, and **Adelphia**, to name a few) raises (or should raise) at least six basic questions in the minds of corporate directors everywhere.

1) Facts: ***What happened—what was misstated at WorldCom and how?***

On the day the WorldCom board announced the discovery of a misstatement, the **Securities and Exchange Commission** filed a civil action in federal district court in New York naming the global communications provider.[1]

In its complaint, the Commission alleges that WorldCom fraudulently overstated its income before income taxes and minority interests by approximately $3.055 billion in 2001 and $797 million during the first quarter of 2002. The complaint claims that WorldCom portrayed itself untruthfully as a profitable business during 2001 and the first quarter of 2002 by reporting "earnings that it did not have." The SEC alleges that WorldCom did this by "capitalizing (and deferring) rather than expensing (and immediately recognizing) approximately $3.8 billion of its costs." The company transferred these costs to capital accounts in violation of established generally accepted accounting principles (GAAP) as well as certain provisions of federal securities law.[2] In a related action, the Commission ordered WorldCom to file with the Commission, under oath, a detailed report of the circumstances and specifics of these matters by 8 a.m. Monday, July 1. However, SEC Chairman **Harvey Pitt** characterized their response negatively, saying "WorldCom's statement is wholly inadequate and incomplete. It demonstrates a lack of commitment to full disclosure to investors and less than full cooperation with the SEC."

2) Definitions: ***What exactly is an accounting misstatement and are all accounting misstatements punishable?***

The SEC defines an accounting misstatement as a failure to follow GAAP. Material misstatements are punishable by law.

The SEC's Staff Accounting Bulletin No. 99 (SAB No. 99, issued in August 1999) explains what makes a misstatement "material." Some of the circumstances listed in SAB No. 99 that should be considered are whether a misstatement:

- masks a change in earnings or other trends
- hides a failure to meet analysts' consensus expectations for the enterprise
- changes a loss into income or vice versa
- concerns a segment of the registrant's business that plays a significant role in the registrant's present or future operations or profitability
- affects compliance with loan covenants or other contractual requirements, and
- has the effect of increasing management's compensation.

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1 Litigation Release No. 17594 / June 28, 2002. Securities and Exchange Commission v. WorldCom, Inc., Civil Action 02 CV 4963 (S.D.N.Y.) (June 27, 2002)

2 Sections 10(b) and 13(a) of the Securities Exchange Act of 1934 (Exchange Act) and Exchange Act Rules 10b-5, 13a-1, 13a-13, and 12b-20.

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Intentional misstatements, even of small amounts, that were made to manage earnings may be inappropriate. Public companies must maintain books, records, and accounts that "in reasonable detail, accurately and fairly reflect the transactions of a company."[3] SAB No. 99 sets forth various factors, in addition to those used to evaluate materiality, that a company may consider in deciding whether a misstatement violates its obligation to keep books and records that are accurate "in reasonable detail." Some of these factors are:

1. the significance of the misstatement, which means inconsequential misstatements may be treated differently than more significant ones
2. how the misstatement arose, for example, whether it is part of an effort to manage earnings or an insignificant flaw in an operations system
3. the cost of correcting the misstatement, and
4. the clarity of the authoritative accounting guidance with respect to the misstatement.

Research from **Prof. Thomas Weinrich** of **Central Michigan University** shows that there are several common techniques to misstate financial results, based on a study of 96 accounting and auditing enforcement releases (AAERs) issued from July 1, 1997, to December 31, 1999, involving 38 audits by the **Big Five** firms. The most frequently misstated transactions and accounts were as follows:

- revenues and accounts receivable (26 cases)
- expenses (13) (this was the kind of misstatement WorldCom made)
- cost of sales and inventory (9)
- sales discounts and allowances (8)
- property, plant, and equipment (7)
- accounts paying and accrued liability (5), and
- securities valuations (3).

These findings were consistent with a study issued in 1999 by the Committee on Sponsoring Organizations of the Treadway Committee (COSO), and reported in the September 1999 issue of *Director's Monthly*, pp. 4-5.

Since the most common kind of accounting misstatement involves inappropriate recognition of revenues, it is good to know when revenues may be recognized. Under GAAP, revenue is recognized when it is earned and realized or realizable. The SEC's SAB No. 101 addresses this topic. It sets forth four underlying conditions that must exist in order for revenue to be recognized. First, there must be persuasive evidence that the company has an *arrangement* to receive the revenue. Second, the company recognizing the revenue must have actually *delivered* the goods or rendered the service. Third, the *price* of the goods or services must be fixed or at least determinable. And finally, the company must have reasonable assurance that it can *collect* the revenue. For more on SAB No. 99 and SAB No. 101, see http://www.sec.gov/news/speech/spch359.htm.

3) Risk: ***Are accounting misstatements relatively common—and thus likely to be a problem at companies where I serve?***

Accounting misstatements that are "material" (important) enough to warrant regulatory action have been relatively rare in recent years, but seem to be increasing in frequency. According to the COSO study cited above, only 300 companies were named in fraud-focused AAERs from the SEC between January 1987 and December 1997.[4] Furthermore, the COSO study found that most of the companies accused of fraud were small—with median assets of $16 million, and not listed on the major stock exchanges.

In the past five years, however, the number of larger companies named in such matters has grown, raising broader problems. In a letter to the editor of the *COA Journal* in April 2001, **Abraham J. Briloff**, Emanuel Saxe Distinguished Professor Emeritus, **Baruch College**, New York City, wrote that the AAERs that served as the basis for the COSO report did not reflect the "periodic high-profile cases of fraudulent financial reporting," such as **Cendant**, that "raise concerns about the credibility of the U.S. financial reporting process" and that "call into question the roles of auditors, regulators, and analysts in financial reporting." Interestingly, this letter appeared at the precise time that WorldCom managers began to capitalize some expenses. Sadly, Professor Briloff's warning about more widespread problems went unheeded.

3 As stated in the footnotes to SAB No. 99, "Criminal liability may be imposed if a person knowingly circumvents or knowingly fails to implement a system of internal accounting controls or knowingly falsifies books, records, or accounts. 15 U.S.C. §§ 78m(4) and (5). See also Rule 13b2-1 under the Exchange Act, 17 CFR 240.13b2-1, which states, 'No person shall, directly or indirectly, falsify or cause to be falsified, any book, record, or account subject to Section 13(b)(2)(A) of the Securities Exchange Act.' Further, SAB No. 99 clarifies that "The books and records provisions of Section 13(b) of the Exchange Act originally were passed as part of the Foreign Corrupt Practices Act (FCPA). In the conference committee report regarding the 1988 amendments to the FCPA, the committee stated, 'The conference committee adopted the prudent man qualification in order to clarify that the current standard does not connote an unrealistic degree of exactitude or precision. The concept of reasonableness of necessity contemplates the weighing of a number of relevant factors, including the costs of compliance.

Cong. Rec. H2116 (daily ed. April 20, 1988).' "

4 Rule 10(b)-5 of the 1934 Securities Exchange Act or Section 17(a) of the Securities Act.

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4) Exposure: ***If a major accounting misstatement is discovered at a company where I serve, can I be sued as a director for failing to detect it?***

Depending on the allegations made in the lawsuit, there is some chance of legal exposure under state law, common law, and/or federal law. The duties, responsibilities, and powers of all corporations, whether publicly traded or not, and whether large or small, are defined under state law, which varies from state to state. Additional principles for boards have evolved under common law, which automatically applies nationwide through judicial interpretation on a case-by-case basis. Additional legal restraints may be imposed by federal law—for example federal securities law or broadly applicable federal laws such as the Foreign Corrupt Practices Act. Finally, stock exchanges also impose rules in the form of listing requirements (e.g., independent audit committees). Each of these sources of rules can add an extra layer of liability exposure for a board.

Under state law, expressed with various nuances, certain powers of the corporation are reserved to the board. Only the board has these powers. These include the power to sell the corporation or substantial assets, to declare dividends, and to declare bankruptcy. In addition, there are certain functions normally expected of the board, under state law: to oversee management of the corporation, to review strategic plans, etc. In exercising its powers and in fulfilling its functions, state law requires that directors must act with care (duty of care) and loyalty (duty of loyalty). Thousands of court cases have helped define exactly what these duties imply.

Director decisions, if made with due care and loyalty, are protected by the common law judicial doctrine known as the Business Judgment Rule. This judicial tradition (which is not written up in any legal code or rule) says that directors who make decisions with due care and loyalty cannot be sued for their decisions, even if the decisions turn out to be wrong. In the case of an accounting misstatement, if it is found that directors exercised due care and had no conflicts of interest, there would be no liability. A litigant may charge that directors failed to exercise due care with respect to the corporations internal accounts or external audit. To disprove this charge, and thus gain the protection of the Business Judgment Rule, directors would have to show that they received reasonable assurances that the internal auditor system was sufficient, and the the external auditors were competent and had no conflicts of interest. Furthermore, to show that they met the duty of loyalty standards, directors would have to show that they had no conflicts of interest with regard to the misstatement.

It is generally agreed that the duty of care implies a duty to be reasonably informed. In the **Delaware Chancery Court** case *In Re Caremark International, Inc*. (1996), Judge William Allen opined that the board cannot meet its duty to be reasonably informed "without assuring [itself] that information and reporting systems exist in the organization that are reasonably designed to provide to the senior management and to the board itself timely, accurate information sufficient to allow management and the board, *each within its scope*, to reach informed judgments concerning both the corporation's compliance with law and its business performance." (Emphasis added.)

Although there is some question as to what the "scope" of a board's understanding should be, in the case of public companies, this is becoming clearer. The **New York Stock Exchange** and **Nasdaq** require listed companies to have independent audit committees composed of members who are "financially literate." This new requirement does not imply that audit committee members have an affirmative duty to use their financial literacy to detect fraud. Given the increasing frequency of discovery of major accounting frauds in recent months, however, directors would do well to refresh their knowledge of this topic—known generally as "forensic accounting."[5]

5) Prevention, Detection, and Reporting: ***What can directors do to ensure the prevention, detection, and proper reporting of accounting misstatements?***

As for *prevention*, it is best to follow the guidelines of the **Federal Sentencing Commission** pertaining to compliance. These seven guidelines outline steps for an effective compliance program. For details on this and other sources referenced in this DMX, see the "Research Edition" at **www.nacdonline.org**.

5 See David B. Kaufman, "Employing Forensic Accounting Techniques to Detect Fraud in Financial Statements," Director's Monthly, February 1999, pp. 13-15. See also Report of the NACD Best Practices Council: Coping with Fraud and Other Illegal Activity (1998), "Procedures and Red Flags to Help Stop Fraud," by Herrington Bryce, Director's Monthly, March 1999, p. 14; The Report of the NACD Blue Ribbon Commission on Audit Committees: A Practical Guide (2000).

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Detection means looking for red flags in both financial reporting and management behavior. See the "red flags" list of the **NACD Blue Ribbon Commission on Audit Committees**, and the financial risk list from the **American Institute of Certified Public Accountants**' Statement on Audit Standards No. 82 (SAS No. 82) on "risk factors."[6]

As for *reporting*, the following should occur. Whoever finds the misstatement should report it to the audit committee, which should report it to the SEC, or ask the external auditor to do so. In the WorldCom case, this correct procedure was followed. The problem is that the reporting took place too late—15 months after the misstatement first appeared.

6) Policy: ***What is the single most important thing corporate America can do to restore confidence in equity markets?***

This question came from corporate director **Barbara Hackman Franklin** when she recently shared a forum with SEC Chairman **Harvey Pitt**. The former Secretary of Commerce and current NACD director was present as a designated questioner during SEC chairman's **June 26 speech at the Economic Club of New York**. Chairman Pitt said that the main answer lies in "better and faster disclosure" as an integral part of the many reforms he emphasized in his speech—including holding corporate leaders more accountable, and punishing them if they violate the corporate trust. In response to Hon. Franklin's questions, Chairman Pitt emphasized the value of having a new, independent oversight board to monitor the work of auditors. Currently, there are multiple proposals for such a board—including an SEC proposal and the ones contained in Congressional bills—including **S. 2673**, introduced by **Sen. Paul Sarbanes** (D-MD) on June 25, 2002, and the **House-passed H.R. 3763, Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002**, introduced by **Rep. Michael G. Oxley** (R-OH). Chairman Pitt that the main proposals are trying to do the same thing. Whatever happens, he said, the SEC will be "ready to go." If there is legislation, he added, the SEC will incorporate whatever it says. He emphasized the need for speed in getting this body set up. ■

6 See AICPA Statement on Auditing Standards 82, "Consideration of Fraud in a Financial Statement Audit" (1997). That statement was issued to provide guidance to auditors in fulfilling their responsibility "to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud." Although these risk factors cover a broad range of situations, they are only examples. In the final analysis, audit committee members should use sound informed judgment when assessing the significance and relevance of fraud risk factors that may exist.

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National Association of Corporate Directors (NACD), an independent not-for-profit organization founded in 1977, is the country's only membership organization devoted exclusively to improving corporate board performance. The NACD conducts educational programs and standard-setting research, and provides information and guidance on a variety of board governance issues and practices. Membership comprises board members from U.S. and overseas companies ranging from large publicly held corporations to small over-the-counter, private, and closely held firms. NACD lists all interested members on The Director's Registry, which is used by member companies and others that seek qualified directors. With chapters in many major cities providing educational programs and networking opportunities, NACD operates at both a national and local level. To educate the corporate community and to provide networking links among NACD chapter members, the NACD holds an annual Corporate Governance Conference, where it presents a Director of the Year Award.

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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.

[1] The NASD has also approved most of these proposals. The remainder will be submitted for NASD approval shortly.

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- 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

- 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] *Ibid*

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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.

Other Proposals

- 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.

- Require that a going concern qualification in an audit opinion be disclosed through the issuance of a press release.

- Clarify that NASDAQ will presume that a change of control will occur, for purposes of the shareholder approval rules, once an investor acquires 20% of an issuer's outstanding voting power, unless a larger ownership and/or voting position is held on a post-

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transaction basis by: (1) a shareholder, or an identified group of shareholders, unaffiliated with the investor, or (2) the issuer's directors and officers that are unaffiliated with the investor.

- Clarify the authority of NASDAQ to deny re-listing to an issuer based upon a corporate governance violation that occurred while that issuer's appeal of the delisting was pending.

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Corporate Governance

On August 21, 2002, the Executive Committee of the NASDAQ Board of Directors approved modifications to previously announced corporate governance reforms. The majority of these changes were designed to take into account provisions contained in the Sarbanes-Oxley Act of 2002. While the most recent changes still require approval from the NASD Board of Governors, which is expected shortly, NASDAQ is now in the process of submitting rule filings with the U.S. Securities and Exchange Commission (the "SEC") to effectuate its proposals. The rule filings will be posted on this Web site as they are made with the SEC. The updated summary of the NASDAQ proposals, as well as other important information, is posted below.

- Summary of NASDAQ Corporate Governance Proposals (August 28, 2002) (PDF)

- Letter from Wick Simmons to SEC Chairman Harvey Pitt re Corporate Governance Reform (April 11, 2002) (PDF)

Press Releases

- NASDAQ Takes New Actions on Corporate Governance Reform (July 25, 2002)

- NASDAQ Submits First Round of Corporate Governance Rule Changes to the SEC; Announces Plan for Additional Issues for Review This Month (June 5, 2002)

- NASDAQ Approves Rule Changes to Modify Key Corporate Governance Standards (May 24, 2002)

- NASDAQ Proposes Improvements to Corporate Governance Standards to Benefit Investors (April 12, 2002)

Approved Rules:

Below are rule filings that have been approved by the SEC.

Explicit Prohibition on Misrepresenting Information to NASDAQ (PDF)

NASDAQ Rule Filings to Date:

Disclosure of Material Information (PDF)

Please be advised that the texts found below are proposed only, and have not yet been published for public comment by the U.S Securities and Exchange Commission ("SEC"). The rule filings that are published for public comment may be different than the proposed texts, and NASDAQ may amend these proposals prior to publication, based upon input from the SEC or otherwise. Once the rule proposals are published in the Federal Register, they will be subject to public comment before approval by the SEC.

Independent Directors (PDF)

Related Party Transactions (PDF)

Requirement to Disclose Audit Opinions with Going Concern Qualifications (PDF)

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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 16, 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.

<u>Commentary:</u> 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.

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[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

[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.

Shareholder Vote on Equity Compensation Plans

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

* * * *

303.00 Corporate Governance Standards

* * * *

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.

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

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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;

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(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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Principles of Corporate Governance

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.

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

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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 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

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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 with 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 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.

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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. 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.

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 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 chief executive officer 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.

Senior management, led by the CEO, 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.

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.

Effective corporate governance requires a proactive, focused state of mind on the part of directors, the CEO and senior

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management, all of whom must be committed to business success through maintenance of the highest standards of responsibility and ethics. Good corporate 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.

The selection, compensation, and evaluation of a well-qualified and ethical CEO is the single most important function of the board.

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. 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 board also appoints or approves other members of the senior management team.

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- 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 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.

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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.

▲ *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 effectively and within the limits of approved budgets.

▲ *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

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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.
- *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

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committee members and to oversee the composition, structure, practices, and evaluation of the board and its committees.

The CEO and Management

The CEO and senior management run the corporation's day-to-day business operations.

- 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 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 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.

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- *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 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

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permit investors to understand the business 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 integrity and legal compliance 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.
  - ▲ *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.

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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 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 of its directors in order 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'

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A substantial majority of directors of the board of a publicly owned corporation should be independent of management, in both fact and appearance.

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, in both 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 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 nonaffiliated not-for-profit organizations that receive support from the corporation. 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

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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.

- 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.

Most American corporations are well served by a structure in which the CEO also serves as chairman of the board.

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.

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- 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.
- 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 and/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. However, The Business Roundtable does not believe 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.

Audit Committee

- Every publicly owned corporation should have an audit committee comprised solely of independent directors.

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- Audit committees typically consist of three to five members. The listing standards of the major securities markets require audit committees and require that an audit committee have at least three 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 the corporation's risk assessment and management practices.
  - ▲ *Outside auditor.* 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

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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.

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.

- *Auditor independence.* The audit committee should consider the independence of the outside auditor and should develop policies concerning the provision of nonaudit 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 or the attestation function. In considering whether the outside auditor should provide certain types of nonaudit 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 policies, 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.

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- *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 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 should oversee the corporation's internal audit function, including review of reports submitted by the internal audit staff, and should review 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.

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Audit committee meetings should be held frequently enough to allow the committee to appropriately monitor the annual and quarterly financial reports.

- ▲ *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 the corporation from employing members of the audit engagement team in senior financial management positions for some period of time after their work as auditors for the corporation. The audit committee should consider whether to adopt such a 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. 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

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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, 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 corporate governance committee, related to its core

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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. The 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 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 committee has two interrelated responsibilities: overseeing the corporation's overall compensation programs and setting CEO and senior management compensation.
- In addition to reviewing and setting compensation for management, a compensation committee should look more broadly at the overall compensation structure of

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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, 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 inter-

A compensation committee should look . . . at the overall compensation structure of the enterprise to determine that it establishes appropriate incentives for managment and employees at all levels.

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ests 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.

Directors should be incentivized to focus on long-term stockholder value.

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. 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. 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

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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 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.
- 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.

Independent directors should have the opportunity to meet outside the presence of the CEO and any other management directors.

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- 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.
- 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.

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- 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.

The board should have an effective mechanism for evaluating performance on a continuing basis.

Board and Management Evaluation

- 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 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

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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.
- Under the oversight of a committee comprised of independent directors, the nonmanagement members of the board should annually review the performance of the CEO and should 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.

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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.

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.

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.
- Corporations communicate with investors and other constituencies not only in proxy statements, annual and other reports, and formal stockholder meetings, but also in many other ways. All of these communications should be consistent, clear, and candid.
- 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

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Corporations should obtain stockholder approval of new stock option and restricted stock plans in which directors or executive officers participate.

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 ensure 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.

- 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.

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- When corporations offer healthcare, insurance, retirement, 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 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.

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Compliance is not only appropriate, but also 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.

- 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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Summary of Sarbanes – Oxley Act

Excerpted from materials
Provided by the ACCA Central Pennsylvania Chapter

July 29, 2002

Following Chart of Sarbanes-Oxley Bill sets out the sections of the Act with extracts of key provisions

BILL SECTION	SELECTED NOTEWORTHY PROVISIONS	COMMENTS
TITLE I—PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD (PCAOB)	This title deals with a new oversight board for Auditors. This Board will *"oversee the audit of public companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports for companies the securities of which are sold to, and held by and for, public investors."*	This Title and its Sections 101 thru 109 affect Auditors and require them to become registered and provide the new PCAOB information about its practices and procedures.
Sec. 101. Establishment; administrative provisions.	The PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD is established.	
Sec. 102. Registration with the Board.	Every firm that audits a public company must register with this Board.	
Sec. 103. Auditing, quality control, and independence standards and rules.	*The Board shall…establish…such auditing and related attestation standards, such quality control standards, and such ethics standards to be used by… accounting firms in the preparation… of audit reports, as required by [law]… or as may be necessary or appropriate … for the protection of investors.* *The Board:* *(A) shall … require… that each … accounting firm shall* *(i) prepare, and maintain for …not less than 7 years, audit work papers, and other information related to any audit report, in sufficient detail to support the conclusions reached in such report;* *(ii) provide a concurring or second partner …approval of such audit report …, by a qualified person (as prescribed by the Board) associated with the …accounting firm, …or by an independent reviewer (as prescribed by the Board); and* *(iii) describe in each audit report the scope of the auditor's testing of the internal control structure and procedures of the issuer,… and* *present (in such report or in a separate report):* *(I) the findings of the auditor from such testing;* *(II) an evaluation of whether such internal control structure and procedures:* *(aa) include maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer;* *(bb) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer;*	The auditor workpaper retention aspects may affect our financial records retention schedule. The scope of the audit that the Audit Committee establishes with the auditor will be described in the auditor's report. The auditor's evaluation of the Company's internal controls will be included in the report.

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	and *(III) a description, at a minimum, of material weaknesses in such internal controls, and of any material noncompliance found on the basis of such testing.* *(B) shall include, in the quality control standards that it adopts with respect to the issuance of audit reports, requirements for every registered public accounting firm relating to:* *(i) monitoring of professional ethics and independence from issuers on behalf of which the firm issues audit reports;* *(ii) consultation within such firm on accounting and auditing questions;* *(iii) supervision of audit work;* *(iv) hiring, professional development, and advancement of personnel;* *(v) the acceptance and continuation of engagements;* *(vi) internal inspection; and* *(vii) such other requirements as the Board may prescribe….*	
Sec. 104. Inspections of registered public accounting firms.		
Sec. 105. Investigations and disciplinary proceedings.		
Sec. 106. Foreign public accounting firms.		
Sec. 107. Commission oversight of the Board.		
Sec. 108. Accounting standards.		
Sec. 109. Funding.		
TITLE II—AUDITOR INDEPENDENCE		
Sec. 201. Services outside the scope of practice of auditors.	*Except as… [allowed under a PCAO Board waiver], it shall be unlawful for a[n]… accounting firm …that performs for any issuer any audit …, to provide to that issuer, contemporaneously with the audit, any non-audit service, including* *(1) bookkeeping or other services related to the accounting records or financial statements of the audit client;* *(2) financial information systems design and implementation;* *(3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports;* *(4) actuarial services;* *(5) internal audit outsourcing services;* *(6) management functions or human resources;* *(7) broker or dealer, investment adviser, or investment banking services;* *(8) legal services and expert services unrelated to the audit; and* *(9) any other service that the Board determines, by regulation, is impermissible.* *PREAPPROVAL REQUIRED FOR NON-AUDIT SERVICES. A[n]… accounting firm may engage in any non-audit service,*	Nine categories of services that an auditor is barred from providing. Other services not named in the nine above must be approved in advance by the Audit Committee.

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	including tax services, that is ***not*** *described in any of paragraphs (1) through (9) [above]…for an audit client, only if the activity is approved in advance by the audit committee of the issuer….*	
Sec. 202. Preapproval requirements.	*AUDIT COMMITTEE ACTION.—All auditing services (which may entail providing comfort letters in connection with securities underwritings or statutory audits required for insurance companies for purposes of State law) and non-audit services, other than as provided in subparagraph (B), provided to an issuer by the auditor of the issuer shall be preapproved by the audit committee of the issuer.* *DE MINIMUS EXCEPTION.—The preapproval requirement … is waived with respect to the provision of non-audit services for an issuer, if:* *''(i) the aggregate amount of all such non-audit services …constitutes not more than 5 percent of the total amount of revenues paid by the issuer to its auditor during the fiscal year…;* *''(ii) such services were not recognized by the issuer at the time of the engagement to be non-audit services; and* *''(iii) such services are promptly brought to the attention of the audit committee … and approved prior to the completion of the audit by the audit committee or by 1 or more members of the audit committee …to whom authority to grant such approvals has been delegated by the audit committee.* *DISCLOSURE TO INVESTORS.—Approval by an audit committee …of a non-audit service to be performed by the auditor … shall be disclosed to investors in periodic reports [to the SEC]…* *DELEGATION AUTHORITY.—The audit committee of an issuer may delegate to 1 or more … members of the audit committee who are independent directors …, the authority to grant preapprovals required by this subsection.* *The decisions of any member to whom authority is delegated under this paragraph … shall be presented to the full audit committee at each of its scheduled meetings.*	Preapproval of allowed auditor services by Audit Committee. Process to exempt services costing up to 5% of the audit fee. Disclosure is required.
Sec. 203. Audit partner rotation.	5 year limit on responsible partner.	
Sec. 204. Auditor reports to audit committees.	*Each… accounting firm …shall timely report to the audit committee …* *(1) all critical accounting policies and practices to be used;* *(2) all alternative treatments of financial information within [GAAP] that have been discussed with management …, ramifications of the use of such alternative[s]…, and the treatment preferred by the … accounting firm; and* *(3) other material written communications between the … accounting firm and … management …, such as any management letter or schedule of unadjusted differences.*	Mandatory audit/or discussion with Audit Committee.
Sec. 205. Conforming amendments.		
Sec. 206. Conflicts of interest.	*It [is] unlawful for a … accounting firm to perform for an issuer any audit service …, if a chief executive officer, controller, chief financial officer, chief accounting officer… for the issuer, was employed by that … accounting firm and participated in any capacity in the audit of that*	"Revolving door" bar.

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	issuer during the 1-year period preceding the date of the initiation of the audit.	
Sec. 207. Study of mandatory rotation of registered public accounting firms.	One year for study and report to Congress on this concept.	
Sec. 208. Commission authority.		
Sec. 209. Considerations by appropriate State regulatory authorities.		
TITLE III—CORPORATE RESPONSIBILITY		
Sec. 301. Public company audit committees.	*The audit committee of each issuer, in its capacity as a committee of the board of directors, shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related work, and each such registered public accounting firm shall report directly to the audit committee.* *Each member of the audit committee … shall be a member of the board of directors …, and shall otherwise be independent. [T]o be considered … independent for purposes of this paragraph, a member of an audit committee … may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee—* *(i) accept any consulting, advisory, or other compensatory fee from the issuer; or* *''(ii) be an affiliated person of the issuer or any subsidiary thereof.* *The Commission may exempt from the requirements of [the preceding] subparagraph a particular relationship with respect to audit committee members, as the Commission determines appropriate in light of the circumstances.* *COMPLAINTS.—Each audit committee shall establish procedures for—* *(A) the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and* *(B) the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.* *AUTHORITY TO ENGAGE ADVISERS.—Each audit committee shall have the authority to engage independent counsel and other advisers, as it determines* *necessary to carry out its duties.* *FUNDING.—Each issuer shall provide for appropriate funding, as determined by the audit committee, in its capacity as a committee of the board of directors, for payment of compensation—* *(A) to the registered public accounting firm employed by the issuer for*	Audit Committee must appoint auditors. The full board can ratify the choice. Audit Committee members must be independent. This duplicates the existing NYSE requirement, with specific exclusions for consulting, etc. fees. We must assess our complaint and confidential reporting systems. A special Policy may be warranted.

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	the purpose of rendering or issuing an audit report; and *(B) to any advisers employed by the audit committee …*	
Sec. 302. Corporate responsibility for financial reports.	*[E]ffective not later than 30 days after the date of enactment of this Act.…[T]he principal executive officer … and the principal financial officer …[shall] certify in each annual or quarterly report filed …that:* *(1) the signing officer has reviewed the report;* *(2) based on the officer's 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;* *(3) based on such officer's knowledge, the financial statements, and other financial 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;* *(4) the signing officers:* *(A) are responsible for establishing and maintaining internal controls;* *(B) 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;* *(C) have evaluated the effectiveness of the issuer's internal controls as of a date within 90 days prior to the report; and* *(D) have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date;* *(5) the signing officers have disclosed to the issuer's auditors and the audit committee of the board of directors (or persons fulfilling the equivalent function):* *(A) 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* *(B) 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) 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.*	"Based on such officer's knowledge" is a clearer, better standard than SEC's proposed "to the knowledge" The CEO and CFO must evaluate effectiveness of internal controls every quarter. Each 10-K and 10-Q must include CEO and CFO conclusions about internal controls and explain any significant changes. Every fraud, no matter how small, by these employees must be disclosed by CEO and CFO to auditors and Audit Committee.
Sec. 303. Improper influence on conduct of audits.	*It [is] unlawful…for any officer or director of an issuer, or any other person acting under the[ir] direction…, to take any action to fraudulently influence, coerce, manipulate, or mislead any independent public or certified accountant engaged in the performance of an audit*	

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	of the financial statements of that issuer for the purpose of rendering such financial statements materially misleading.	
Sec. 304. Forfeiture of certain bonuses and profits.	*If an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws, the CEO and CFO of the issuer shall reimburse the issuer for:* *(1) any bonus or other incentive-based or equity based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the SEC (whichever first occurs) of the financial document embodying such financial reporting requirement; and* *(2) any profits realized from the sale of securities of the issuer during that 12-month period.* *The SEC may exempt any person from the application of [the above] subsection …as it deems necessary and appropriate.*	
Sec. 305. Officer and director bars and penalties.	Ban on future service as executive of public company for bad conduct.	
Sec. 306. Insider trades during pension fund blackout periods.	*[I]t [is] unlawful for any director or executive officer of an issuer…, directly or indirectly, to purchase, sell, or otherwise acquire or transfer any equity security of the issuer …during any blackout period with respect to such equity security if such director or officer acquires such equity security in connection with his or her service or employment as a director or executive officer.* The law goes on to clarify what types of “blackouts” are covered, prescribe rules for notifying benefit plan participants about the details of blackout periods, sanctions for executives who violate the ban, and otherwise clarify applicability of this provision. This becomes effective 180 days after enactment.	
Sec. 307. Rules of professional responsibility for attorneys.	*Not later than 180 days after the date of enactment of this Act, the Commission shall issue rules, in the public interest and for the protection of investors, setting forth minimum standards of professional conduct <u>for attorneys appearing and practicing before the Commission in any way in the representation of issuers</u>, including a rule:* *(1) requiring an attorney to report evidence of a <u>material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof</u>, to the chief legal counsel or the chief executive officer of the company…; and* *(2) if the counsel or officer does not <u>appropriately respond</u> 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 of the issuer or to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the issuer, or to the board of directors.* <u>[emphasis added]</u>	We should consider whether we need a special procedure on this. Exactly which inside attorneys does this apply to? Who decides what is “material”? Who decides what is an appropriate response?
Sec. 308. Fair funds	This is a palliative that will be of little beneficial effect despite its	

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for investors.	politically popularity. "Disgorgement" from and penalties paid by wrongdoing directors and executives will be put in a fund to reimburse injured shareholders. It creates a handy pot of cash for tort lawyers, but will rarely provide sufficient compensation to injured investors.	
TITLE IV—ENHANCED FINANCIAL DISCLOSURES		
Sec. 401. Disclosures in periodic reports.	*Each financial report that contains financial statements, and that is required to be prepared in accordance with (or reconciled to) [GAAP] … and filed with the SEC shall reflect all material correcting adjustments that have been identified by a registered public accounting firm in accordance with [GAAP] and the rules … of the SEC.* *OFF-BALANCE SHEET TRANSACTIONS.—Not later than 180 days after …enactment …, the SEC shall issue final rules providing that each annual and quarterly financial report required to be filed … shall disclose all material off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of the issuer with unconsolidated entities or other persons, that may have a material current or future effect on financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenues or expenses.* *PRO FORMA FIGURES.— Not later than 180 days after… enactment…, the SEC shall issue final rules providing that pro forma financial information included in any periodic or other report filed with the SEC pursuant to the securities laws, or in any public disclosure or press or other release, shall be presented in a manner that—* *(1) does not contain an untrue statement of a material fact or omit to state a material fact necessary in order to make the pro forma financial information, in light of the circumstances under which it is presented, not misleading; and* *(2) reconciles it with the financial condition and results of operations of the issuer under generally accepted accounting principles.* *STUDY AND REPORT ON SPECIAL PURPOSE ENTITIES…. The SEC shall, not later than 1 year after the effective date of adoption of off-balance sheet disclosure rules… as added by this section, complete a study of filings by issuers and their disclosures to determine—* *(A) the extent of off-balance sheet transactions, including assets, liabilities, leases, losses, and the use of special purpose entities; and* *(B) whether generally accepted accounting rules result in financial statements of issuers reflecting the economics of such off-balance sheet transactions to investors in a transparent fashion.* *Not later than 6 months after the date of completion of the study required by paragraph [above], the SEC shall submit a report to the President, [and Congress]…, setting forth:* *(A) the amount or an estimate of the amount of off-balance sheet transactions, including assets, liabilities, leases, and losses of, and*	

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	the use of special purpose entities by, issuers filing periodic [with the SEC]; *(B) the extent to which special purpose entities are used to facilitate off-balance sheet transactions;* *(C) whether [GAAP] or the rules of the SEC result in financial statements of issuers reflecting the economics of such transactions to investors in a transparent fashion;* *(D) whether [GAAP] specifically result in the consolidation of special purpose entities sponsored by an issuer in cases in which the issuer has the majority of the risks and rewards of the special purpose entity; and* *(E) any recommendations of the SEC for improving the transparency and quality of reporting off-balance sheet transactions in the financial statements and disclosures required to be filed by an issuer with the SEC.*	
Sec. 402. Enhanced conflict of interest provisions.	*PROHIBITION ON PERSONAL LOANS TO EXECUTIVES.* *(1)…It shall be unlawful for any [SEC filing company], directly or indirectly, including through any subsidiary, to extend or maintain credit, to arrange for the extension of credit, or to renew an extension of credit, in the form of a personal loan to or for any director or executive officer … of that [company]. An extension of credit maintained by the [company] on the date of enactment of this [law] shall not be subject to the[se] provisions …, provided that there is no material modification to any term of any such extension of credit or any renewal thereof … on or after that date of enactment.* *(2) LIMITATION.—Paragraph (1) does not preclude any home improvement and manufactured home loans…, consumer credit …, or any extension of credit under an open end credit plan …, or a charge card …, or any extension of credit by a broker or dealer …to an employee of that broker or dealer to buy, trade, or carry securities, that is permitted under rules … of the … Federal Reserve System …(other than an extension of credit that would be used to purchase the stock of that issuer), that is—* *''(A) made or provided in the ordinary course of the consumer credit business of such issuer;* *''(B) of a type that is generally made available by such issuer to the public; and* *''(C) made by such issuer on market terms, or terms that are no more favorable than those offered by the issuer to the general public for such extensions of credit.*	This appears to bar relocation loans as well as virtually all other loans to executive officers.
Sec. 403. Disclosures of transactions involving management and principal stockholders.	The following provisions apply 30 days after the law becomes effective: *TIME OF FILING.—The [Form 3 or 4] statements [of beneficial ownership required to be filed [with the SEC] by officers and directors and 10% shareholders] shall be filed—* *''(A) at the time of the registration of such security on a national securities exchange or by the effective date of a registration statement filed [with the SEC];* *(B) within 10 days after he or she becomes such beneficial owner, director, or officer;* *(C) if there has been a change in such ownership, or if such person shall have purchased or sold a security-based swap agreement … involving such equity security,* ***before the end of the second business day following the day on which the subject transaction has been***	By the end of August, we need to start filing Form 4s with the SEC within 2 days of an officer or director stock transaction. To comply, we need to consider requiring regular pre-clearance by Legal of all proposed transactions.

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	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.* *CONTENTS OF STATEMENTS.— A [Form 4] filed …shall indicate ownership by the filing person at the date of filing, any such changes in such ownership, and such purchases and sales of the security-based swap agreements as have occurred since the most recent such filing under such subparagraph.* *ELECTRONIC FILING AND AVAILABILITY.— Beginning not later than 1 year after the date of enactment of [this law]:* *(A) [Form 4] statements [showing changes in ownership] [not including Form 3] shall be filed electronically;* *(B) the SEC shall provide each such statement on a publicly accessible Internet site not later than the end of the business day following that filing; and* *(C) the issuer (if the issuer maintains a corporate website) shall provide that statement on that corporate website, not later than the end of the business day following that filing.''.*	Securities swap contracts now have to be reported.
Sec. 404. Management assessment of internal controls.	*(a) RULES REQUIRED.—The Commission shall prescribe rules requiring each [10-K] report … 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.* *(b) INTERNAL CONTROL EVALUATION AND REPORTING. —…[E]ach … accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the PCAOBoard. Any such attestation shall not be the subject of a separate engagement.*	New requirement for 10-K's.
Sec. 405. Exemption.	Investment company exemption.	
Sec. 406. Code of ethics for senior financial officers.	*(a) CODE OF ETHICS DISCLOSURE.—The SEC shall issue rules[within 180 days] to require each issuer, together with [10-K, 10-Q and 8-K] periodic reports …, to disclose whether or not, and if not, the reason therefor, such issuer has adopted a code of ethics for senior financial officers, applicable to its principal financial officer and comptroller or principal accounting officer…* *(b) CHANGES IN CODES OF ETHICS.—The SEC shall revise its regulations concerning matters requiring prompt disclosure on Form 8–K …to require the immediate disclosure, by means of the filing of such form, dissemination by the Internet or by other electronic means, by any issuer of any change in or waiver of the code of ethics for senior financial officers.* *(c) DEFINITION.—In this section, the term ''code of ethics'' means such standards as are reasonably necessary to promote—* *(1) honest and ethical conduct, including the ethical handling of*	We should assess whether our Code of Conduct and related policies meet this standard. Consider possible ramifications.

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	actual or apparent conflicts of interest between personal and professional relationships; *(2) full, fair, accurate, timely, and understandable disclosure in the periodic reports required to be filed by the issuer; and* *(3) compliance with applicable governmental rules and regulations.*	
Sec. 407. Disclosure of audit committee financial expert.	*(a) FINANCIAL EXPERT—The Commission shall issue rules [within 180 days],… to require each issuer, together with [10-K, 10-Q and 8-K] periodic reports …, to disclose whether or not, and if not, the reasons therefor, the audit committee of that issuer is comprised of at least 1 member who is a financial expert, as such term is defined by the Commission.* *(b) In defining the term ''financial expert'' …, the Commission shall 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:* *(1) an understanding of [GAAP] and financial statements;* *(2) experience in:* *(A) the preparation or auditing of financial statements of generally comparable issuers; and* *(B) the application of such principles in connection with the accounting for estimates, accruals, and reserves;* *(3) experience with internal accounting controls; and* *(4) an understanding of audit committee functions.*	This merely duplicates the NYSE's existing requirement.
Sec. 408. Enhanced review of periodic disclosures by issuers.	*(a) REGULAR AND SYSTEMATIC REVIEW.—The SEC shall review disclosures made by issuers reporting under section 13(a) of the Exchange Act (including reports filed on Form 10–K), …, on a regular and systematic basis for the protection of investors. Such review shall include a review of an issuer's financial statement.* *(b) REVIEW CRITERIA.—For purposes of scheduling the reviews required by subsection (a), the SEC shall consider, among other factors—* *(1) issuers that have issued material restatements of financial results;* *(2) issuers that experience significant volatility in their stock price as compared to other issuers;* *(3) issuers with the largest market capitalization;* *(4) emerging companies with disparities in price to earning ratios;* *(5) issuers whose operations significantly affect any material sector of the economy; and* *(6) any other factors that the Commission may consider relevant.* *(c) MINIMUM REVIEW PERIOD.—In no event shall an issuer …be reviewed … less frequently than once every 3 years.*	An SEC review at least every 3 years is now required.
Sec. 409. Real time issuer disclosures.	*REAL TIME ISSUER DISCLOSURES.—Each [public company] … shall disclose to the public on a rapid and current basis such additional information concerning material changes in the financial condition or operations of the [company], in plain English, which may include trend and qualitative information and graphic presentations, as the SEC determines, by rule, is necessary or useful for the protection of investors and in the public interest.*	This is a worrisome new requirement. Among other things, it will require us to fret about when aberrant operational results have become a "trend", and could affect how often we assess contingent liabilities. We will have to gear up for rapid disclosure drafting and

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		approval.
TITLE V—ANALYST CONFLICTS OF INTEREST		
Sec. 501. Treatment of securities analysts by registered securities associations and national securities exchanges.	Requires disclosure of analyst conflicts, protects analysts from retribution for negative comments about a firm client and sets enforcement procedures.	
TITLE VI—COMMISSION RESOURCES AND AUTHORITY		
Sec. 601. Authorization of appropriations.	Provides increased SEC funding.	
Sec. 602. Appearance and practice before the Commission.	Allows the SEC to censure people who practice before it.	
Sec. 603. Federal court authority to impose penny stock bars.		
Sec. 604. Qualifications of associated persons of brokers and dealers.		
TITLE VII—STUDIES AND REPORTS	Congress directs various government agencies to study and report on several issues involved in recent corporate scandals because Congress can't figure out what to do about them yet.	
Sec. 701. GAO study and report regarding consolidation of public accounting firms.		
Sec. 702. Commission study and report regarding credit rating agencies.		
Sec. 703. Study and report on violators and violations		
Sec. 704. Study of enforcement actions.		
Sec. 705. Study of investment banks.		
TITLE VIII—CORPORATE AND CRIMINAL FRAUD ACCOUNTABILITY		
Sec. 801. Short title.	*The ''Corporate and Criminal Fraud Accountability Act of 2002''.*	

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Sec. 802. Criminal penalties for altering documents.	***Destruction, alteration, or falsification of records in Federal investigations and bankruptcy --*** *Whoever knowingly alters, destroys, mutilates, conceals, covers up, falsifies, or makes a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States or any case filed under title 11, or in relation to or contemplation of any such matter or case, shall be fined under this title, imprisoned not more than 20 years, or both.* Auditors must *"maintain all audit or review workpapers for a period of 5 years from the end of the fiscal period in which the audit or review was concluded."* [The rule against destroying otherwise outdated records pertinent to ongoing or threatened litigation also applies.] *The SEC shall promulgate, within 180 days,… rules … as are reasonably necessary, relating to the retention of relevant records such as workpapers, documents that form the basis of an audit or review, memoranda, correspondence, communications, other documents, and records (including electronic records) which are created, sent, or received in connection with an audit or review and contain conclusions, opinions, analyses, or financial data relating to such an audit or review….* 10 year jail term and fines for violations.	We should consider what this means for our own financial records retention periods. Will "drafts" be covered? We will want to be especially diligent about being professional in all e-mails to Auditors.
Sec. 803. Debts nondischargeable if incurred in violation of securities fraud laws.	A settlement, judgment or order for any damages, fine, penalty, citation, restitutionary payment, disgorgement payment, attorney fee, cost, or other payment for violation of any of the Federal securities laws, any of the State securities laws, or any regulation or order issued under such Federal or State securities laws; or for common law fraud, deceit, or manipulation in connection with the purchase or sale of any security is not dischargeable in bankruptcy.	
Sec. 804. Statute of limitations for securities fraud.	For all proceedings commenced on or after the date of enactment of this Act, the statute of limitations is extended until the earlier of: 2 years after the discovery of the facts constituting the violation; or 5 years after such violation.	We should consider what this means to our records retention schedules.
Sec. 805. Review of Federal Sentencing Guidelines for obstruction of justice and extensive criminal fraud.	Federal Sentencing Commission is directed to look at its sentencing guidelines to stiffen penalties for corporate crimes.	
Sec. 806. Protection for employees of publicly traded companies who provide evidence of fraud.	*WHISTLEBLOWER PROTECTION FOR EMPLOYEES OF PUBLIC COMPANIES.—No [public] company …, or any officer, employee, contractor, subcontractor, or agent of such company, may discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee in the terms and conditions of employment because of any lawful act done by the employee:* *(1) to provide information…, or otherwise assist in an investigation regarding any conduct which the*	

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	employee reasonably believes constitutes a violation of section 1341, 1343, 1344, or 1348, any rule …of the SEC, or any provision of Federal law relating to fraud against shareholders, when the information or assistance is provided to or the investigation is conducted by: *(A) a Federal regulatory or law enforcement agency;* *(B) any Member of Congress or any committee of Congress; or* *(C) a person with supervisory authority over the employee (or such other person working for the employer who has the authority to investigate, discover, or terminate misconduct); or* *(2) to file, cause to be filed, testify, participate in, or otherwise assist in a proceeding filed or about to be filed (with any knowledge of the employer) relating to an alleged violation of section 1341, 1343, 1344, or 1348, any rule …of the SEC, or any provision of Federal law relating to fraud against shareholders.* Violations can be redressed through Labor Dep't or civil action.	
Sec. 807. Criminal penalties for defrauding shareholders of publicly traded companies.	*Whoever knowingly executes, or attempts to execute, a scheme or artifice:* *(1) to defraud any person in connection with any security of a [public company]; or* *(2) to obtain, by means of false or fraudulent pretenses, representations, or promises, any money or property in connection with the purchase or sale of any security of [a public company];* *shall be fined…, or imprisoned not more than 25 years, or both.*	
TITLE IX—WHITE-COLLAR CRIME PENALTY ENHANCEMENTS		
Sec. 901. Short title.	*The ''White-Collar Crime Penalty Enhancement Act of 2002''*	
Sec. 902. Attempts and conspiracies to commit criminal fraud offenses.	*Any person who attempts or conspires to commit any offense under this chapter shall be subject to the same penalties as those prescribed for the offense, the commission of which was the object of the attempt or conspiracy.*	
Sec. 903. Criminal penalties for mail and wire fraud.	*Mail and Wire Fraud penalties increased from 5 to 20 years.*	
Sec. 904. Criminal penalties for violations of the Employee Retirement Income Security Act of 1974.	Increases penalties to up to 10 years' prison and $500,000 fine.	
Sec. 905. Amendment to sentencing guidelines relating to certain white-collar offenses.	Federal Sentencing Commission is directed to look at its sentencing guidelines to stiffen penalties for white-collar crimes.	

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Sec. 906. Corporate responsibility for financial reports.	*Each periodic report containing financial statements filed by an issuer with the SEC shall be accompanied by a written statement by the CEO and CFO. The statement … shall certify that the periodic report containing the financial statements fully complies with the requirements of … the Exchange Act …, and that information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer.* *Whoever:* *(1) certifies any statement as set forth above knowing that the periodic report accompanying the statement does not comport with all the requirements set forth in this section shall be fined not more than $1,000,000 or imprisoned not more than 10 years, or both; or* *(2) willfully certifies any statement as set forth in subsections (a) and (b) of this section knowing that the periodic report accompanying the statement does not comport with all the requirements set forth in this section shall be fined not more than $5,000,000, or imprisoned not more than 20 years, or both.*	
TITLE X—CORPORATE TAX RETURNS		
Sec. 1001. Sense of the Senate regarding the signing of corporate tax returns by chief executive officers.	*It is the sense of the Senate that the Federal income tax return of a corporation should be signed by the chief executive officer of such corporation.* This has no binding effect.	
TITLE XI—CORPORATE FRAUD AND ACCOUNTABILITY		
Sec. 1101. Short title.	*The ''Corporate Fraud Accountability Act of 2002''*	
Sec. 1102. Tampering with a record or otherwise impeding an official proceeding.	*Whoever corruptly—* *(1) alters, destroys, mutilates, or conceals a record, document, or other object, or attempts to do so, with the intent to impair the object's integrity or availability for use in an official proceeding; or* *(2) otherwise obstructs, influences, or impedes any official proceeding, or attempts to do so, shall be fined under this title or imprisoned not more than 20 years, or both.*	
Sec. 1103. Temporary freeze authority for the Securities and Exchange Commission.	*Whenever, during the course of a lawful investigation involving possible violations of the Federal securities laws by an issuer of publicly traded securities or any of its directors, officers, partners, controlling persons, agents, or employees, it shall appear to the Commission that it is likely that the issuer will make extraordinary payments (whether compensation or otherwise) to any of the foregoing persons, the Commission may petition a Federal district court for a temporary order requiring the issuer to escrow, subject to court supervision, those payments in an interest-bearing account for 45 days.*	

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	A temporary order shall be entered … only after notice and opportunity for a hearing, unless the court determines that notice and hearing prior to entry of the order would be impracticable or contrary to the public interest. *A temporary order … shall:* *(I) become effective immediately;* *(II) be served upon the parties subject to it; and* *(III) unless set aside, limited or suspended by a court of competent jurisdiction, shall remain effective and enforceable for 45 days.* *The effective period of an order …may be extended by the court upon good cause shown for not longer than 45 additional days, provided that the combined period of the order shall not exceed 90 days.*	
Sec. 1104. Amendment to the Federal Sentencing Guidelines.	*The Sentencing Commission is requested to review and strengthen penalties for corporate fraud.*	
Sec. 1105. Authority of the Commission to prohibit persons from serving as officers or directors.	*The SEC may issue an order in any cease-and-desist proceeding to prohibit, …for such period of time as it shall determine, any person who has violated [the antifraud section of the Securities Act], from acting as an officer or director of any [public company], if the conduct of that person demonstrates unfitness to serve as an officer or director of any such issuer.''.* *The SEC may issue an order in any cease-and-desist proceeding to prohibit, …for such period of time as it shall determine, any person who has violated section 17(a)(1) or the rules or regulations thereunder, from acting as an officer or director of any [public company] if the conduct of that person demonstrates unfitness to serve as an officer or director of any such issuer.*	
Sec. 1106. Increased criminal penalties under Securities Exchange Act of 1934.	*Penalties increased from $1,000,000, or 10 years' prison to $25,000,000, or 20 years' prison.*	
Sec. 1107. Retaliation against informants	*Whoever 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, shall be fined under this title or imprisoned not more than 10 years, or both.*	

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MEMORANDUM

To: **Our Public Company Clients** **August 9, 2002**

From: **Luse Gorman Pomerenk & Schick, P.C.**

Re: **The Sarbanes-Oxley Act of 2002**
Corporate Governance, Accounting and Corporate Reporting Reform Legislation

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On July 30, 2002 President Bush signed into law the Sarbanes-Oxley Act of 2002 (the "Act"), which imposes significant new obligations, restrictions and responsibilities on public companies and their executive officers, directors and independent auditors. As a general matter, the Act applies to any company (a "Public Company") that has equity or debt securities registered with the Securities and Exchange Commission (the "SEC") under the Securities Exchange Act of 1934 (the "Exchange Act"). Many provisions of the Act are directed in particular to the chief executive officer (the "CEO"), the chief financial officer (the "CFO") and the audit committee. Certain provisions of the Act are effective immediately (e.g., the prohibition on loans to directors and executive officers), while others will become effective (over a period of 30 to 270 days). The Act imposes new civil and criminal penalties for violations of the federal securities laws. Every Public Company should give immediate attention to compliance with its provisions.

One consequence of the Act is the establishment of a Public Company Accounting Oversight Board (the "Oversight Board") to regulate, examine and when appropriate sanction, accounting firms that audit the financial statements of a Public Company. An accounting firm will have to be registered with the Oversight Board, and therefore will be subject to its supervision, in order to audit, or participate in the audit of, a Public Company's financial statements. The Oversight Board will be funded by assessments levied on all Public Companies on the basis of relative market capitalization. The Oversight Board is required to be functioning by April 26, 2003 and will be subject to SEC oversight.

This memorandum summarizes the provisions of the Act that we believe are most likely to impact a Public Company and its executive officers and directors. This memorandum is not a complete description of the Act and does not constitute legal advice applicable to any particular situation. There are numerous exceptions to the provisions of the Act described below, and the SEC regulations that will be issued to implement the Act may significantly affect their application. Finally, there are new corporate governance rules recently adopted or proposed by the securities exchanges (the NYSE, Amex and Nasdaq – referred to as the "Exchanges") that will supplement and enhance certain provisions of the Act.

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Executive Summary

The Act establishes: (i) new requirements for audit committees, including independence, expertise, and responsibilities; (ii) additional responsibilities regarding financial statements for the CEO and CFO of Public Companies; (iii) new standards for auditor independence and regulation of audits; (iv) increased disclosure and reporting obligations for Public Companies and their directors and executive officers; and (v) new and increased civil and criminal penalties for violations of securities laws. Highlights of the Act include the following:

1. **Audit Committees.**

   Independence – Each member of the audit committee must be unaffiliated with the Public Company and no audit committee member may receive compensation from the Public Company other than for service as a director.

   Expertise – Public Companies will be required to disclose in their annual and quarterly reports whether or not the audit committee includes at least one member who is a "financial expert" (and if not, the reasons).

   Responsibilities – Audit committees are responsible for the appointment and compensation of the Public Company's auditor and for the oversight of the work of the auditor in preparing or issuing any audit report (and related work).

   Complaints – Audit committees must establish procedures for handling complaints regarding accounting and internal controls.

2. **CEO/CFO Certification.** CEOs and CFOs must certify to the correctness and completeness of annual and quarterly reports and to their responsibility for and evaluation of internal controls. A CEO/CFO certification is required for all periodic reports filed after July 30, 2002, *including the quarterly report on Form 10-Q for the quarter ended June 30, 2002, which must be filed with the SEC by August 14, 2002*.

3. **Forfeiture by CEO/CFO of Certain Bonuses and Profits.** CEOs and CFOs must disgorge incentive pay and stock profits (received during the 12 months following the first issuance or filing of the financial statements subsequently restated) if a Public Company restates its financial statements due to material non-compliance by the Public Company, as a result of misconduct.

4. **Code of Ethics.** A Public Company must adopt a code of ethics for senior financial officers and publicly disclose waivers of and changes to the code.

5. **Loans to Insiders.** Personal loans by a Public Company to its directors or executive officers are prohibited, other than certain customary consumer lending transactions, and in the case of insured depository institutions, loans permitted

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under Section 22(h) of the Federal Reserve Act. Existing loans can continue without material revision but cannot be renewed.

6. **Beneficial Ownership Reports.** Reports of changes in beneficial ownership (Forms 4) must be filed within two business days of a transaction. By July 30, 2003, all Forms 4 and 5 must be filed electronically and if the Public Company maintains a website, they must be available on the website by the end of the business day after filing.

7. **Trading During Blackout Periods.** Trading by directors and executive officers during any blackout period applicable to an employee stock benefit plan is prohibited.

8. **Auditor Independence.** New standards for determining auditor independence are established and accounting firms are prohibited form providing many of the non-audit services (other than tax services) that they in the past have provided. Audit partners must rotate off an audit engagement at least every five years.

9. **Public Company Accounting Oversight Board.** A Public Accounting Oversight Board is created to regulate accounting firms in providing audit services to Public Companies.

10. **SEC Authority Over GAAP.** The SEC has been granted greater authority to determine what constitutes GAAP.

11. **Accuracy of Financial Reports.** All financial reports filed with the SEC must reflect all material correcting adjustments identified by the Public Company's independent auditor.

12. **Enhanced Review of SEC Rulings.** More frequent SEC reviews of Public Company reporting is required.

13. **Extension of Statute of Limitations.** The statute of limitations for securities laws violations is extended to the earlier of two years after discovery of facts giving rise to the claim, or five years after the violation.

14. **Enhanced SEC Enforcement Authority.** The SEC has the authority to ban persons from serving as directors and officers of a Public Company and, in the course of investigating securities laws violations, to freeze "extraordinary payments" that appear likely to be made to officers or directors of a Public Company.

15. **Criminal Penalties.** A "knowing" violation of the CEO/CFO certification is subject to a fine of up to $1,000,000 or imprisonment of 10 years, or both. A "willful" violation is subject to a fine of up to $5,000,000 or imprisonment for 20 years, or both.

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Detailed Summary and Analysis

I. Provisions of the Act Relating to the Audit Committee and Auditors

A. Audit Committee Listing Requirements.

A. Audit Committee Listing Requirements. *By April 26, 2003*, the SEC must promulgate rules directing the Exchanges to prohibit the listing of any security of an issuer that does not comply with the requirements set forth in 1 - 3 below.

1. **Composition.** Each member of the audit committee must be an independent director. No director will be considered independent if he has accepted any consulting, advisory or compensatory fee from the Public Company (other than in his or her capacity as a director) or is an affiliated person of the company or any subsidiary. Although not defined in the Act, an affiliated person is likely to include executive officers, directors, and controlling shareholders.

2. **Procedures for Complaints Regarding Accounting Related Matters.** The audit committee must establish procedures for the receipt, retention and treatment of complaints received by the Public Company regarding accounting and auditing matters, as well as for the confidential submission by employees of concerns regarding questionable accounting or auditing matters. In a related provision, the Act prohibits a Public Company from discharging, demoting or otherwise discriminating against any employee who lawfully provides information regarding conduct reasonably believed by such employee to constitute a violation of the securities or financial fraud laws (the "whistle blower protection" provisions). Criminal and civil remedies are available for violations of the whistle blower protection provisions.

3. **Responsibilities, Authority and Funding.** The audit committee must have the exclusive authority to appoint, *compensate* and oversee the work of the independent auditing firm, which must report directly to the audit committee. The audit committee must have the authority to engage additional advisors as it deems necessary, and a Public Company must provide such funding *as determined necessary by the audit committee* to provide for the compensation of the auditing firm and any other advisors employed by the audit committee.

B. Other Provisions Affecting the Audit Committee.

1. **Disclosure of Financial Expert.** *By January 26, 2003*, the SEC must adopt rules requiring Public Companies to disclose in their periodic reports whether or not (and if not, why not) the audit committee is comprised of at least one member who is a "financial expert." In defining the term "financial expert," the SEC must consider whether the person has, through education and experience as a public accountant or auditor, or as a principal accounting or financial officer or controller of a Public Company: an understanding of GAAP and financial statements; experience in the preparation of financial statements of comparable companies and in the application of such principles in connection with accounting

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for estimates, accruals, and reserves; experience with internal accounting controls; and an understanding of audit committee functions.

2. **Approval of Audit and Non-Audit Services.** All audit services (including comfort letters and statutory audits) must be pre-approved by the audit committee. The Act enumerates nine categories of services that (*beginning 180 days* after commencement of the operation of the Oversight Board) cannot be provided by the auditor, including: financial information systems design and implementation; internal audit outsourcing; appraisal or valuation services, fairness opinions, and contribution in kind reports; management functions or human resources; bookkeeping; broker or dealer or investment banking services; legal services unrelated to the audit; actuarial services; and services determined by the Oversight Board to be impermissible. All permissible non-audit services must be pre-approved by the audit committee (subject to a *de minimus* exception). The authority to approve audit and non-audit services may be delegated by the committee to one or more of its members, provided that any delegated approvals are reported to the full committee. All approvals of non-audit services must be disclosed in a Public Company's periodic reports. The SEC is required to adopt rules implementing this requirement *no later than January 26, 2003*.

C. **Auditor Independence.**

1. **Auditor Reports to the Audit Committee.** The auditor must timely report to the audit committee (i) all critical accounting policies and practices to be used, (ii) all alternative treatments of financial information within GAAP that have been discussed with management, the ramifications of the alternative treatments, and the treatment preferred by the auditor, and (iii) other material communications between the audit firm and management, such as a management letter or schedule of unadjusted differences.

2. **Audit Partner Rotation.** The lead (or coordinating) audit partner having primary responsibility for the audit, and the audit partner responsible for reviewing the audit, must rotate off the audit at least every five years. The Act also directs the Comptroller General (of the General Accounting Office) to study the effects of requiring the mandatory rotation of the independent auditing firm.

3. **Auditor Conflict of Interest.** An auditing firm is disqualified from performing audit services to a Public Company if the CEO, CFO, controller, chief accounting officer or persons serving in equivalent positions with the Public Company was employed by the audit firm and participated in any capacity in the audit of the company during the one year period preceding the date of initiation of the audit.

4. **SEC Rulemaking.** The SEC must adopt regulations regarding auditor independence (including B.2 above) *no later than January 26, 2003*, and no auditor can prepare or issue an audit report for a Public Company if the firm does not comply with the rules.

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D. Other Provisions of the Act Relating to the Audit Committee.

1. **Adoption of Code of Ethics for Senior Financial Officers.** *No later than January 26, 2003*, the SEC is required to adopt rules requiring each Public Company to disclose whether or not, and if not why not, it has adopted a code of ethics for senior financial officers, applicable to the principal financial officer and controller or principal accounting officer, and persons performing similar functions. The SEC rules must include a requirement for the public disclosure in the Form 8-K of any change in, or waiver of, the code of ethics. The code of ethics must include standards reasonably necessary to promote: honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interests between personal and professional relationships; fair, accurate, timely, and understandable disclosure in periodic reports; and compliance with applicable governmental rules and regulations.

2. **Management and Independent Auditor Assessment of Internal Controls.** The SEC is required to adopt rules requiring each annual report to contain an internal control report that: (i) states the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and (ii) contains an assessment, as of the end of the fiscal year, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting. The audit firm is required to attest to and report on the assessment made by management in the internal control report. The attestation is deemed part of the audit engagement.

3. **Internal Control Certification to the Audit Committee.** As part of the newly-imposed CEO and CFO certification (discussed below), and in connection with each annual and quarterly report, the Act requires the CEO and the CFO to certify to the auditor and the audit committee all significant deficiencies and material weaknesses in the design or operation of the internal controls, and any fraud, whether or not material, that involves management or other employees who have a significant role in the company's internal controls. The SEC is required to adopt rules implementing this provision *by August 29, 2002*.

4. **Improper Influence on the Conduct of Audits.** The SEC is required to adopt rules *no later than April 26, 2003*, making it unlawful for any officer or director of a Public Company, or any person acting under the direction thereof, to take any action to fraudulently influence, coerce, manipulate, or mislead any accountant engaged in the performance of an audit, for the purpose of rendering such financial statements materially misleading. The SEC is given exclusive authority to enforce this provision in civil proceedings.

5. **Reports by Attorneys of Violations and Breaches of Fiduciary Duty.** *No later than January 26, 2003*, the SEC is required to adopt rules setting forth minimum standards of professional conduct for attorneys appearing and practicing before the SEC, including a rule (i) requiring an attorney to report to the CEO or chief legal counsel any material violation of securities law or fiduciary duty, or a

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similar violation by the Public Company or any agent thereof, and (ii) if the counsel or CEO does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions), requiring the attorney to report the evidence to the audit committee or to the entire board.

E. Establishment of Public Accounting Oversight Board. A Public Company Accounting Oversight Board is created to regulate accounting firms in providing audit services for Public Companies. The SEC will appoint the members of the Oversight Board, will have oversight authority with respect to it, and must approve the standards adopted by it. Funding for the operations of the Oversight Board will be provided by an assessment on issuers and the accounting firms that audit Public Companies. Registration with the Oversight Board is required for accounting firms that prepare audit reports for Public Companies. In registering, accounting firms must also consent to comply with any request of the Oversight Board or the SEC for testimony or production of documents. The Oversight Board's functions include adopting standards for determining auditor independence and generally accepted auditing standards, establishing quality-control standards for audit firms, and conducting investigations of auditor misconduct and auditor disciplinary proceedings. The Oversight Board will have the authority to impose sanctions on registered public accounting firms and their professional employees.

F. SEC Authority Over GAAP. The Act also gives the SEC enhanced authority to determine what constitutes GAAP, on its own for SEC reporting purposes or based on activities of private self-regulatory standard-setting bodies, over which it is also given additional oversight powers. In addition, the Act requires that the operations of the Financial Accounting Standards Board (FASB) be funded by an assessment on Public Companies.

II. Corporate Responsibility and Enhanced Public Disclosures

A. Provisions Applicable to CEOs, CFOs, Executive Officers and Directors.

1. CEO and CFO Certifications. *By August 29, 2002*, the SEC must adopt regulations requiring the CEO and the CFO to certify in each annual and quarterly report that

(i) they have reviewed the report,

(ii) based on their 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 they were made, not misleading,

(iii) based on their knowledge, the financial statements and other financial information included in the report, fairly present in all material respects the financial condition and results of operations as of and for the periods presented,

(iv) they are responsible for establishing and maintaining internal controls, have designed the internal controls to ensure that material information is made known to them, have evaluated the effectiveness of the internal

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controls *within 90 days* prior to the report, and have presented in the report their conclusions about the effectiveness of the internal controls,

(v) they have disclosed to the auditors and the audit committee all significant deficiencies and material weaknesses in the design or operation of the internal controls, and any fraud, whether or not material, that involves management or other employees who have a significant role in the company's internal controls, and

(vi) they 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.

2. **Immediate Certification Requirement**. Despite the language in the Act requiring SEC rules *within 30 days* of enactment to require CEO and CFO certifications, the penalty provisions of the Act impose criminal penalties on a CEO and CFO if a periodic report is not accompanied by a certification that: (i) the report complies with the requirements of the securities laws, and (ii) fairly presents in all material respects the financial condition and results of operations of the company. This penalty provision is effective immediately. Accordingly, despite a likely intention to require certifications following SEC rulemaking, the Act appears to require that all periodic reports filed after enactment be accompanied by a CEO and a CFO certification, *including quarterly reports on Form 10-Q for the quarter ended June 30, 2002 that are required to be filed by August 14*.

3. **Prohibition on Loans to Executive Officers and Directors.** *Effective immediately* upon enactment, it is unlawful for a Public Company, directly or indirectly, to extend or maintain credit, to arrange for the extension of credit, or to renew an extension of credit, in the form of a personal loan to or for any director or executive officer. Loans in existence on the effective date are not prohibited, provided there is no material modification to any term or any renewal subsequent to enactment. Loans that are made in the ordinary course of business, of a type generally made available by the company to the public, and made on terms no more favorable than offered to the general public by the company, and are home improvement and certain consumer credit arrangements (e.g., credit card), are not prohibited. **Loans made by an insured depository institution in accordance with the provisions of Section 22(h) of the Federal Reserve Act are not prohibited.**

4. **CEO and CFO Disgorgement.** If a Public Company is required to prepare an accounting restatement (i.e., restate its financial statements) due to the material noncompliance by the Public Company, as a result of misconduct, with any financial reporting requirement under the securities laws, the CEO and CFO shall reimburse the company for any (i) bonus or other incentive-based or equity-based

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compensation received by the officer during the 12 month period following the first public issuance or filing with the SEC of the document that did not comply with the financial reporting requirement, and (ii) any profits realized from the sale of securities of the company during that 12 month period.

5. **Prohibition on Trading During "Blackout Period" Applicable to Employee Benefit Plans.** It will be unlawful for any director or executive officer of a Public Company to directly or indirectly purchase or sell an equity security of the company during a "blackout period." A "blackout period" is generally defined to include any period of three days or more during which at least 50% of the participants in a company's qualified employee stock benefit plan (e.g., a 401(k) plan) are subject to restrictions on trading company securities held for their account in such plan. This prohibition applies if the equity security was acquired or would be acquired in connection with such person's service as a director or executive officer. Any profit realized by a trade in violation of this prohibition is recoverable by the company, regardless of the officer's intent as to the trade, or if the company fails to bring an action, by a lawsuit that can be initiated by any stockholder of the company. *Unlike Section 16(b), a matching trade during the blackout period is not required in order for liability to arise.* The Public Company is required to timely notify executive officers and directors of any blackout period, and to provide plan participants thirty days advance notice of blackout periods. The provisions of the Act relating to blackout periods are *effective January 26, 2003*.

B. **Enhanced Disclosure Requirements.**

1. **Accelerated Filing of Reports of Changes in Beneficial Ownership.** *Effective August 29, 2002*, reports of changes in beneficial ownership reports (Forms 4) are required to be filed within two business days of the execution of the security transaction. (Currently a Form 4 must be filed within the first 10 days of the month immediately following the month in which the transaction occurs.) Within one year of the enactment of the Act, all Forms 4 and 5 must be filed electronically and must be available on the SEC's website, and if the company maintains a website, on the company's website, by the end of the business day after filing.

2. **Accuracy of Financial Reports.** Each financial report that contains financial statements prepared under GAAP and filed with the SEC under Section 13 of the Exchange Act must include all material correcting adjustments that have been identified by the "registered public accounting firm" (registered with the Oversight Board).

3. **Off-Balance Sheet Transactions.** *By January 26, 2003*, the SEC must adopt regulations requiring each quarterly and annual report to disclose all material off-balance sheet transactions, arrangements, obligations (including contingent obligations) and other relationships with unconsolidated entities or other persons that may have a material current or future effect on financial condition, changes in

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financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenues or expenses.

4. **Pro Forma Financial Information.** *By January 26, 2003*, the SEC must adopt rules regarding pro forma financial information included in any periodic report or in any public disclosure or press release, which rules shall require that any such pro forma information not contain any untrue statement of material fact or omit to state a material fact, and reconciles such information with the financial condition and results of operation reported under GAAP.

5. **Real Time Disclosure of Material Information.** The SEC is mandated to adopt rules requiring disclosure to the public, in plain English and on a rapid and current basis, information concerning material changes in the financial condition or operations of the company, including trend and qualitative information and graphic presentations.

6. **Mandated Review of Periodic Reports.** The SEC is required to review the reports filed by Public Companies that have a class of securities listed or traded on an Exchange, including in particular the annual report on Form 10-K, on a regular and systematic basis, and in no event less than once every three years.

III. Enforcement and Increased Penalties for Securities Laws Violations

A. SEC Enforcement and Securities Laws Violations.

1. **Officers and Directors May be Barred From Service.** The SEC is granted the authority in a cease-and-desist proceeding to prohibit any person who has violated the anti-fraud provisions of the federal securities laws from acting as an officer or director of a Public Company, if the conduct of that person demonstrates an "unfitness" to serve (before the Act, a bar required judicial action, and the standard was "substantial unfitness").

2. **Freeze of Assets.** If in the course of an investigation into possible violations of the federal securities laws it appears likely that a Public Company will make "extraordinary payments" to a director, officer, controlling person, agent or employee of the company, the SEC is authorized to seek a temporary order freezing such payments.

B. Criminal and Other Penalty Provisions.

1. **Statute of Limitations.** The Acts extends the statute of limitations for securities law fraud to the earlier of two years after the discovery of facts giving rise to the claim, or five years after the violation.

2. **Violation of CEO and CFO Certifications.** A knowing violation of the CEO or CFO certification requirement is subject to a fine of $1,000,000 or imprisonment for up to ten years, or both, while a willful violation is subject to a fine of $5,000,000 or imprisonment for up to 20 years, or both.

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3. **Securities Fraud.** Persons who commit fraud in connection with the securities of a Public Company can be fined or imprisoned for up to 25 years, or both.

4. **Audit Papers.** Auditors are required to maintain all audit or review workpapers for a period of five years following the end of the related fiscal period. SEC rules implementing the workpaper requirements must be adopted *by January 26, 2003*. A knowing and willful violation of the workpaper retention requirement is punishable by a fine or up to 10 years imprisonment, or both.

5. **Document Destruction.** Any person who knowingly destroys, falsifies or alters corporate documents with the intent to impede, obstruct or influence an investigation by a U.S. government agency or department is subject to a fine or up to 20 years imprisonment, or both.

6. **Bankruptcy.** Debts relating to fines and penalties for violations of the federal or state securities laws are not dischargeable in bankruptcy.

Please do not hesitate to contact any of the following attorneys with questions you may have regarding the Act.

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MEMORANDUM

To: **Our Publicly Traded Clients** **September 3, 2002**

From: **Luse Gorman Pomerenk & Schick, P.C.**

Re: **Summary of Nasdaq Corporate Governance Proposals**

The Board of Directors of The Nasdaq Stock Market, Inc. ("Nasdaq") recently approved approximately 25 corporate governance proposals designed to increase accountability and transparency for the benefit of investors. These proposals on corporate governance have been filed with the Securities and Exchange Commission ("SEC"), which must approve the Nasdaq rules before they become effective. Nasdaq is proposing that those changes that require a company to take action to modify the composition of its board of directors be effective immediately following a company's first annual meeting, provided the meeting is at least 120 days after SEC approval of the changes.

We encourage all officers and directors of Nasdaq publicly traded companies to review these proposals, along with new rules that the SEC will be promulgating pursuant to the recently enacted Sarbanes-Oxley Act. We will keep you informed of any new developments in this area, including SEC rules implementing the Sabanes-Oxley Act.

The 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, such as 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.

Increase Board Independence

Require that a majority of the board of directors be independent.

Require regularly convened executive sessions of the independent directors.

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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 family member of the director.

Prohibit a director from being considered independent if the company makes payments to a charity where the director is an executive officer and such payments exceed the greater of $200,000 or 5% of either the company's or the charity's gross revenues.

Provide that a shareholder owning or controlling 20% or more of the company's voting securities will not be considered independent.

Provide that any relative of an executive officer of an issuer or its affiliates will not be considered independent.

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.

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 a shareholder owning more than 20% of the issuer's securities (even if that person is also an officer of the company), or (2) for two years, pursuant to the same "exceptional and limited circumstances" provisions that all markets presently apply to the audit committee.

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 on the independent compensation committee pursuant to the same "exceptional and limited circumstances" provisions that all markets presently apply to the audit committee, but limited to two years.

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Empower Audit Committees

Require that audit committees have the sole authority to hire and fire the outside auditors.

Require that audit committees approve, in advance, the provision by the auditor of all services not related to the audit.

Require that audit committees have the authority to consult with and retain legal, accounting and other experts in appropriate circumstances.

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 "exceptional and limited circumstances" to two years, and prohibit that person from serving as the chair of the audit committee.

Conform the audit committee requirements for issuers that file reports under SEC Regulation S-B to those of other issuers (i.e., the audit committee must include at least three independent directors, able to read and understand fundamental financial statements, one of whom is financially sophisticated as defined in Rule 4350(d)(2)(A)).

Mandate Director Continuing Education

Mandate continuing education for all directors, pursuant to rules to be developed by the Nasdaq Listing and Hearing Review Council and approved by the Board.

Mandate Accelerated Disclosure of Insider Transactions

Require companies to disclose transactions in company stock by officers or directors within 2 business days for transactions exceeding $100,000. For smaller transactions, disclosure would be required not later than the second business day of the following week.

Codes of Conduct

Require all companies to have a code of conduct addressing, at a minimum, conflicts of interest and compliance with applicable laws, rules and regulations, with an appropriate compliance mechanism and disclosure of any waivers to executive officers and directors. Waivers can only be granted by independent directors. The code of conduct must be publicly available.

Other Proposals

Harmonize the Nasdaq rule on the disclosure of material information with SEC Regulation FD so that issuers may use Regulation FD compliance 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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Clarify that a material misrepresentation or omission by an issuer to Nasdaq may result in the company being delisted.

Require that a going concern qualification in an audit opinion be disclosed through the issuance of a press release.

Clarify that Nasdaq will presume that a change of control will occur, for purposes of the shareholder approval rules, once an investor acquires 20% of an issuer's outstanding voting power, unless a larger ownership and/or voting position is held on a post-transaction basis by: (1) a shareholder, or an identified group of shareholders, unaffiliated with the investor, or (2) the issuer's directors and officers that are unaffiliated with the investor.

Clarify the authority of Nasdaq to deny re-listing to an issuer based upon a corporate governance violation that occurred while that issuer's appeal of the delisting was pending.

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MEMORANDUM

To: **Our Publicly Traded Clients** **September 2002**

From: **Luse Gorman Pomerenk & Schick, P.C.**

Re: **Summary of New York Stock Exchange Corporate Governance Proposals**

In August 2002, the Board of Directors of the New York Stock Exchange ("NYSE") approved corporate governance proposals designed to both further the ability of directors to function effectively, and to allow stockholders to more easily monitor board performance. These proposals were drafted in response to a request from the Chairman of the Securities and Exchange Commission ("SEC"). The SEC must approve the NYSE rules before they become effective.

New corporate governance requirements have also been proposed by the Nasdaq. The Nasdaq and the NYSE proposals are similar in concept but vary in several particular areas. We anticipate that both Nasdaq and the NYSE will be encouraged to conform their governance requirements. Accordingly, we encourage all officers and directors of publicly traded companies to review these proposals, along with proposals put forth by the Nasdaq. We will keep you informed of any new developments in this area, including SEC rules implementing the Sabanes-Oxley Act.

The following is a summary of the NYSE corporate governance proposals:

1. Independent Board of Directors.

Listed companies must have a majority of independent directors within 24 months of the effective date of the rule, and must publicly disclose when they achieve compliance with this requirement. In order to tighten the definition of "independent director" for purposes of these standards:

> No director qualifies as "independent" unless the board of directors affirmatively determines that the director has no material relationship with the 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.
>
> No director who is a former employee of the listed company can be "independent" until five years after the employment has ended.

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No director who is, or in the past five years has been, affiliated with or employed by an (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 concurrently employs the director.

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

Disclosures regarding compliance with these requirements and the standards used by the Board to determine that relationships are not material must be disclosed in the proxy statement.

2. Executive Sessions of the Board.

The non-management directors of each company must meet at regularly scheduled executive sessions without management. The Board is not required to designate an individual director to preside at executive sessions; however, if it does, the identity of that individual must be disclosed in the proxy statement.

3. Nominating/Governance Committee Composed Entirely of Independent Directors.

Listed companies must have a nominating/corporate governance committee composed entirely of independent directors. The nominating/corporate governance committee must have a written charter that addresses:

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 company;

The committee's goals, responsibilities, structure and operations – which must reflect, at minimum, the board's criteria for selecting new directors, and oversight of the evaluation of the board and management; and

An annual performance evaluation of the committee.

4. Compensation Committee Composed Entirely Of Independent Directors.

Every company must have a compensation committee composed entirely of independent directors. The compensation committee must have a written charter that addresses:

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

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an annual report on executive compensation for inclusion in the company's proxy statement, in accordance with applicable rules and regulations;

The committee's duties and responsibilities – which, at minimum, must be to:

- 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;

- make recommendations to the board with respect to incentive-compensation plans and equity-based plans; and

An annual performance evaluation of the compensation committee.

5. Stricter Definition of Independence for Audit Committee Members.

To be considered "independent" for purposes of serving on an audit committee will require that director's fees are the only compensation received from the company (the materiality of other fees/compensation would otherwise be the test). Disallowed compensation would include fees paid for services as a consultant or as a legal or financial advisor, and would also include fees paid to a director's firm even if the director is not the actual provider of the services. Disallowed compensation would not include amounts paid to a customer or supplier or other business relationship that the board has already determined to be immaterial.

6. Increased Authority and Responsibility for Audit Committee.

The audit committee is required to have the sole authority to hire and fire independent auditors, and to approve any significant non-audit relationship with the independent auditors. Each listed company must have an internal audit function (which may be outsourced). The audit committee must have a written charter that addresses:

The committee's purpose – which, at minimum, must be to:

- assist board oversight of (i) the integrity of the company's financial statements, (ii) the company's compliance with legal and regulatory requirements, (iii) the independent auditor's qualifications and independence, and (iv) the performance of the company's internal audit function and independent auditors;

- prepare the report that SEC rules require be included in the company's annual proxy statement;

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

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

- at least annually, obtain and review a report by the independent auditor describing: the firm's internal quality-control procedures; any material issues

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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;

- discuss the annual audited financial statements and quarterly financial statements with management and the independent auditor, including the company's disclosure under "Management's Discussion and Analysis of Financial Condition and Results of Operations;"
- discuss earnings press releases, as well as financial information and earnings guidance provided to analysts and rating agencies (which may be done generally, rather than as to each specific release or guidance);
- as appropriate, obtain advice and assistance from outside legal, accounting or other advisors;
- discuss policies with respect to risk assessment and risk management;
- meet separately and periodically, with management, with internal auditors (or other personnel responsible for the internal audit function) and with independent auditors;
- review with the independent auditor any audit problems or difficulties and management's response;
- set clear hiring policies for employees or former employees of the independent auditors; and
- report regularly to the board of directors.

An annual performance evaluation of the audit committee.

7. Shareholder Approval Of All Equity Compensation Plans.

Shareholders must be given the opportunity to vote on all equity-compensation plans, except inducement options, plans acquired through mergers or acquisitions, and tax qualified and excess benefit plans. Any material revision to the terms of an equity compensation plan (including option repricing) must also be approved by shareholders.

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8. The Board Must Adopt And Disclose Corporate Governance Guidelines.

A company's web site must include its corporate governance guidelines, as well as the charters of its most important committees (at least the audit, nominating/governance and compensation). The annual report must state that the guidelines are available on the company's web site and available in print to any shareholder who requests it. The following subjects must be addressed in the corporate governance guidelines:

Director qualification standards.

Director responsibilities.

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

Director compensation.

Director orientation and continuing education.

Management succession.

Annual performance evaluation of the board.

9. The Board Must Adopt And Disclose A Code Of Business Conduct And Ethics.

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. A company's web site must include its code of business conduct and ethics. The annual report must state that the code of business conduct and ethics is available on the company's web site and available in print to any shareholder who requests it. Each company may determine its own policies, but all listed companies should address the most important topics, including the following:

Conflicts of interest.

Corporate opportunities.

Confidentiality.

Fair dealing.

Protection and proper use of company assets.

Compliance with laws, rules and regulations (including insider trading laws).

Encouraging the reporting of any illegal or unethical behavior.

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10. CEO Certification As To Compliance With NYSE Governance Requirements

Each listed company's chief executive officer 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.

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