036 Counseling the Board of Public Companies—New and Recurring Issues

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Before joining Nationwide, Ms. Hatler had been general counsel and corporate secretary for Independence Blue Cross in Philadelphia. During that time, she was responsible for all internal and external legal functions and reported to the chief executive officer. Ms. Hatler’s legal career also includes service with Dechert, Price and Rhoads in Philadelphia, Fulbright and Jaworski in Houston, Stinson, Mag and Fizzell in Kansas City, and Steptoe and Johnson in Washington, DC.

Ms. Hatler has been a hearing committee officer for the Pennsylvania Supreme Court Attorney Disciplinary Board. She also has been active in the Philadelphia Bar Association, the Caring Foundation for Children, and has been a faculty member of the Insurance Law Institute at the Pennsylvania Bar Institute.

Ms. Hatler holds a bachelor’s degree *magna cum laude* from Duke University and a law degree from the University of Virginia, where she was a Hardy Dillard Fellow. She also completed the Executive Program for Corporate Counsel at Duke University’s Fuqua School of Business.

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Mr. Watson is a graduate of the Amos Tuck Executive Program. He received the 1999 Distinguished Service Award from ACCA's Greater New York Chapter and the 1998 Pioneer of the Profession Award from the Minority Corporate Counsel Association. He is a member of One Hundred Black Men, Inc. He was a member of the advisory board of the Agent Orange Settlement Fund. As an avid saltwater fly fisherman, he is also a member of The Anglers' Club of New York.

Mr. Watson received a BA from Howard University. While at Howard, he wrote for *The Promethean*, a literary magazine, was a member of the Reserve Officers Training Corps and Scabbard and Blade (a military honorary society), and was a member of the track team. Mr. Watson then served in the Army as a lieutenant in the military police corps. While stationed in Vietnam, he was awarded the Bronze Star and Army Commendation Medals. He earned his JD from Harvard Law School.

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THE BUSINESS JUDGMENT RULE AND DIRECTORS' DUTY OF CARE

by Bart Schwartz[1]

I. The Delaware Business Judgment Rule

A. The Operation of the Business Judgment Rule

1. "The business judgment rule is a 'presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.'" *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985) (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)); *see also Brehm v. Eisner*, 746 A.2d 244, 264 n. 66 (Del. 2000), *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985). The legal consequence of this presumption, if it is not rebutted, is that a court will not substitute its own judgment for the judgment of a company's board of directors on matters that have properly come before the board and on which the board has taken action. *See Cede & Co. v. Technicolor, Inc*., 634 A.2d 345 (Del. 1993), *modified*, 636 A.2d 956 (Del. 1994*), aff'd sub nom. Cinerama, Inc. v. Technicolor, Inc*., 663 A.2d 1156 (Del. 1995).

2. The business judgment rule will be applied only when the board has made a conscious decision to act. It does not apply where the board has abdicated its functions or failed to act without making a conscious decision (for example, if the CEO informs the board of a proposed course of conduct but the matter is left as an information item only and there is no resolution of the board). Yet a conscious decision to refrain from acting is considered "a valid exercise of business judgment and enjoy[s] the protections on the rule." *Aronson*, 473 A.2d at 813.

3. The presumption of the business judgment rule may be rebutted if a plaintiff proves that the directors:

a) were interested in the transaction in question or lacking in independence,

b) did not act in good faith,

c) acted in a manner that cannot be attributed to a rational business purpose, or

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d) reached their decision by a grossly negligent process (for example, by failing to consider all material facts reasonably available). *See Brehm*, 746 A.2d at 264 n. 66.

4. Put otherwise, if their decisions are to qualify for the protection of the business judgment rule, the directors must fulfill their two main duties to the company and its shareholders — the duty of loyalty and the duty of care (sometimes as three duties — the duty of good faith, the duty of loyalty and the duty of due care).

B. The Necessary Conditions for the Application of the Business Judgment Rule

1. The Duty of Loyalty

a) All decisions made by a director must be made in good faith. *See Brehm*, 746 A.2d at 264 n. 66. A decision demonstrably made in bad faith, for whatever reason, will not qualify for the protection of the business judgment rule.

b) The directors whose votes are necessary for the action must be disinterested.

(1) "[T]his means that directors can neither appear on both sides of a transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all the stockholders generally." *Aronson*, 473 A.2d at 812.

(2) Where one or more directors have an interest in the matter at hand, the decision of the board may be afforded the protection of the business judgment rule where there is an affirmative vote by a majority of the disinterested directors, even if the number of disinterested directors does not constitute a quorum, and where the material facts as to the self-interest are disclosed to the board. *See* 8 Del. Gen. Corp. Law § 144(a)(1). Nevertheless, "a material interest of 'one or more directors less than a majority of those voting' would rebut the application of the business judgment rule if … 'the interested director *controls* or *dominates* the board as a whole….'" *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1168 (Del. 1995) (quoting *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1134, 1153 (Del. Ch. 1994) (emphasis in original).

2. The Duty of Care

a) "[T]o invoke the rule's protection directors have a duty to inform themselves, prior to making a business decision, of all material

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information reasonably available to them. Having become so informed, they must then act with requisite care in the discharge of their duties.…" *Aronson*, 473 A.2d at 812; *See also Van Gorkom*, 488 A.2d 858.

b) The "reasonably available" standard is interpreted broadly. For instance, in *Van Gorkom*, the Delaware Supreme Court stated that outside valuation studies and fairness opinions by investment bankers are not essential to afford protection in a takeover context. "Often insiders familiar with the business of a going concern are in a better position than are outsiders to gather relevant information; and under appropriate circumstances, such directors may be fully protected in relying in good faith upon the valuation reports of their management." 488 A.2d at 876; *See also* 8 Del. C. § 141(e). Nevertheless, in the M&A context, especially in the wake of *Van Gorkom*, it has become standard practice to present an investment banker's fairness opinion to the board of each company requiring board approval.

c) The practice implication of this duty, for the corporate lawyer, is to tale pains to make sure that, for any item on which the directors are expected to vote (and especially if the item is controversial or comes up in a context that could be expected to result in litigation), the directors should have ample, objective material available to them sufficiently in advance of the meeting to study the matter and make an informed decision. This means, for example, that

> **(1)** the directors should receive relevant documents and analyses at least a few days before the meeting (and sooner, if possible);
>
> **(2)** the corporate lawyer should consider advising the chairperson to bring in third-party experts (such as investment bankers or compensation consultants) for meetings at which the board will act on any matter that is likely to result in controversy and perhaps litigation;
>
> **(3)** ample time is devoted the discussion at the board meeting of the matter in question and the directors have a complete opportunity to call for additional information, to ask questions, and to discuss and debate the matter before voting.

d) In Delaware, "under the business judgment rule director liability is predicated upon concepts of gross negligence." *Aronson*, 473 A.2d at 812; *see also Van Gorkom*, 488 A.2d 858. Note that, in other states, the standard may be less than stringent. *See, e.g., Hanson Trust plc v. ML SCM Acquisition, Inc*., 781 F.2d 264, 275-76 (2d Cir. 1986)(under New York law, conduct that did "not rise to that level of gross negligence found

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in *Smith v. Van Gorkom*" nevertheless amounted to a breach of the duty of care).

e) Under the gross negligence standard, directors are rarely found to have breached the duty of care. One such rare example is *Van Gorkom*, 488 A.2d 858. The Delaware Supreme Court concluded that the board did not reach an informed business decision for three reasons. *Id.* at 874.

> **(1)** The directors "did not adequately inform themselves as to Van Gorkom's role in forcing the 'sale' of the Company and in establishing the per share purchase price." Van Gorkom, chairman of the board and CEO, arrived at a per share price by having numbers run to find a price at which a leveraged buy-out could be financed such that most of the loan would be paid off within five years by using the surplus cash flow of the company. While the price per share represented a premium over the market price, it did not result from a valuation of the company or a process reasonably designed to ensure that the price was the highest available, other things being equal. Van Gorkom also arranged the sale without first consulting either the board or senior management. Van Gorkom unilaterally made an offer to a well-known takeover specialist who was also a social acquaintance of his. Van Gorkom never disclosed these facts nor did the board inquire.
>
> **(2)** The directors "were uninformed as to the intrinsic value of the Company." They merely relied on Van Gorkom's unsupported representation that the price per share was reasonable. Had they inquired, the directors would easily have discovered that the price to which Van Gorkom had agreed had no necessary relationship to the actual value of the company, measured in any objective way.
>
> **(3)** The directors, "at a minimum, were grossly negligent in approving the 'sale' of the Company upon two hours' consideration, without prior notice, and without the exigency of a crisis or emergency." The meeting at which the sale was approved was an emergency meeting called by Van Gorkom. The directors were notified of the noontime Saturday meeting only the day before. At the meeting, lasting only two hours, the board approved the deal relying solely upon Van Gorkom's 20-minute oral presentation of the proposal. The board saw neither a written summary of the merger terms nor any documentation supporting the adequacy of the proposed sale price. The court noted that, while directors may rely on "reports," even when oral, the directors "were duty bound to make reasonable inquiry" regarding the basis of the information given the hasty nature of the proceedings. Moreover, there was no emergency to sell as evidenced by a five-

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year forecast prepared by management two months prior to the approval meeting.

II. The Caremark Case — The Board's Duty to Monitor

A. A much-noted decision of the Delaware Chancery Court expounded on the directors' duty of care. *See In re Caremark International Inc. Derivative Litigation*. 698 A.2d 959 (De. Ch. 1996). *Caremark* represents an important clarification (some would say expansion) of the directors' duty of care.

B. The case involved a health-care company that ultimately paid out about $160 million in civil settlements and fines and pleaded guilty to certain criminal charges resulting from improper physician-referral practices and alleged kickbacks. In the wake of these developments, shareholder derivative suits were filed against Caremark's directors for alleged breach of their fiduciary duties to the corporation, especially the duty of care.

C. "The complaint charges the director defendants with breach of their duty of attention or care in connection with the on-going operation of the corporation's business. The claim is that the directors allowed a situation to develop and continue which exposed the corporation to enormous legal liability and that in so doing they violated a duty to be active monitors of corporate performance." *Id*. at 967.

D. The published decision dealt with the court's approval of a settlement of a series of shareholder derivative actions. The court found the settlement to be fair and reasonable, noting that it was unlikely that the derivative plaintiffs would have been able to prove that the Caremark directors breached their fiduciary duties.

E. In so finding, the court noted that, "Director liability for a breach of the duty to exercise appropriate attention may, in theory, arise in two distinct contexts. First, such liability may be said to follow from a board decision that results in a loss because that decision was ill advised or 'negligent'. Second, liability to the corporation for a loss may be said to arise from an unconsidered failure of the board to act in circumstances in which due attention would, arguably, have prevented the loss." *Id.*

F. The court further observed that, "The second class of cases in which director liability for inattention is theoretically possible entail circumstances in which a loss eventuates not from a decision but, from unconsidered inaction." *Id*. at 968. Citing a series of then-recent corporate financial calamities (at Salomon Brothers, Kidder Peabody and Prudential Insurance), Chancellor Allen concluded that "Financial and organizational disasters such as these raise the question, what is the board's responsibility with respect to the organization and monitoring of the enterprise to assure that the corporation functions within the law to achieve its purposes?" *Id*. at 968-69.

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G. Chancellor Allen answered his own question as follows:

> "[I]t would be a mistake to conclude . . . that corporate boards may satisfy their obligation to be reasonably informed concerning the corporation, without assuring themselves that information and reporting systems exist in the organization that are reasonably designed to provide to 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***.
>
> . . . .
>
> "Thus, I am of the view that a director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards."
>
> *Id*. at 970 (emphasis added).

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Bulletproof Your Special Committees in Interested Fiduciary Transactions

By Patricia R. Hatler, Roger A. Craig, Michael Groll, and Paul Davis Fancher

In 1988, the CEO and majority shareholder of Dairy Mart Convenience Stores decided that his company's stock was undervalued, and he began to explore the possibility of a management-sponsored leveraged buyout with Salomon Brothers. For six months, the bankers worked with Dairy Mart's senior management to formulate a buyout proposal. Eventually, Dairy Mart's management and Salomon Brothers offered $15 per share for the minority interest.

Because a majority of Dairy Mart's board of directors had a financial interest in the transaction, the board established a special committee of disinterested directors to consider the buyout proposal. This two-member committee subsequently chose legal and financial advisors, all recommended by the attorney assisting management in the buyout. Although the investment banker-advisor had significant prior dealings with the majority shareholder, the committee selected him without conducting an interview or an investigation.

The Dairy Mart special committee did not attempt to negotiate with management to raise the $15-per-share offer, and it ignored a competing offer of $16 per share. Moreover, Dairy Mart's controlling shareholder prohibited the committee from entertaining other offers.

In deciding whether to approve management's buyout proposal, the special committee instructed its financial advisors to develop a range of fairness for offers. When the advisors first considered the value of the stock, they determined that management's offer fell below this range. But after one of the special committee members had discredited their projections, the bankers revised the range to encompass management's offer

The special committee endorsed management's proposal. The next day, the entire board of directors voted to approve the leveraged buyout. Although the deal fell through when management failed to obtain financing, the board reimbursed the management group for the expenses it had incurred in proposing the buyout.

Minority shareholders subsequently brought a derivative action against the board of directors. After having analyzed the facts, the court in Kahn v. Dairy Mart Convenience Stores, Inc.,1 decided that the special committee had not effectively protected the interests of the minority and denied the defendant's motion for summary judgment.

The Dairy Mart case provides a textbook example of mistakes that boards of directors and special committees sometimes make when using a special committee in an interested fiduciary transition. Acting more as an extension of the board than as an independent decision-maker, the special committee chose unsuitable advisors, whose advice it then rejected, bowed to pressure from the board, and otherwise failed to protect the interests of shareholders. It did not engage in arm's-length negotiations, nor did it seem to have the power to say no to the board. When shareholders challenged the board's decisions, the court refused to defer to the special

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committee's judgment. Instead, errors cost the Dairy Mart board of directors a favorable judicial standard of review.

To protect your board of directors in interested fiduciary transactions, you must bulletproof its special committees by ensuring their proper creation and use. If your board and its special committees avoid common pitfalls, their actions will likely pass judicial scrutiny and benefit all shareholders.

PURPOSE OF SPECIAL COMMITTEES

Corporate boards of directors increasingly began to use special committees in the early 1980s when they discovered the enormous benefits that special committees could provide in interested fiduciary transactions. Courts consider a director to be interested if "he or she will receive a personal financial benefit from a transaction that is not equally shared by the stockholders."2 If used properly, a special committee of disinterested directors can protect minority shareholders and shield directors from liability. Corporate fiduciaries also benefit because courts give greater deference to decisions made by these independent committees.

Boards commonly use special committees for management leveraged buyouts, mergers and acquisitions involving a related corporate entity, and transactions implicating a controlling shareholder.

LAW OF INTERESTED FIDUCIARY TRANSACTIONS

As fiduciaries, directors owe two duties to their corporation and its shareholders: a duty of care and a duty of loyalty. A duty of care requires directors to perform their corporate responsibilities with the care that an ordinary prudent person would exercise in managing his or her own affairs under similar circumstances.3 A duty of loyalty requires them to protect corporate interests and to refrain from conduct that would injure the corporation or its shareholders or deprive them of profit or advantage.4 Generally, a director who acts in good faith and has no financial or personal interest in conflict with the corporation and its shareholders satisfies his or her loyalty obligation.

It is in furtherance of both fiduciary duties that directors facing conflicting financial or personal interests form special committees that can make decisions solely on the corporate merits of the transaction or matter at issue. Of course, once appointed to a special committee, disinterested directors must discharge their responsibilities with due care.

Courts generally evaluate the actions of a board of directors under the business judgment rule, which presumes that directors have acted on an informed basis, in good faith, and in the honest belief that they were serving the best interests of the company.5 The business judgment rule usually prevents substantive judicial review of the merits of a business decision made in good faith and with due care.6 The rule is not the proper standard of review, however, for an interested transaction.

Entire Fairness Doctrine

In cases in which companies engage in certain interested transactions, such as an internal restructuring or a corporate merger, with controlling shareholders, the Delaware courts apply an enhanced standard of review to board decisions.7 The enhanced standard requires directors who

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are on both sides of a transaction to "demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain."8 Directors must prove so-called "entire fairness."9

The Delaware Supreme Court describes entire fairness as having two aspects: fair dealing and fair price. Fair dealing encompasses "when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approval of the directors and the stockholders [was] obtained."10 Fair price relates to "the economic and financial considerations of the proposed [transaction], including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company stock."11 The entire fairness test requires a "unified approach" involving "an examination of all aspects of the transaction to gain a sense of whether the deal in its entirety is fair."12

Where the rule of entire fairness applies, the proponents of a challenged transaction have the burden of proving it. Boards of directors can shift this burden to dissenting shareholder plaintiffs, however, by establishing a special committee, which serves as a separate independent negotiator for the benefit of minority interests.13

To summarize, when deciding whether to uphold board action in an interested transaction, a court first determines whether a majority of the directors who approved the transaction were disinterested and independent. If so, the business judgment rule affords them protection. If a majority of the directors had a conflict of interest, however, a reviewing court would apply the entire fairness standard. As noted above, the burden of proving entire fairness rests initially with the interested fiduciary. But if the board establishes a special committee, which then conducts an arm's-length negotiation, the plaintiff has the burden of proving the unfairness of the transaction. As in-house counsel, you will want to advise your board on how to obtain the burden-shifting benefit of a special committee. Critical to the success of a special committee are its formation, composition, and functioning.

FORMATION OF SPECIAL COMMITTEE

Many corporations encounter problems in the initial formation of special committees. The special committee must be independent of management and all interested parties and must be able to exercise real bargaining power at arm's length. Its decisions must be governed strictly by the merits of the corporate issues at stake. The board should remember these overarching principles when forming a special committee to negotiate a corporate transaction. A handy checklist appears in the sidebar.

You should advise your board of directors that it has sole responsibility for creating special committees and appointing their members. Your board should not permit management to select or influence the selection of special committee members. It is important that your board remain unfettered by any outside influences when establishing these independent committees.

In an egregious example of managerial overreaching, the Delaware Court of Chancery rejected a special committee whose members were handpicked by an interested CEO.14 Management wanted to initiate a leveraged buyout of the company, but before proceeding, the CEO had met with one of the outside directors, a former law school classmate, to discuss the plan. The CEO told his friend that he wanted him to be chairman of the special committee that the board would

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create to consider the leveraged buyout. The two men further discussed which other board members should be selected to serve on the special committee. At a meeting a week later, the board chose the CEO's law school friend to chair the committee and appointed the other directors favored by the CEO.15 In rejecting the committee's claim of independence, the court declared:

It cannot . . . be the best practice to have the interested CEO in effect handpick the members of the Special Committee as was . . . done here. . . . A suspicious mind is made uneasy contemplating the possibilities when the interested CEO is so active in choosing his adversary.16

Your board should give the special committee full authority to make definitive decisions, unless state statutory law prohibits it from doing so, as is often the case for fundamental corporate changes, such as mergers. When special committees lack final decision-making power, the board should authorize them to make recommendations. Whether making decisions or recommendations, committees should have full authority to negotiate transactions.

It is also critical at formation that special committee members understand their role in the transaction. You should explain to members that they must aggressively promote the interests of the minority, not just close the deal or passively evaluate its fairness. Special committee members must actively negotiate on behalf of minority shareholders to ensure that the transaction is favorable to them.

In the case of In re Trans World Airlines, Inc. Shareholders Litig.,17 a special committee's basic misunderstanding of its role in the transaction prevented it from functioning properly. Committee members thought they were charged with deciding whether the controlling shareholder's merger offer was fair to the minority. The committee did not realize that it was supposed to negotiate with the controlling shareholder to obtain the highest price possible. The Delaware court decided that it would not shift the burden of proving entire fairness to the plaintiff in a case in which the committee's misunderstanding of its function had prevented it from serving as an acceptable surrogate to an arm's-length transaction.18

COMPOSITION OF SPECIAL COMMITTEE

As previously emphasized, directors who serve on special committees must be disinterested and independent. Although it might be impossible for your board to select directors who are completely disinterested and independent, it should avoid naming directors with a material conflict, a definition that can be culled from the caselaw.

Your board should also give thought to the number of directors it selects. In general, there is safety in numbers. You should tell your board to appoint as many disinterested directors as possible to a special committee: numbers speak to fairness and, thus, improve the integrity of the committee's decision-making process.

Independence

To be considered independent, special committee members must be able to make decisions based on the merits of the transaction at issue rather than on unrelated considerations or undue influences. Courts will not automatically conclude that an interested party controls a director simply because he or she has business or personal relations with that party. In deciding whether a

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director's relationship with an interested party makes him or her conflicted, courts evaluate the director's ability to make an independent decision. To prove independence, a director must demonstrate that he or she is not beholden to the controlling shareholder.19

Your board of directors may have difficulty determining whether a particular director has a conflict. Such a determination, obviously, requires a factual analysis. The following case decisions will help you in advising your board:

* In Kahn v. Tremont Corp.,20 the Supreme Court of Delaware questioned the independence of three special committee members who had derived significant benefit from board positions and consulting fees that the controlling shareholder had given them. One of the members was affiliated with a law firm that had represented the controlling shareholder in several corporate takeovers. After this committee member had left the firm, corporate management invested in several business ventures that he had promoted. When the business ventures proved unsuccessful, management paid the member $10,000 per month, plus $325,000 in bonuses, to consult for a related entity. The other two committee members also received substantial fees from related entities.21

* In the case of In re MAXXAM Inc./Federated Dev. Shareholders Litig.,22 the Delaware Court of Chancery ruled that the business and financial ties that some special committee members had to MAXXAM's majority shareholder "raise[d] concerns" about the committee's independence.23 One member served as chairman and CEO of another corporation owned by the controlling shareholder and received $450,000 per year in salary plus significant additional compensation under an incentive plan. The controlling shareholder paid another special committee member $250,000 per year in consulting fees derived from a MAXXAM subsidiary, as well as director fees for serving on the boards of other corporations he owned.

* In T. Rowe Price Recovery Fund v. Rubin,24 the Delaware Court of Chancery decided that the financial relationship between the controlling shareholder and a new director was too close to consider the latter independent. When the board asked the new director, recently appointed by the controlling shareholder, whether he could act independently of the shareholder, he downplayed their financial connection. Later evidence showed, however, that the new director was actually an investment banker who received a $150,000 monthly retainer fee from the majority shareholder for work in an unrelated bankruptcy. The court found this and other financial dealings significant, especially given the director's silence in the face of pointed questions. The court further noted the director's strong advocacy for the controlling shareholder's proposal.25

You should perform due diligence in order to determine whether a particular director is disinterested and independent. You should inquire into the financial ties between the potential committee member and any interested party. You should also ask the director whether he or she will potentially benefit from the transaction. You should stress that failure to be completely candid might cause a court to overturn a board's decision. If you are unsure whether a director can act in a disinterested and independent manner, you should discourage the board from appointing the director to the special committee.

You should advise your board of directors that, if at all possible, its special committees must comprise more than one member-director. Although some states require a special committee to have at least two directors, Delaware corporate law allows boards to appoint committees of

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one.26 But Delaware courts also heighten their scrutiny of single member committees. According to the Supreme Court of Delaware, "the member should, like Caesar's wife, be above reproach.'"27

Not only do Delaware courts exercise careful judicial scrutiny over a single member's personal and financial affiliations and dealings, but they also carefully analyze his or her actions. The same is true of larger committees dominated by one member. In one case, the court considered a three-member committee dominated by one director to be a de facto committee of one, whose actions merited close scrutiny.28 In another case, the court disabled one committee member because of a conflict of interest and then analyzed the actions of the remaining member under the more demanding test of careful judicial scrutiny.29

The cases demonstrate that courts are often influenced by the number of members on a special committee. Thus, you should advise your board to select as many disinterested directors as possible to serve on a special committee.

Outside Consultants

If your board decides that none of its members is disinterested and independent, you can suggest two possible solutions. First, you can advise the board to increase its size and add one or more disinterested and independent board members. Expanding the board may not be the most practical course of action, however. Second, you can inform your board that it may create a special committee of consultants who do not sit on the board. Consultants can make recommendations to the board, which it can then vote to accept. Although using a consultant committee would not enable your board to shift the burden of proving entire fairness, it is evidence of the fairness of the transaction.

FUNCTIONING OF SPECIAL COMMITTEE

Although you may advise your board of directors on the proper formation of special committees, you should take no part in their functioning. At least one court has held that in-house counsel's involvement in the work of a special committee makes its decisions "inherently suspect."30 You should tell the special committee to hire outside counsel and make no recommendations concerning the selection of a particular counsel. In certain circumstances, you may need to pass along information about the committee's process for selecting advisors and its use of them, once retained. But when you do so, make sure that the special committee does not view your intervention as an attempt to influence its choice of advisors. Bottom line: you may educate committee members about their duties, but you may not actively counsel them.

You may also answer the questions of board members who are not on the committee but will vote on its recommendation. Many of these directors may wonder about the committee's authority and decision-making process. To advise them, you will need to have a thorough understanding of how special committees operate.

Selection of Advisors

When courts review the actions of a special committee, they carefully scrutinize its financial and legal advisors for interest or bias. Although courts prefer advisors who have had no previous

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dealings with the corporation, an advisor's prior or current employment with the corporation is not dispositive.

A reviewing court will analyze an advisor's business relationships with the corporation, as well as the process by which the special committee selected him or her. Courts have been highly critical of financial and legal advisors chosen or recommended by interested managers, a controlling shareholder, or in-house counsel. Although an interested fiduciary can recommend advisors, this practice is generally not advisable. In the event that an interested party makes a recommendation to the special committee, the committee should carefully evaluate it before making a selection.

When selecting and using advisors, a special committee should understand the following information:

- Advisors owe duties to the corporation and its shareholders, not to management.
- Advisors should be paid in fee arrangements that do not provide an incentive for them to achieve a result. If an advisor's fee is contingent on a transaction being concluded, for example, he or she might recommend a transaction when inaction is preferable.
- Legal advisors should take an active role in the negotiation process and not simply draft the final proposal. Some courts consider negotiation by retained lawyers to be evidence of a committee's intention to protect the shareholder's interests.
- Legal advisors should frame the committee's agenda, review its financial reports, and draft or review its minutes. All of these acts demonstrate careful decision-making.
- Legal advisors should apprise the committee of possible indemnification from the corporation for any decision it makes.
- Financial and legal advisors should submit written opinions on the fairness of the transaction or matter at issue.

Conduct of Business

In order to function properly, a special committee must replicate an arm's-length bargaining process. The special committee must be fully informed during the decision-making process, which means that members must have access to all relevant information. The committee also must aggressively promote the interests of the minority shareholders. And the committee must be free to function without the interference of corporate management or the controlling shareholder.

* ***Special Committee Must Be Fully Informed***

When evaluating an interested fiduciary transaction, the special committee and its advisors should consider a variety of factors, including the historic and current financial conditions of the corporation, the performance of its stock, its ability to fund capital expenditures, corporate income projections, the status of research and development of new products, the value of assets, and the depth of management.31 To be fully informed, the committee should get opinions on these items in writing; it should never rely solely upon the oral opinions of management-selected financial advisors.

When directors make decisions likely to affect shareholder welfare, their duty of care requires them to be reasonably diligent in gathering and considering material information. Directors may be liable to shareholders for failing to reasonably obtain material information or for failing to

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make a reasonable inquiry into material matters. This duty of care applies to directors whether they are acting on board matters or serving on special committees.

In Plaza Securities v. Edelman,32 a federal district court in Michigan determined that a special committee had breached its duty of care by not examining or requesting information relevant to a proposed leveraged buyout. In fact, the committee had received no written materials about the buyout until the day it adopted the proposal. At the committee's last meeting, its legal advisor presented final drafts of the transaction documents, which did not include an opinion as to the fairness of the transaction. In the rush to close the buyout, the committee neither reviewed these documents nor understood the proposal's financing agreements. Nonetheless, the committee recommended that the board approve the leveraged buyout.

After having analyzed the special committee's actions, the court identified information that the committee should have requested before reaching its decision, including (1) an opinion as to the value of the company, (2) a description of how the purchase price would be funded, and (3) competing proposals. The court said that the special committee had breached its duty of care by having failed to obtain this information.33

A special committee should review every proposal that it evaluates with an eye toward whether the board should accept it. The committee should inquire into the financing of the transaction, as well as any applicable regulations that could affect the transaction.

* ***Special Committee Must Aggressively Promote Interests of Minority***

In order to simulate an arm's-length negotiation process, a special committee must aggressively promote the minority's interests. Committee members should (1) carefully consider all available options and avoid rushing to judgment, (2) take an active role in the negotiations and the decision-making process, and (3) show no preference for the position of management or a controlling shareholder to the detriment of the minority shareholders.

* CAREFUL CONSIDERATION. Before reaching a decision, a special committee must devote ample time to reviewing the proposed transaction. If a committee acts too swiftly, it may invite closer judicial scrutiny. The committee should coordinate with its advisors, who, in turn, should provide thorough analyses. The committee should obtain an opinion from its advisors about the fairness of the transaction relative to similar transactions. It should also give its advisors the authority to negotiate improvements to the proposal wherever possible. Finally, the committee should prepare a record detailing its decision-making process and explaining its recommendation to the board. The need for extra care by the committee is understandable when you consider that a board of directors will often rely solely on the committee's opinion when it takes action. Careful analysis helps satisfy the committee's duty of care, as well as the directors' duty of care.

* ACTIVE ROLE. All special committee members must actively participate in deliberations and decision-making. Committees cannot allow one member or a small number of members to dominate their decision. You will recall that in the MAXXAM, Inc., case34 discussed earlier, one committee member controlled the selection of legal and financial advisors. He retained advisors without first having consulted with the other four special committee members, who then rubberstamped his choices. In addition, the special committee delegated authority to negotiate on its behalf to this dominating committee member and one other member.

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This delegation, coupled with the unilateral selection of advisors, prompted the court to more closely scrutinize the independence and negotiating ability of the two committee designees. After having analyzed the facts, the court refused to shift the burden of proving entire fairness. You should keep in mind that, when a court reviews a special committee's decisions, it will consider the independence and actions of the active members only.35

* NO PREFERENCE. The special committee must try to promote the interests of all shareholders and never favor management or the controlling shareholder to the detriment of the minority. Again, it is helpful to examine caselaw to gauge indicators of favoritism. In the Plaza Securities Co.36 case, a U.S. district court considered whether a special committee had satisfied its duty of care when it had ignored a competing bid in an auction for corporate control. The management in Plaza Securities had initiated a leveraged buyout in order to prevent a hostile takeover. After having formulated the buyout, management established a special committee to consider its proposal and a competing offer. Not only did the special committee fail to consider the competing bid, but also it had no contact with the bidder. Committee members claimed that the competing bidder had not shown firm financial commitments for the transaction, but Plaza Securities management had not placed its money on the table, either. The court decided to observe Delaware's Revlon doctrine, which requires directors to try to maximize shareholder value after the sale of a corporation becomes inevitable. Thus, directors must act as neutral auctioneers. The court ruled that the special committee directors had violated their fiduciary duties by discriminating against the nonmanagement proposal and failing to seek the highest value reasonably available for the shareholders.

* Special Committee Must Have the Power to Say No

In order for a special committee to function properly, it cannot be unduly influenced by management and controlling shareholders. It must have the power to say no. It must be willing and able to stand up to outside pressures. It must be truly independent.

The Supreme Court of Delaware addressed the problem of undue influence in Kahn v. Lynch Communication Systems, Inc.,37 which involved a possible merger of a telecommunications company with an indirect subsidiary of its controlling shareholder. The board of directors established a special committee to evaluate the shareholder's offer; the committee rejected it as inadequate. The shareholder responded to the rejection by offering to purchase the remainder of the telecommunications company's stock. This offer prompted the board to authorize the special committee to consider proposals for the company's possible acquisition. Again, the committee determined that the controlling shareholder's offer was inadequate. The controlling shareholder indicated, however, that, if the committee rejected its purchase offer, it would proceed with a hostile tender at a lower price. Believing it had no other choice, the special committee approved the controlling shareholder's offer.

The court ruled against the special committee, holding that it could not approve a price that was unfair, even if it was the highest price an interested fiduciary would pay. The court noted that the special committee in this case lacked the power to say no and to stand up to the shareholder. Without this power, the committee could not negotiate at arm's length. Therefore, the court decided that the burden of proving entire fairness remained with the defendant.38

CONCLUSION

Special committees are an invaluable tool for corporations in interested fiduciary transactions because they operate to protect the interests of minority shareholders and to shield directors from liability. They remove decision-making authority from directors who have a personal or financial

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stake in the outcome and vest it in committees composed of independent directors who can evaluate transactions on their merits. Special committees also benefit interested fiduciaries by shifting the burden of proof to the plaintiff under the entire fairness standard.

To attain this burden-shifting benefit for your board of directors, you must bulletproof your special committees. You must ensure that the board properly chooses disinterested directors to serve as members and vests full authority in them to make decisions or recommendations about proposed transactions. Boards should thoroughly evaluate the independence of individual directors, as well as determine the appropriate number of directors needed to serve on a particular special committee to safeguard fairness. Reviewing courts will respect the decisions of special committees whose members are disinterested, competently advised, fully informed, assertive, and unpressured by management or a controlling shareholder.

Although you may (and should) advise your board of directors on the proper formation of special committees and inform committee members about their authority and duties, you should not participate in committee functioning. You should tell the special committee to hire outside counsel and then make no recommendations concerning the selection of a particular counsel. In certain circumstances, you may need to pass along information about the committee's process for selecting advisors and its use of them, once retained. But you should not influence its choice of advisors.

The two-member Dairy Mart special committee in the opening scenario bowed to pressure from the board of directors that had created it. It did not engage in arm's length negotiations, nor did it seem to have the power to say no to the board. Not surprisingly, when shareholders challenged the board's decisions, the court refused to defer to the special committee's judgment. Process errors cost the Dairy Mart board of directors a favorable judicial standard of review. You can prevent your board from making similar mistakes by overseeing the proper formation and use of any special committees it creates.

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Special Committee Process and Best Practices

1. Formation

The board of directors should:

* Create the special committee.
* Appoint committee members.
* Exclude management from the selection of committee members.
* Give the committee full authority. _The special committee should:_
* Understand its role is to protect the interests of minority shareholders.

2. Composition

The board of directors should:

* Select disinterested and independent board members to serve.
* Compose committees of more than one member, if possible.
* Appoint as many disinterested directors as possible.

3. Functioning

A. Selection of Legal and Financial Advisors

The special committee should:

* Choose disinterested advisors.
* Resist being influenced by a controlling shareholder, management, or in-house counsel in its selections.
* Understand that advisors owe duties to the corporation and shareholders, not to management.
* Expect legal advisors to take an active role in the negotiation process.
* Ask for written fairness opinions from financial and legal advisors.

B. Responsibilities

The special committee should:

* Try to replicate an arm's-length negotiation.
* Be fully informed during decision-making and have access to all relevant information.
* Aggressively promote the interests of minority shareholders.
* Avoid rushing to judgment, carefully considering all options.
* Participate actively in negotiations and decision-making.
* Show no favoritism toward management or a controlling shareholder to the detriment of minority shareholders.
* Freely function without the interference of management or the controlling shareholder.

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NOTES

1. No. 12489, 1996 Del. Ch. LEXIS 38, 1996 WL 159628 (Del. Ch. Mar. 29, 1996).

2. Rales v. Blasband, 634 A.2d 927, 936 (Del. 1993).

3. In practice, a duty of care means that "[d]irectors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them. Having become so informed, they must then act with requisite care in the discharge of their duties." Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). In considering directors' duty of care, it is important to note the following:
1. Although they need not read every legal document in detail, directors must adequately review key transaction documents before approving a transaction. They may read the documents themselves or have an expert fully explain them. 2. Directors must try to obtain additional information and raise all questions they have regarding any proposed transaction, both before and during the meeting at which they consider the transaction. 3. Directors must verify that the officers of the corporation have completed the necessary background work to support any recommendation made. 4. Directors must recess a meeting and reconvene later if they require time to obtain more information. 5. Although they need not possess any particular expertise, directors must obtain the assistance of outside consultants with the knowledge necessary for them to evaluate a transaction. Directors cannot delegate their responsibilities to advisors, however. Each director must carefully examine any recommendation by an advisor before reaching a decision.

4. See LOU R. KLING & EILEEEN NUGENT SIMON, NEGOTIATED ACQUISITIONS OF COMPANIES, SUBSIDIARIES AND DIVISIONS ? 4.02[2] (1999); see also RODMAN WARD JR., ET AL., I FOLK ON THE DELAWARE CORPORATION LAW ? 141.2 (1999). To satisfy the duty of loyalty, directors must be both "disinterested" and "independent." KLING & SIMON at ? 4.02[2] (citing Aronson, 473 A.2d at 814-15). To be disinterested, a director must never appear on both sides of a transaction or derive any personal financial benefit from a transaction, other than the type that all shareholders derive, such as the benefit of stock ownership. See Aronson, 473 A.2d at 812. To be independent, a director must make decisions solely on the "corporate merits" of the transaction or matter at issue rather than "extraneous considerations or influences." KLING & SIMON at ? 4.02[2] (citing Aronson, 473 A.2d at 816).

5. See Parners v. Bally Entertainment Corp., 722 A.2d 1243, 1246 (Del. 1999) (quoting Aronson, 473 A.2d at 812). One formulation of the business judgment rule provides: "A decision by a board of directors (i) in which the directors possess no direct or indirect personal interest, (ii) which is made (a) with reasonable awareness of all reasonably available information, and (b) after prudent consideration of the alternatives, and (iii) which is in good faith furtherance of a rational corporate purpose, will not be interfered with by the courts, . . . even if the decision appears to have been unwise or to have caused loss to the corporation or its stockholders." DAVID A. DREXLER ET AL., 1 DELAWARE CORPORATION LAW AND PRACTICE ? 15.03 (1999). Courts apply the business judgment rule when reviewing decisions in which directors do not have potentially conflicting interests, such as a decision to acquire a nonaffiliate. Note, however, that under Delaware law, the business judgment rule will not protect a board decision to approve certain internal reorganization transactions involving an interested fiduciary.

6. See WARD, supra note 4, at ? 141.2.2.2.

7. See Kahn v. Lynch Communication Sys., Inc., 638 A.2d 1110, 1116 (Del. 1994) (citing Rosenblatt v. Getty Oil Co., 493 A.2d 929, 937 (Del. 1985)) [hereinafter Lynch I].

8. See Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983).

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9. Entire fairness is the "exclusive standard of judicial review in examining the propriety of an interested cash-out merger transaction by a controlling or dominating stockholder." Lynch I, 638 A.2d at 1117 (citing Weinberger v. UOP, Inc., 457 A.2d at 710-11). Weinberger sets forth the basic rules that generally apply whenever a controlling person proposes a "going private" transaction. See ARTHUR M. BORDEN, GOING PRIVATE ?? 4.05 and 4.06 (1999). Entire fairness applies whenever controlling shareholders propose a transaction and contemplate continuing to control the company regardless of whether minority shareholders approve the transaction. Even when unintended by the controlling shareholder, this relationship may influence or coerce minority shareholders into voting for the proposed transaction. See Citron v. du Pont, 584 A.2d 490, 502 (Del. Ch. 1990); see also Lynch I, 638 A.2d at 1116. The court in Citron notes that, "[e]ven where no coercion is intended, stockholders . . . might perceive that their disapproval could risk retaliation of some kind by a controlling stockholder. For example, the controlling stockholder might decide to stop dividend payments or to effect a subsequent cash-out merger at a less favorable price." Citron, 584 A.2d at 502. The enhanced standard thus protects a subsidiary's shareholders from being forced into a transaction in which a parent offers inadequate consideration.
10. Weinberger v. UOP, Inc., 457 A.2d at 711.
11. Id.
12. Kahn v. Lynch Communication Sys., Inc., 669 A.2d 79, 84 (Del. 1995) [hereinafter Lynch II].
13. Boards can also shift the burden of proof in interested transactions by obtaining approval of the transaction by a majority of the shareholders unaffiliated with the corporation, but informed of the material facts, for example, through accurate and complete information set forth in a proxy statement. See, e.g., Weinberger v. UOP, Inc., 457 A.2d 701, in which the court determined that a shareholder vote approving a transaction was not an informed one and that, therefore, the burden of proof would not shift. The court ruled that material information, necessary to familiarize shareholders with the bargaining positions of the parties, had been withheld. This documentation included a feasability study performed by several directors indicating that, even if minority shareholders received a higher price, the transaction would still be a good investment for the controlling shareholder. In American Gen. Corp. v. Texas Air Corp., Nos. 8390, 8406, 8650, and 8805 (Del. Ch. Feb. 5, 1987), a 72 percent majority shareholder of Continental sought to cash out the minority shareholders of Continental. The court explained: "The burden of persuasion, which ordinarily rests upon the defendant in an interested transaction, shifts to the plaintiffs if the transaction is validly ratified. The transaction would be validly ratified if (i) approved by a fully informed majority of minority stockholders or (ii) approved by fully informed disinterested directors." Id. at *11 (citing Weinberger v. UOP, Inc., 457 A.2d 701).
14. See In re Fort Howard Corp. Shareholders Litig., No. 9991, 1988 Del. Ch. LEXIS 110 (Del. Ch. Aug. 8, 1988).
15. See id. at *9, *11.
16. Id. at *36.
17. No. 9844, 1988 Del. Ch. LEXIS 139 (Del. Ch. Oct. 21, 1988).
18. See id. at *10-12, *21-22.
19. See Rales v. Blasband, 634 A. 2d 927, 936 (Del. 1993).
20. 694 A.2d 422 (Del. 1997).
21. Id. at 426, 429-30.

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22. No. 12111, 1997 Del. Ch. LEXIS 51 (Del. Ch. Apr. 4, 1997).
23. Id. at *66-67.
24. No. 18013, 2000 Del. Ch. LEXIS 86 (Del. Ch. June 23, 2000).
25. Id. at *11-13.
26. See DEL. CODE ANN. tit. 8, ? 141(c) (2000).
27. See Kahn v. Tremont Corp., 694 A.2d at 430 (quoting Lewis v. Fuqua, 502 A.2d 962, 967 (Del. Ch. 1985)).
28. Id.
29. See Kahn v. Dairy Mart Convenience Stores, Inc., No. 12489, 1996 Del. Ch. LEXIS 38 (Del. Ch. Mar. 29, 1996).
30. See In re Oracle Sec. Litig., 829 F. Supp. 1176, 1188 (N.D. Cal. 1993) (The court reasoned that "in-house attorneys are inevitably subservient to the interests of the . . . directors and officers whom they serve").
31. See Scott V. Simpson, The Emerging Role of the Special Committee: Ensuring Business Judgment Rule Protection in the Context of Management Leveraged Buyouts and Other Corporate Transactions Involving Conflicts of Interest, 43 BUS. L. 665 (Feb. 1988).
32. 643 F. Supp. 1535 (E.D. Mich. 1986).
33. See id. at 1538-39, 1543.
34. No. 12111, 1997 Del. Ch. LEXIS 51 (Del. Ch. Apr. 4, 1997).
35. Id. at *67-70.
36. 643 F. Supp. 1535 (E.D. Mich. 1986).
37. 638 A.2d 1110 (Del. 1994).
38. See id. at 1112-13, 1119-21.

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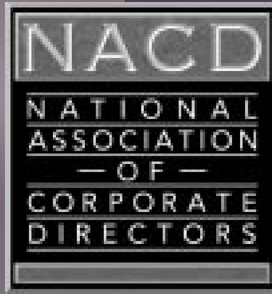

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Appendix C

Definitions of Director Independence

I. Federal Definitions
  A. Tax Law
  B. Securities Law
II. Stock Exchange Definitions
  A. New York Stock Exchange Listed Companies
  B. Nasdaq and American Stock Exchange Listed Companies
III. Other Definitions
  A. The American Law Institute
  B. The Business Roundtable
  C. Council of Institutional Investors
  D. A *Fortune* 500 Company
  E. National Association of Corporate Directors

I. Federal Definitions

A. Tax Law

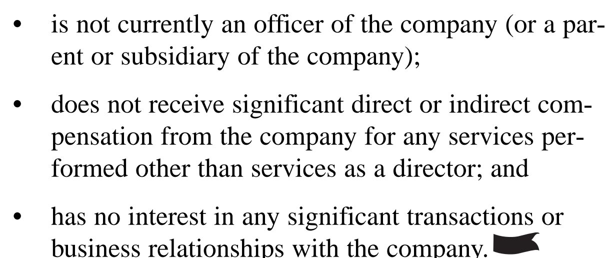
Section 162(m) of the Internal Revenue Code stipulates that executive compensation over $1 million is not deductible. However, this section provides a number of exceptions to non-deductibility; one such exception is achieved if the compensation is "performance based" and is determined by a compensation committee that is comprised solely of two or more "outside directors." The regulations addressing Section 162(m) define a director as an outside director if the director:

- is not a current or former employee of the corporation; and
- does not receive significant direct or indirect compensation in any capacity other than as director (i.e., remuneration for services or goods).

B. Securities Law

Pursuant to Rule 16b-3 promulgated under the Securities Exchange Act of 1934, a "non-employee director" is a person who:

- is not currently an officer of the company (or a parent or subsidiary of the company);
- does not receive significant direct or indirect compensation from the company for any services performed other than services as a director; and
- has no interest in any significant transactions or business relationships with the company.



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II. Stock Exchange Definitions (for Audit Committee Service)

The Securities and Exchange Commission, the New York Stock Exchange, the National Association of Securities Dealers, and the Auditing Standards Board have adopted new rules that require audit committees be composed of at least three “independent” directors all of whom are financially literate and one of whom has accounting or related financial management expertise.

The following two checklists* provide definitions of independence adopted by the exchanges. For the full checklist, see *DM Extra,* February 2000.

A. New York Stock Exchange Listed Companies

Relationships Precluding Independence

- Current employee of company or affiliate, or employee of the company or any of its affiliates in last three years;
- Current employee of entity that is a current parent or corporate predecessor of company or was the parent or corporate predecessor of the company in last three years;
- Immediate family member of current executive officer of company or affiliate, or an immediate family member of an executive officer of the company or affiliate in last three years;
- Executive of another business organization where any of the company's executives serve on the business organization's compensation committee;
- Partner, controlling shareholder, or executive officer of a business organization that has a business relationship with the company; or
- Person who has a direct business relationship with the company.

Exception: Rebuttal of Preclusion of Independence

A partner, controlling shareholder, or executive officer of an organization that has a business relationship with the company, or a person who has a direct business relationship with the company, may be considered independent if the board of directors determines in its business judgment that the relationship does not interfere with the director's exercise of independent judgment.

Exception: One Non-Independent Member

One director who is:

- a past employee of the company, or
- an immediate family member of a past executive officer of the company or its affiliates,

but who is precluded from being considered independent due to the three-year time restriction, may serve on the audit committee if the board determines in its business judgment that membership on the committee by the individual is required by the best interests of the corporation and its shareholders, and the company discloses in the next annual proxy statement after this determination the nature of the relationship and the reasons for the determination.

B. Nasdaq and American Stock Exchange Listed Companies

Relationships Precluding Director Independence

- Current employee of company or affiliate, or employee of company or any of its affiliates in last three years;
- Current employee of entity that is a current parent or corporate predecessor of company or was the parent or corporate predecessor of the company in last three years;
- Immediate family member of current executive officer of company or company affiliate, or an immediate family member of an executive officer of the company or affiliate in last three years;
- Executive of another business organization where any of the company's executives serve on the business organization's compensation committee;
- Partner, controlling shareholder, or executive officer of any for-profit business organization to which the company made, or from which the company received, payments that exceeded 5% of the company's or business organization's gross revenues for that year, or $200,000, whichever is more, in any of the last three years, or
- Person who accepts any compensation from the corporation or any of its affiliates in excess of

* Note: These checklists were prepared by Paula Lowitt, an associate at Weil, Gotshal & Manges LLP in New York, New York.

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$60,000 during the previous fiscal year other than compensation for board service, benefits under a tax qualified retirement plan, or non-discretionary compensation.

Exception:
One Non-Independent Member

One director who is:

- not independent under the above definition
- not a current employee or immediate family member of employee of the company

may serve on the audit committee if the board "under exceptional and limited circumstances" determines that membership on the committee by the individual is required by the best interests of the corporation and its shareholders, and the board discloses in the next annual proxy statement after this determination the nature of the relationship and the reasons for the determination.

III. Other Definitions

A. The American Law Institute (ALI)

The ALI recommends that boards of large publicly held corporations (2,000 or more holders of record and $100 million or more total assets) should be composed of a majority of directors "who are free of any significant relationship" with the corporation's senior executives, and also recommends that boards of other publicly held corporations should have at least three such directors. ALI, *Principles of Corporate Governance* § 3A-01. The ALI considers a director to have a significant relationship with the senior executives of the company if:

- the director is employed by the corporation, or was so employed within the two preceding years;
- the director is a member of the immediate family of an individual who (A) is employed by the corporation as an officer, or (B) was employed by the corporation as a senior executive within the two preceding years;
- the director has made to, or received from, the corporation during either of its two preceding years commercial payments that exceeded $200,000, or the director owns or has power to vote an equity interest in a business organization to which the corporation made, or from which the corporation received, during either of its two preceding years, commercial payments that, when multiplied by the director's percentage equity interest in the organization, exceeded $200,000;
- the director is a principal manager of a business organization to which the corporation made, or from which the corporation received, during either of the organization's two preceding years, commercial payments that exceeded 5 percent of the organization's consolidated gross revenues for that year, or $200,000, whichever is more; or
- the director is affiliated in a professional capacity with a law firm that was the primary legal advisor to the corporation with respect to general corporate or securities law matters, or with an investment banking firm that was retained by the corporation in an advisory capacity or acted as a managing underwriter in an issue of the corporation's securities, within the two preceding years, or was so affiliated with such a law or investment banking firm when it was so retained or so acted.

A director who meets one of the above criteria can, nonetheless, be considered not to have a significant relationship with management "if, on the basis of countervailing or other special circumstances, it could not reasonably be believed that the judgment of a person in the director's position would be affected by his relationship . . . in a manner adverse to the corporation." ALI, *Principles of Corporate Governance* § 1.34.

The ALI also recommends that every large publicly held corporation have an audit committee consisting of at least three members and composed exclusively of directors who are neither employed by the corporation nor were so employed by the corporation within the two preceding years, including at least a majority of members who have no significant relationship with the corporation's senior executives. ALI, *Principles of Corporate Governance* § 3.05.

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B. The Business Roundtable

According to The Business Roundtable, *Statement on Corporate Governance* (September 1, 1997), independent directors are "[persons] who do not hold management responsibilities within the corporation."

C. Council of Institutional Investors (CII)

According to a definition adopted March 1998 by CII and revised March 2000:

A director is deemed independent if his or her only non-trivial professional, familial or financial connection to the corporation or its CEO is his or her directorship.

A director will not generally be considered independent if he or she:

- has been employed by the corporation or an affiliate in an executive capacity;
- is, or in the past two years has been, an employee or owner of a firm that is one of the corporation's or its affiliate's or the CEO's paid advisers or consultants;
- is employed by a significant customer or supplier;
- has, or in the past two years has had, a personal services contract with the CEO, the corporation or one of its affiliates;
- is an employee, officer or director of a foundation, university or other non-profit organization that receives significant grants or endowments from the corporation or one of its affiliates;
- is a relative of an executive of the corporation or one of its affiliates; and
- is part of an interlocking directorate in which the CEO or other executive officer of the corporation serves on the board of another corporation that employs the director.

D. A **Fortune** *500 Company*

Determination of independence of directors. In its determination of a director's eligibility to be classified as an independent director pursuant to this section, the board shall consider, among such other factors as it may in any case deem relevant, that the director:

- has not been employed by the Corporation as an executive officer within the past three years;
- is not a paid advisor or consultant to the Corporation and derives no financial benefit from any entity as a result of advice or consultancy provided to the Corporation by such entity;
- is not an executive officer, director or significant stockholder of a significant customer or supplier of the Corporation;
- has no personal services contract with the Corporation;
- is not an executive officer or director of a tax-exempt entity receiving a significant part of its annual contributions from the Corporation;
- is not a member of the immediate family of any director who is not considered an independent director;
- is free of any other relationship that would interfere with the exercise of independent judgment by such director.

E. National Association of Corporate Directors

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;
- receives no compensation from the company, other than director fees.

For other definitions of independence, and for additional comparisons on other governance matters, see Holly J. Gregory, *Comparison of Corporate Governance Guidelines and Codes of Best Practice: United States* (New York: Weil, Gotshal & Manges LLP, 2000).

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REPORT AND RECOMMENDATIONS

OF THE

BLUE RIBBON COMMITTEE

ON

IMPROVING THE EFFECTIVENESS OF

CORPORATE AUDIT COMMITTEES

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Letter From the Chairmen

Dear Messrs. Grasso and Zarb:

Since the end of September 1998, when you called upon us to chair this Blue Ribbon Committee, we have been honored to work with our fellow Committee members on what we believe to be a truly collaborative effort.

We are pleased to submit to you this Report and Recommendations, but wish to acknowledge that much of our work is based on the outstanding research and best practices documents previously drafted and disseminated by others. In particular, the Committee wishes to commend and thank those responsible for the Report of the National Commission on Fraudulent Financial Reporting (Treadway Commission (1987)) and Strengthening the Professionalization of the Independent Auditor, Report to the Public Oversight Board of the SEC Practice Section, American Institute of Certified Public Accountants (AICPA) from the Advisory Panel on Auditor Independence (1994) ("1994 POB Report") – both resources the Committee used liberally.

This Report, however, is not intended to cover the breadth of financial reporting issues addressed by these and other prior reports. Nor does this Report focus on fraud per se, although many of our recommendations may reduce the possibility of fraud. The Committee's focus is on the large grey area where discretion and subjective judgments bear on the quality of financial reporting. It is not possible to lay down hard and fast rules where discretion is required. Accordingly, we emphasize the need for financial management to make sound financial judgments and the process by which the outside auditors and the audit committee evaluate those judgments.

Our Report is geared toward effecting pragmatic, progressive changes in the functions and expectations placed on corporate boards, audit committees, senior and financial management, the internal auditor, and the outside auditors regarding financial reporting and the oversight process. Underpinning our work is the recognition that quality financial accounting and reporting can only result from effective interrelationships among these relevant corporate participants.

Throughout our deliberations we have strived to produce recommendations that promote quality financial reporting, recognizing the benefits that inure from this practice: market confidence, a more efficient allocation of capital, and the resulting lower cost of capital. The strength of America's capital markets always has been their adherence to transparency and full disclosure.

Because so many groups within the corporate community are vested in some aspect of board oversight and the financial reporting process, you have assembled in this Committee representatives from the whole spectrum of the interested parties. In this spirit, the Committee gathered input from a wide range of constituencies through a public hearing and open request for formal written comments on the topic.

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Finally, we applaud the current parallel efforts by other organizations, namely the Public Oversight Board's Panel on Audit Effectiveness, the National Association of Corporate Directors' Blue Ribbon Commission on Audit Committees, and the Independence Standards Board.

The substantive matters covered by the Committee's recommendations have been studied and commented upon by business and professional groups, and scholars, for years. This time, because of how, and by whom, this Committee was convened, the Committee anticipates prompt and serious consideration of formal implementation of the Committee's recommendations on the part of the SEC, the NYSE, the NASD, and the accounting profession. The precise forms of implementation are, obviously, the domain of each of them; it is the substance of our recommendations that we trust will be considered and implemented. The Committee anticipates, too, that its recommendations will be seriously considered by newly energized audit committees – even as the regulatory and self-regulatory bodies engage in their implementation processes. Corporate governance should be a do-it-yourself kit, and audit committees can, if they wish to, start the improvement process immediately without formal rules, standards and regulations; the Committee urges audit committees to take such voluntary action. Precipitating action this time will be the reward for the voluntary efforts the Committee extended, as well as the voluntary efforts of all of those who assisted the Committee through testimony, comment, and debate.

We appreciate the opportunity to serve on the Committee and to contribute to this important area.

Sincerely,

John C. Whitehead Ira M. Millstein

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Overview and Recommendations

Recommendations for the performance of audit committees must be founded in the practices and attitudes of the entire board of directors. We, therefore, at the outset, urge boards of directors to understand and adopt the attitude of the modern board which recognizes that the board must perform active and independent oversight to be, as the law requires, a fiduciary for those who invest in the corporation. Board membership is no longer just a reward for "making it" in corporate America; being a director today requires the appropriate attitude and capabilities, and it demands time and attention.

The measure of the board, then, is not simply whether it fulfills its "legal" requirements but, more importantly, the board's attitude and how it puts into practice its awareness and understanding of its responsibilities. Is the board simply going through the motions, or has it demonstrated awareness of its important role by having some form of independent leadership that can act without relying only on management's initiative? Has the board established guidelines or operational procedures for its own functioning? Do the independent directors meet alone periodically to evaluate management and company performance and strategy? Does the board engage in individual director and full board evaluation? From self-generated measures such as these, one can infer that the board is aware, independent, professional and well-governing, or at least is endeavoring to be distinct from management. In essence, these signs show that a board is moving from being passive to active.

If a board is functioning properly, the audit committee can build on and relate to these very same board-wide principles. If the board is dysfunctional, the audit committee likely will not be much better. We cannot, however, suggest a single appropriate template for oversight by all audit committees. Just as "one size doesn't fit all" when it comes to board governance, "one size can't fit all" audit committees. Within broad parameters, each audit committee should evolve and develop its own guidelines suited to itself and its corporation.

A starting point for the development of audit committee guidelines is a recognition of the audit committee's position in the larger governance process as it relates to the oversight of financial reporting. Certainly, it is not the role of the audit committee to prepare financial statements or engage in the myriad of decisions relating to the preparation of those statements. The committee's job is clearly one of oversight and monitoring, and in carrying out this job it acts in reliance on senior financial management and the outside auditors. A proper and well-functioning system exists, therefore, when the three main groups responsible for financial reporting -- the full board including the audit committee, financial management including the internal auditors, and the outside auditors -- form a "three-legged stool" that supports responsible financial disclosure and active and participatory oversight. However, in the view of the Committee, the audit committee must be "first among equals" in this process, since the audit committee is an extension of the full board and hence the ultimate monitor of the process.

Turning from awareness and execution of responsibilities to another modern element of governance, we note that disclosure and transparency have become the first hallmark of good governance looked to by investors. The lack of disclosure and transparency no doubt contributed to the recent flight of capital from Asia. If a corporation is to be a viable attraction for capital, its board must ensure disclosure and transparency concerning the company's true

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financial performance as well as its governance practices. Accounting games may be short-term fixes, but they are not long-term bases for financial credibility.

Our recommendations, therefore, build on these two essentials: first, an audit committee with actual practices and overall performance that reflect the professionalism embodied by the full board of which it is a part, and second, a legal, regulatory, and self-regulatory framework that emphasizes disclosure and transparency and accountability.

The Committee wishes to stress that while the recommendations in this Report appear separately, they together form a mosaic to enhance financial reporting and oversight of that process; in this light, the Committee views the recommendations as an integrated set of objectives that must be adopted in its entirety in order to accomplish the intended results. The need for such an integrated approach is of even greater importance given the fact that implementation will require action by a number of entities including the Securities and Exchange Commission (SEC), the securities markets through the self-regulatory organizations (SROs), the accounting profession, and, of course, boards and audit committees.

Notably, while several of the recommendations that apply to public companies contemplate an exemption for smaller entities due to the burdens involved, the Committee urges all companies regardless of size to make a good faith attempt to follow these recommendations. Similarly, while a number of the recommendations propose amendments to the listing standards applied by the NYSE and the NASD, the Committee hopes that these proposed amendments to listing standards be considered by any market that is a primary venue for U.S. equities.

It is with these perspectives the Committee advances the recommendations outlined in summary form below. The section of this Report, entitled “The Audit Committee as Catalyst for Effective Financial Reporting,” more fully describes the rationale and intentions underlying each of these recommendations.

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Summary

The first two recommendations are aimed at strengthening the independence of the audit committee:

Recommendation 1

The Committee recommends that both the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) adopt the following definition of independence for purposes of service on the audit committee for listed companies with a market capitalization above $200 million (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and the NASD):

Members of the audit committee shall be considered independent if they have no relationship to the corporation that may interfere with the exercise of their independence from management and the corporation. Examples of such relation-ships include:

- A director being employed by the corporation or any of its affiliates for the current year or any of the past five years;
- A director accepting any compensation from the corporation or any of its affiliates other than compensation for board service or benefits under a tax-qualified retirement plan;
- A director being a member of the immediate family of an individual who is, or has been in any of the past five years, employed by the corporation or any of its affiliates as an executive officer;
- A director being a partner in, or a controlling shareholder or an executive officer of, any for-profit business organization to which the corporation made, or from which the corporation received, payments that are or have been significant[*] to the corporation or business organization in any of the past five years;
- A director being employed as an executive of another company where any of the corporation's executives serves on that company's compensation committee.

A director who has one or more of these relationships may be appointed to the audit committee, if the board, under exceptional and limited circumstances, determines that membership on the committee by the individual is required by the best interests of the corporation and its shareholders, and the board discloses, in the next annual proxy statement subsequent to such determination, the nature of the relationship and the reasons for that determination.

Recommendation 2

The Committee recommends that in addition to adopting and complying with the definition of independence set forth above for purposes of service on the audit committee, the NYSE and the NASD require that listed companies with a market capitalization above $200 million (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and the NASD) have an audit committee comprised solely of independent directors.

[*] The Committee views the term "significant" in the spirit of Section 1.34(a)(4) of the American Law Institute Principles of Corporate Governance and the accompanying commentary to that section.

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The Committee recommends that the NYSE and the NASD maintain their respective current audit committee independence requirements as well as their respective definitions of independence for listed companies with a market capitalization of $200 million or below (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and the NASD).

Our second set of recommendations is aimed at making the audit committee more effective:

Recommendation 3

The Committee recommends that the NYSE and the NASD require listed companies with a market capitalization above $200 million (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and the NASD) to have an audit committee comprised of a minimum of three directors, each of whom is financially literate (as described in the section of this report entitled "Financial Literacy") or becomes financially literate within a reasonable period of time after his or her appointment to the audit committee, and further that at least one member of the audit committee have accounting or related financial management expertise.

The Committee recommends that the NYSE and the NASD maintain their respective current audit committee size and membership requirements for companies with a market capitalization of $200 million or below (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and the NASD).

Recommendation 4

The Committee recommends that the NYSE and the NASD require the audit committee of each listed company to (i) adopt a formal written charter that is approved by the full board of directors and that specifies the scope of the commit-tee's responsibilities, and how it carries out those responsibilities, including structure, processes, and membership requirements, and (ii) review and reassess the adequacy of the audit committee charter on an annual basis.

Recommendation 5

The Committee recommends that the Securities and Exchange Commission (SEC) promulgate rules that require the audit committee for each reporting company to disclose in the company's proxy statement for its annual meeting of shareholders whether the audit committee has adopted a formal written charter, and, if so, whether the audit committee satisfied its responsibilities during the prior year in compliance with its charter, which charter shall be disclosed at least triennially in the annual report to shareholders or proxy statement and in the next annual report to shareholders or proxy statement after any significant amendment to that charter. The Committee further recommends that the SEC adopt a "safe harbor" applicable to all disclosure referenced in this Recommendation 5.

Our final group of recommendations addresses mechanisms for accountability among the audit committee, the outside auditors, and management:

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Recommendation 6

The Committee recommends that the listing rules for both the NYSE and the NASD require that the audit committee charter for every listed company specify that the outside auditor is ultimately accountable to the board of directors and the audit committee, as representatives of shareholders, and that these shareholder representatives have the ultimate authority and responsibility to select, evaluate, and, where appropriate, replace the outside auditor (or to nominate the outside auditor to be proposed for shareholder approval in any proxy statement).

Recommendation 7

The Committee recommends that the listing rules for both the NYSE and the NASD require that the audit committee charter for every listed company specify that the audit committee is responsible for ensuring its receipt from the outside auditors of a formal written statement delineating all relation-ships between the auditor and the company, consistent with Independence Standards Board Standard 1, and that the audit committee is also responsible for actively engaging in a dialogue with the auditor with respect to any disclosed relationships or services that may impact the objectivity and independence of the auditor and for taking, or recommending that the full board take, appropriate action to ensure the independence of the outside auditor.

Recommendation 8

The Committee recommends that Generally Accepted Auditing Standards (GAAS) require that a company's outside auditor discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the company's accounting principles as applied in its financial reporting; the discussion should include such issues as the clarity of the company's financial disclosures and degree of aggressiveness or conservatism of the company's accounting principles and underlying estimates and other significant decisions made by management in preparing the financial disclosure and reviewed by the outside auditors. This requirement should be written in a way to encourage open, frank discussion and to avoid boilerplate.

Recommendation 9

The Committee recommends that the SEC require all reporting companies to include a letter from the audit committee in the company's annual report to shareholders and Form 10-K Annual Report disclosing whether or not, with respect to the prior fiscal year: (i) management has reviewed the audited financial statements with the audit committee, including a discussion of the quality of the accounting principles as applied and significant judgments affecting the company's financial statements; (ii) the outside auditors have discussed with the audit committee the outside auditors' judgments of the quality of those principles as applied and judgments referenced in (i) above under the circumstances; (iii) the members of the audit committee have discussed among themselves, without management or the outside auditors present, the information disclosed to the audit committee described in (i) and (ii) above; and (iv)` the audit committee, in reliance on the review and discussions conducted with management and the outside auditors pursuant to (i) and (ii) above, believes that the company's financial

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statements are fairly presented in conformity with Generally Accepted Accounting Principles (GAAP) in all material respects. The Committee further recommends that the SEC adopt a "safe harbor" applicable to any disclosure referenced in this Recommendation 9.

Recommendation 10

The Committee recommends that the SEC require that a reporting company's outside auditor conduct a SAS 71 Interim Financial Review prior to the company's filing of its Form 10-Q. The Committee further recommends that SAS 71 be amended to require that a reporting company's outside auditor discuss with the audit committee, or at least its chairman, and a representative of financial management, in person, or by telephone conference call, the matters described in AU Section 380, Communications With the Audit Committee, prior to the filing of the Form 10-Q (and preferably prior to any public announcement of financial results), including significant adjustments, management judgments and accounting estimates, significant new accounting policies, and disagreements with management.

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Final Rule:
Audit Committee Disclosure

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 210, 228, 229, and 240

[Release No. 34-42266; File No. S7-22-99]

RIN 3235-AH83

Audit Committee Disclosure

AGENCY: Securities and Exchange Commission

ACTION: Final rule

SUMMARY: The Securities and Exchange Commission is adopting new rules and amendments to its current rules to require that companies' independent auditors review the companies' financial information prior to the companies filing their Quarterly Reports on Form 10-Q or Form 10-QSB with the Commission, and to require that companies include in their proxy statements certain disclosures about their audit committees and reports from their audit committees containing certain disclosures. The rules are designed to improve disclosure related to the functioning of corporate audit committees and to enhance the reliability and credibility of financial statements of public companies.

Dates: *Effective Date:* January 31, 2000. *Compliance Dates::* Registrants must obtain reviews of interim financial information by their independent auditors starting with their Forms 10-Q or 10-QSB to be filed for fiscal quarters ending on or after March 15, 2000. Registrants must comply with the new proxy and information disclosure requirements (e.g., the requirement to include a report of their audit committee in their proxy statements, provide disclosures regarding the independence of their audit committee members, and attach a copy of the audit committee's charter) for all proxy and information statements relating to votes of shareholders occurring after December 15, 2000. Companies who become subject to Item 302(a) of Regulation S-K as a result of today's amendments must comply with its requirements after December 15, 2000. Registrants voluntarily may comply with any of the new requirements prior to the compliance dates.

FOR FURTHER INFORMATION CONTACT: Mark Borges, Attorney-Adviser, Division of Corporation Finance (202-942-2900), Meridith Mitchell, Senior Counselor, Office of the General Counsel (202-942-0900), or W. Scott Bayless, Associate Chief Accountant, or Robert E. Burns, Chief Counsel, Office of the Chief Accountant (202-942-4400).

SUPPLEMENTARY INFORMATION: The Commission is adopting amendments to Rule 10-01 of Regulation S-X, Item 310 of Regulation S-B, Item 7 of Schedule 14A under the Securities Exchange Act of 1934 (the "Exchange Act"), and Item 302 of Regulation S-K. Additionally, the Commission is adopting new Item 306 of Regulation S-K and Item 306 of Regulation S-B.

I. Executive Summary

We are adopting new rules and amendments to current rules to improve disclosure relating to the functioning of corporate audit committees and to enhance the reliability and credibility of financial statements of public companies. As more fully described in the Proposing Release, the new rules and amendments are based in large measure on recommendations made by the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (the "Blue Ribbon Committee"). The new rules and amendments have been adopted in most respects as proposed, with modifications discussed below. Audit committees play a critical role in the financial reporting system by overseeing and

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monitoring management's and the independent auditors' participation in the financial reporting process. We have seen a number of significant changes in our markets, such as technological developments and increasing pressure on companies to meet earnings expectations, that make it ever more important for the financial reporting process to remain disciplined and credible. We believe that additional disclosures about a company's audit committee and its interaction with the company's auditors and management will promote investor confidence in the integrity of the financial reporting process. In addition, increasing the level of scrutiny by independent auditors of companies' quarterly financial statements should lead to fewer year-end adjustments, and, therefore, more reliable financial information about companies throughout the reporting year.

Accordingly, the new rules and amendments:

- require that companies' independent auditors review the financial information included in the companies' Quarterly Reports on Form 10-Q or 10-QSB prior to the companies filing such reports with the Commission (see Section III.A below);

- extend the requirements of Item 302(a) of Regulation S-K (requiring at fiscal year end appropriate reconciliations and descriptions of any adjustments to the quarterly information previously reported in a Form 10-Q for any quarter) to a wider range of companies (see Section III.A below);

- require that companies include reports of their audit committees in their proxy statements; in the report, the audit committee must state whether the audit committee has: (i) reviewed and discussed the audited financial statements with management; (ii) discussed with the independent auditors the matters required to be discussed by Statement on Auditing Standards No. 61, as may be modified or supplemented; and (iii) received from the auditors disclosures regarding the auditors' independence required by Independence Standards Board Standard No. 1, as may be modified or supplemented, and discussed with the auditors the auditors' independence (see Section III.B below);

- require that the report of the audit committee also include a statement by the audit committee whether, based on the review and discussions noted above, the audit committee recommended to the Board of Directors that the audited financial statements be included in the company's Annual Report on Form 10-K or 10-KSB (as applicable) for the last fiscal year for filing with the Commission (see Section III.B below);

- require that companies disclose in their proxy statements whether their Board of Directors has adopted a written charter for the audit committee, and if so, include a copy of the charter as an appendix to the company's proxy statements at least once every three years (see Section III.C below);

- require that companies, including small business issuers, whose securities are quoted on NASDAQ or listed on the American Stock Exchange ("AMEX") or New York Stock Exchange ("NYSE"), disclose in their proxy statements whether the audit committee members are "independent" as defined in the applicable listing standards, and disclose certain information regarding any director on the audit committee who is not "independent" (see Section III.D below);

- require that companies, including small business issuers, whose securities are not quoted on NASDAQ or listed on the AMEX or NYSE disclose in their proxy statements whether, if they have an audit committee, the members are "independent," as defined in the NASD's, AMEX's or NYSE's listing standards, and which definition was used (see Section III.D below); and

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- provide "safe harbors" for the new proxy statement disclosures to protect companies and their directors from certain liabilities under the federal securities laws (see Section III.E below).

To provide companies with the opportunity to evaluate their compliance with the revised listing standards of the NASD, AMEX, and NYSE and to prepare for the new disclosure requirements, we are providing transition periods for compliance with the new requirements (see Section V below).

II. Background

As discussed in the Proposing Release, given the changes in our markets, such as the increasing number of investors entering our markets and changes in the way and speed with which investors receive information, it is vitally important for investors to remain confident that they are receiving the highest quality financial reporting. The demand for reliable financial information appears to be at an all time high, as technology makes information available to more people more quickly. The new dynamics of our capital markets have presented companies with an increasingly complex set of challenges. One challenge is that companies are under increasing pressure to meet earnings expectations. We have become increasingly concerned about inappropriate "earnings management," the practice of distorting the true financial performance of the company.

The changes in our markets and the increasing pressures on companies to maintain positive earnings trends have highlighted the importance of strong and effective audit committees. Effective oversight of the financial reporting process is fundamental to preserving the integrity of our markets. Audit committees play a critical role in the financial reporting system by overseeing and monitoring management's and the independent auditors' participation in the financial reporting process. Audit committees can, and should, be the corporate participant best able to perform that oversight function.

As discussed more fully in the Proposing Release, since the early 1940s, the Commission, along with the auditing and corporate communities, has had a continuing interest in promoting effective and independent audit committees. Most recently, the NYSE and NASD sponsored the Blue Ribbon Committee in response to "an increasing sense of urgency surrounding the need for responsible need for responsible financial reporting given the market's increasing focus on corporate earnings and a long and powerful bull market." The new rules and amendments affirm what have long been considered sound practice and good policy within the accounting and corporate communities.

While almost all of the commenters that provided comment letters on the Proposing Release supported our goals of improving disclosure about audit committees and enhancing the reliability and credibility of financial statements, many commenters suggested alternative approaches to achieving those goals. Some commenters believed that we should impose more rigorous requirements. Other commenters recommended that we not adopt certain aspects of the proposals. In this regard, the concern most frequently expressed was that as a result of the new requirements to provide certain disclosures in a report, audit committees may be exposed to additional liability, and that consequently it may be difficult for companies to find qualified people to serve on audit committees.

It is not our intention to subject audit committee members to increased liability. We addressed concerns about liability by modifying our initial proposals from the Blue Ribbon Committee's recommendations and by providing safe harbor protections. Nevertheless, we appreciate that many commenters continue to be concerned about the audit committee report generally, and specifically the requirement that the audit committee state whether anything has come to the attention of the members of the audit committee that caused the audit committee to believe that the audited financial statements included in the company's Annual Report on Form 10-K or 10-KSB contain an untrue statement of material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading.

In response, we have modified that disclosure item, which was the subject of most of the commentary. We are adopting, instead, one of the other alternatives proposed – the audit committee must state

whether, based on the review and discussion of the audited financial statements with management and discussions with the independent auditors, the audit committee recommended to the Board that the audited financial statements be included in the company's Annual Report on Form 10-K or 10-KSB (as applicable) for the last fiscal year for filing with the Commission. As we discussed in the Proposing Release, we do not believe that improved disclosure about the audit committee and increased involvement by the audit committee should result in increased exposure to liability. Consequently, we believe that this modification, together with the safe harbors, should further alleviate concerns about increased liability exposure, while promoting our goal of improving the financial reporting process.

Some commenters expressed concern about applying the new requirements to small businesses, particularly the interim financial review requirement. We have considered those comments carefully. We think that improvements in the financial reporting process for companies of all sizes is important for promoting investor confidence in our markets. In this regard, because we have seen instances of financial fraud at small companies as well as at large companies, we think that improving disclosures about the audit committees of small and large companies is important. As discussed in the Proposing Release, interim financial information generally may include more estimates than annual financial statements, but interim financial statements have never been subject to the discipline provided by having auditors associated with these statements on a timely basis. Investors, however, rely on and react quickly to quarterly results of companies, large and small. Accordingly, we believe that it is appropriate to require small business issuers to obtain reviews of interim financial information. As discussed below, however, small business issuers are not included in the expanded group of issuers subject to Item 302(a) disclosure requirements. In addition, we think that the transition period should help small businesses prepare for and adapt to the new requirements.

The Blue Ribbon Committee also made recommendations that call for action by the NASD, the NYSE, and the AICPA. In response, the NASD and NYSE proposed, and the Commission approved, changes to their listing standards, and the Auditing Standards Board ("ASB") recently proposed amendments to SAS 61 and SAS 71.

III. Discussion of New Rules and Amendments

A. Pre-Filing Review of Quarterly Financial Statements; Item 302(a)

[text of IIIA deleted]

B. The Audit Committee Report

We are adopting new Item 306 of Regulations S-K and S-B and Item 7(e)(3) of Schedule 14A that require the audit committee to provide a report in the company's proxy statement. The required disclosure will help inform shareholders of the audit committee's oversight with respect to financial reporting, and underscore the importance of that role.

Many commenters were concerned that a report by the audit committee that indicates whether various discussions have occurred would expose the audit committee members to increased scrutiny and liability. We do not believe that will be the case. Under state corporation law, the more informed the audit committee becomes through its discussions with management and the auditors, the more likely that the "business judgment rule" will apply and provide broad protection. Those discussions should serve to strengthen the "information and reporting system" that should be in place. Adherence to a sound process should result in less, not more, exposure to liability.

Accordingly, we are adopting, as proposed, the requirement that the audit committee disclose whether the audit committee has reviewed and discussed the audited financial statements with management and discussed certain matters with the independent auditors. Under paragraphs (a)(1), (a)(2), and (a)(3) of Item 306 (paragraph (a)(4) is discussed separately, below), audit committees must state whether:

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(1) the audit committee has reviewed and discussed the audited financial statements with management;

(2) the audit committee has discussed with the independent auditors the matters required to be discussed by SAS 61, as may be modified or supplemented; and

(3) the audit committee has received the written disclosures and the letter from the independent auditors required by ISB Standard No. 1, as may be modified or supplemented, and has discussed with the auditors the auditors' independence.

If the company does not have an audit committee, the board committee tasked with similar responsibilities, or the full board of directors, would be responsible for the disclosure.

The disclosure required by paragraph (a)(3) relates to written disclosures, a letter from the independent auditors, and discussions between the audit committee and the independent auditors required by ISB Standard No. 1. The Commission has long recognized the importance of auditors being independent from their audit clients. Public confidence in the reliability of a company's financial statements depends on investors perceiving the company's auditors as being independent from the company.

As noted above, paragraph (a)(4) was the subject of the most criticism. Commenters expressed concern about increased liability exposure, which they believed may result in qualified audit committee members resigning or companies having difficulty recruiting qualified members. Some commenters, on the other hand, were skeptical that there would be increased liability exposure.

Because of concerns about liability, we did not propose the disclosure requirement recommended by the Blue Ribbon Committee, but instead proposed that the audit committee indicate whether, based on its discussions with management and the auditors, its members became aware of material misstatements or omissions in the financial statements. As discussed in the Proposing Release, we did not intend, nor do we believe, that the proposed disclosure about the audit committee and increased involvement by the audit committee would result in increased exposure to liability. Because commenters continued to be concerned, however, we are adopting an alternative contained in the Proposing Release. We believe that the revised language, together with the safe harbors, addresses those concerns.

As adopted, new paragraph (a)(4) requires the audit committee to state whether, based on the review and discussions referred to in paragraphs (a)(1) through (a)(3), it recommended to the Board of Directors that the financial statements be included in the Annual Report on Form 10-K or 10-KSB for the last fiscal year for filing with the Commission. Because the new language in paragraph (a)(4) focuses on the annual audited financial statements and the filing of those financial statements with the Commission, we believe that this requirement will provide investors with a better understanding of the audit committee's oversight role in the financial reporting process. The audit committee's recommendation that the financial statements be used in Commission filings already is implicit in, and is consistent with, board members signing the company's Annual Report on Form 10-K or 10-KSB. Further, several commenters preferred this alternative.

In addition, in performing its oversight function, the audit committee likely will be relying on advice and information that it receives in its discussions with management and the independent auditors. Accordingly, the text of the new requirement acknowledges that the audit committee had such discussions with management and the auditors, and, based on those discussions, made decisions about the financial statements and the filing of the company's Form 10-K or 10-KSB. This approach is consistent with state corporation law that permits board members to rely on the representations of management and the opinions of experts retained by the corporation when reaching business judgments. The Blue Ribbon Committee noted the "impracticability of having the audit committee do more than rely upon the information it receives, questions, and assesses in making this disclosure."

We are adopting, as proposed, the requirement that the new disclosure appear over the printed names of each member of the audit committee. This requirement will emphasize for shareholders the importance of the audit committee's oversight role in the financial reporting process.

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The disclosures are required in the company's proxy statement because they could have a direct bearing on shareholders' voting decisions, and because the proxy statement is actually delivered to shareholders and is accessible on the SEC's web site. Companies must provide the disclosure only in a proxy statement relating to an annual meeting of shareholders at which directors are to be elected (or special meeting or written consents in lieu of such meeting). The disclosure needs to be provided only one time during the year (*e.g.*, in a proxy statement for an annual meeting at which directors are to be elected, but not in proxy solicitation material used in a subsequent election contest during that same year).

C. Audit Committee Charters

We are adopting, as proposed, the requirement that companies disclose in their proxy statements whether their audit committee is governed by a charter, and if so, include a copy of the charter as an appendix to the proxy statement at least once every three years. The requirement appears in new paragraph (e)(3) under Item 7 of Schedule 14A. The new disclosure regarding audit committees' charters should help shareholders assess the role and responsibilities of the audit committee.

We believe that audit committees that have their responsibilities set forth in a written charter are more likely to play an effective role in overseeing the company's financial reports. The amendments, however, will not require companies to adopt audit committee charters, or dictate the content of the charter if one is adopted.

Several commenters expressed concern that the requirement to attach the charter would result in boilerplate charters. We believe that it is useful for shareholders to know about the responsibilities and the duties of audit committees, and while it is inevitable that some of the same provisions will appear in charters of different audit committees, we encourage companies to tailor the charters to their specific circumstances.

Consistent with some of the comments regarding the audit committee report, some commenters recommended that the charter be attached to the Form 10-K instead of the proxy statement because of concerns about expanding the length of the proxy statement. We believe that information about the responsibilities and the duties of audit committees is most relevant to shareholders when they are electing directors and reviewing their performance. Accordingly, we have determined to require, as proposed, that the charter be attached to the proxy statement every three years.

D. Disclosure About "Independence" of Audit Committee Members

As early as 1940, the Commission encouraged the use of audit committees composed of independent directors. As the Commission staff stated in a report to Congress in 1978, "[i]f the [audit] committee has members with vested interests related to those of management, the audit committee probably cannot function effectively. In some instances this may be worse than having no audit committee at all by creating the appearance of an effective body while lacking the substance." Further, as the Blue Ribbon Committee noted, ". . . common sense dictates that a director without any financial, family, or other material personal ties to management is more likely to be able to evaluate objectively the propriety of management's accounting, internal control and reporting practices."

As noted in the Proposing Release, because of the importance of having an audit committee that is comprised of independent directors, we believe that shareholders should know about the independence of the members. We believe that the new disclosures will accomplish that goal.

Under the revised listing standards of the NYSE, AMEX, and NASD, under exceptional and limited circumstances, companies may appoint to their audit committee one director who is not independent if the Board determines that membership on the committee by the individual is required by the best interests of the corporation and its shareholders, and the Board discloses, in the next annual proxy statement subsequent to such determination, the nature of the relationship and the reasons for that determination. We are adopting, as proposed, the requirement that companies whose securities are listed

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on the NYSE or AMEX or quoted on NASDAQ that have a non- independent audit committee member disclose the nature of the relationship that makes that individual not independent and the reasons for the Board's determination to appoint the director to the audit committee. Small business issuers are not required to comply with this requirement.

In addition, companies, including small business issuers, whose securities are listed on the NYSE or AMEX or quoted on NASDAQ, must disclose whether the audit committee members are independent, as defined in the applicable listing standards. While companies are required to provide in their proxy statements certain disclosures that relate to the independence of directors,we thought that it was important to make the disclosure about all of the audit committee members' independence explicit and clear for shareholders. For example, if we required disclosure about only those audit committee members who are not independent, there would have been an implication that all of the other members are independent. Because of the importance of having independent directors on the audit committee, shareholders should be informed explicitly, rather than implicitly, of each member's status.

While we recognize that the new requirements of the NYSE, AMEX, and NASD regarding independence of audit committees need not be complied with for 18 months, we think that companies will be able to provide the new disclosures in the first proxy season after year 2000 because, as a practical matter, to meet the 18-month deadline, most companies will elect new directors during the year 2000. For other companies, this will show their progress in moving toward compliance with the listing requirements.

We are also adopting, as proposed, the requirement that companies, including small business issuers, whose securities are not listed on the NYSE or AMEX or quoted on NASDAQ, disclose in their proxy statements whether, if they have an audit committee, the members are independent as defined in the NYSE's, AMEX's, or NASD's listing standards, and which definition was used. These companies would be able to choose which definition of "independence" to apply to the audit committee members in making the disclosure. Whichever definition is chosen must be applied consistently to all members of the audit committee.

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Item 7. Directors and executive officers.

If action is to be taken with respect to the election of directors, furnish the following information in tabular form to the extent practicable. If, however, the solicitation is made on behalf of persons other than the registrant, the information required need be furnished only as to nominees of the persons making the solicitation.

(a) The information required by instruction 4 to Item 103 of Regulation S-K (§229.103 of this chapter) with respect to directors and executive officers.

(b) The information required by Items 401, 404 (a) and (c), and 405 of Regulation S-K (§229.401, §229.404 and §229.405 of this chapter).

(c) The information required by Item 404(b) of Regulation S-K (§229.404 of this chapter).

(d)(1) State whether or not the registrant has standing audit, nominating and compensation committees of the Board of Directors, or committees performing similar functions. If the registrant has such committees, however designated, identify each committee member, state the number of committee meetings held by each such committee during the last fiscal year and describe briefly the functions performed by such committees.

(2) If the registrant has a nominating or similar committee, state whether the committee will consider nominees recommended by security holders and, if so, describe the procedures to be followed by security holders in submitting such recommendations.

(3) If the registrant has an audit committee:

(i) Provide the information required by Item 306 of Regulation S-K (17 CFR 229.306).

(ii) State whether the registrant's Board of Directors has adopted a written charter for the audit committee.

(iii) Include a copy of the written charter, if any, as an appendix to the registrant's proxy statement, unless a copy has been included as an appendix to the registrant's proxy statement within the registrant's past three fiscal years.

(iv) (A) For registrants whose securities are listed on the New York Stock Exchange ("NYSE") or American Stock Exchange ("AMEX") or quoted on NASDAQ:

(1) Disclose whether the members of the audit committee are independent (as independence is defined in Sections 303.01(B)(2)(a) and (3) of the NYSE's listing standards, Section 121(A) of the AMEX's listing standards, or Rule 4200(a)(15) of the National Association of Securities Dealers' ("NASD") listing standards, as applicable and as may be modified or supplemented); and

(2) If the registrant's Board of Directors determines in accordance with the requirements of Section 303.02(D) of the NYSE's listing standards, Section 121(B)(b)(ii) of the AMEX's listing standards, or Section 4310(c)(26)(B)(ii) or 4460(d)(2)(B) of the NASD's listing standards, as applicable and as may be modified or supplemented, to appoint one director to the audit committee who is not independent, disclose the nature of the relationship that makes that individual not independent and the reasons for the Board's determination. Small business issuers (17 CFR 228.10(a)(1)) need not provide the information required by this paragraph (d)(3)(iv)(A)(2).

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(B) For registrants, including small business issuers, whose securities are not listed on the NYSE or AMEX or quoted on NASDAQ, disclose whether, if the registrant has an audit committee, the members are independent. In determining whether a member is independent, registrants must use the definition of independence in Sections 303.01(B)(2)(a) and (3) of the NYSE's listing standards, Section 121(A) of the AMEX's listing standards, or Rule 4200(a)(15) of the NASD's listing standards, as such sections may be modified or supplemented, and state which of these definitions was used. Whichever definition is chosen must be applied consistently to all members of the audit committee.

(v) The information required by paragraph (d)(3) of this Item shall not be deemed to be "soliciting material," or to be "filed" with the Commission or subject to Regulation 14A or 14C (17 CFR 240.14a-1 et seq. or 240.14c-1 et seq.), other than as provided in this Item, or to the liabilities of section 18 of the Exchange Act (15 U.S.C. 78r), except to the extent that the registrant specifically requests that the information be treated as soliciting material or specifically incorporates it by reference into a document filed under the Securities Act or the Exchange Act. Such information will not be deemed to be incorporated by reference into any filing under the Securities Act or the Exchange Act, except to the extent that the registrant specifically incorporates it by reference.

(vi) The disclosure required by this paragraph (d)(3) need only be provided one time during any fiscal year.

(vii) Investment companies registered under the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.), other than closed-end investment companies, need not provide the information required by this paragraph (d)(3).

(e) In lieu of paragraphs (a) through (d)(2) of this Item, investment companies registered under the Investment Company Act of 1940 (15 U.S.C. 80a) must furnish the information required by Item 22(b) of this Schedule 14A.

(f) State the total number of meetings of the board of directors (including regularly scheduled and special meetings) which were held during the last full fiscal year. Name each incumbent director who during the last full fiscal year attended fewer than 75 percent of the aggregate of (1) the total number of meetings of the board of directors (held during the period for which he has been a director) and (2) the total number of meetings held by all committees of the board on which he served (during the periods that he served).

(g) If a director has resigned or declined to stand for re-election to the board of directors since the date of the last annual meeting of security holders because of a disagreement with the registrant on any matter relating to the registrant's operations, policies or practices, and if the director has furnished the registrant with a letter describing such disagreement and requesting that the matter be disclosed, the registrant shall state the date of resignation or declination to stand for re-election and summarize the director's description of the disagreement. If the registrant believes that the description provided by the director is incorrect or incomplete, it may include a brief statement presenting its view of the disagreement.

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Item 9. Independent public accountants.

If the solicitation is made on behalf of the registrant and relates to: (1) The annual (or special meeting in lieu of annual) meeting of security holders at which directors are to be elected, or a solicitation of consents or authorizations in lieu of such meeting or (2) the election, approval or ratification of the registrant's accountant, furnish the following information describing the registrant's relationship with its independent public accountant:

(a) The name of the principal accountant selected or being recommended to security holders for election, approval or ratification for the current year. If no accountant has been selected or recommended, so state and briefly describe the reasons therefor.

(b) The name of the principal accountant for the fiscal year most recently completed if different from the accountant selected or recommended for the current year or if no accountant has yet been selected or recommended for the current year.

(c) The proxy statement shall indicate: (1) Whether or not representatives of the principal accountant for the current year and for the most recently completed fiscal year are expected to be present at the security holders' meeting, (2) whether or not they will have the opportunity to make a statement if they desire to do so, and (3) whether or not such representatives are expected to be available to respond to appropriate questions.

(d) If during the registrant's two most recent fiscal years or any subsequent interim period, (1) an independent accountant who was previously engaged as the principal accountant to audit the registrant's financial statements, or an independent accountant on whom the principal accountant expressed reliance in its report regarding a significant subsidiary, has resigned (or indicated it has declined to stand for re-election after the completion of the current audit) or was dismissed, or (2) a new independent accountant has been engaged as either the principal accountant to audit the registrant's financial statements or as an independent accountant on whom the principal accountant has expressed or is expected to express reliance in its report regarding a significant subsidiary, then, notwithstanding any previous disclosure, provide the information required by Item 304(a) of Regulation S-K (§ 229.304 of this chapter).

(e) (1) Disclose, under the caption Audit Fees, the aggregate fees billed for professional services rendered for the audit of the registrant's annual financial statements for the most recent fiscal year and the reviews of the financial statements included in the registrant's Forms 10-Q (17 CFR 249.308a) or 10-QSB (17 CFR 249.308b) for that fiscal year.

(2) Disclose, under the caption Financial Information Systems Design and Implementation Fees, the aggregate fees billed for the professional services described in Paragraph (c)(4)(ii) of Rule 2-01 of Regulation S-X (17 CFR 210.2-01(c)(4)(ii)) rendered by the principal accountant for the most recent fiscal year. For purposes of this disclosure item, registrants that are investment companies must disclose fees billed for services rendered to the registrant, the registrant's investment adviser (not including any sub-adviser whose role is primarily portfolio management and is subcontracted with or overseen by another investment adviser), and any entity controlling, controlled by, or under common control with the adviser that provides services to the registrant.

(3) Disclose, under the caption All Other Fees, the aggregate fees billed for services rendered by the principal accountant, other than the services covered in paragraphs (e)(1) and (e)(2) of this section, for the most recent fiscal year. For purposes of this disclosure item, registrants that are investment companies must disclose fees billed for services rendered to the registrant, the registrant's investment adviser (not including any sub-adviser whose role is primarily portfolio management and is subcontracted with or overseen by another

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investment adviser), and any entity controlling, controlled by, or under common control with the adviser that provides services to the registrant.

(4) Disclose whether the audit committee of the board of directors, or if there is no such committee then the board of directors, has considered whether the provision of the services covered in paragraphs (e)(2) and (e)(3) of this section is compatible with maintaining the principal accountant's independence.

(5) If greater than 50 percent, disclose the percentage of the hours expended on the principal accountant's engagement to audit the registrant's financial statements for the most recent fiscal year that were attributed to work performed by persons other than the principal accountant's full-time, permanent employees.

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Final Rule:
Revision of the Commission's Auditor Independence Requirements

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 210 and 240

[Release Nos. 33-7919; 34-43602; 35-27279; IC-24744; IA-1911; FR-56; File No. S7-13-00]

RIN 3235-AH91

Revision of the Commission's Auditor Independence Requirements

AGENCY: Securities and Exchange Commission

ACTION: Final rule

SUMMARY: The Securities and Exchange Commission (“SEC” or “Commission”) is adopting rule amendments regarding auditor independence. The amendments modernize the Commission's rules for determining whether an auditor is independent in light of investments by auditors or their family members in audit clients, employment relationships between auditors or their family members and audit clients, and the scope of services provided by audit firms to their audit clients. The amendments, among other things, significantly reduce the number of audit firm employees and their family members whose investments in audit clients are attributed to the auditor for purposes of determining the auditor's independence. The amendments shrink the circle of family and former firm personnel whose employment impairs an auditor's independence. They also identify certain non-audit services that, if provided by an auditor to public company audit clients, impair the auditor's independence. The scope of services provisions do not extend to services provided to non-audit clients. The final rules provide accounting firms with a limited exception from being deemed not independent for certain inadvertent independence impairments if they have quality controls and satisfy other conditions. Finally, the amendments require most public companies to disclose in their annual proxy statements certain information related to, among other things, the non-audit services provided by their auditor during the most recent fiscal year.

Effective Date: February 5, 2001.

Transition Dates: Until August 5, 2002, providing to an audit client the non-audit services set forth in § 210.2-01(c)(4)(iii) (appraisal or valuation services or fairness opinions) and §210.2-01(c)(4)(v) (internal audit services) will not impair an accountant's independence with respect to the audit client if performing those services did not impair the accountant's independence under pre-existing requirements of the SEC, the Independence Standards Board, or the accounting profession in the United States. Until May 7, 2001, having the financial interests set forth in §210.2-01(c)(1)(ii) or the employment relationships set forth in §210.2-01(c)(2) will not impair an accountant's independence with respect to the audit client if having those financial interests or employment relationships did not impair the accountant's independence under pre-existing requirements of the SEC, the Independence Standards Board, or the accounting profession in the United States. Until December 31, 2002, §210.2-01(d)(4) shall not apply to offices of the accounting firm located outside of the United States. Registrants must comply with the new proxy and information statement disclosure requirements for all proxy and information statements filed with the Commission after the effective date.

FOR FURTHER INFORMATION CONTACT: John M. Morrissey, Deputy Chief Accountant, or Sam Burke, Assistant Chief Accountant, Office of the Chief Accountant, at (202) 942-4400, or with respect to questions about investment companies, John S. Capone, Chief Accountant, Division of Investment Management, at (202) 942-0590, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549.

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SUPPLEMENTARY INFORMATION: The Commission today is adopting amendments to Rule 2-01 of Regulation S-X and Item 9 of Schedule 14A under the Securities Exchange Act of 1934 (the "Exchange Act").

I. Executive Summary

We are adopting amendments to our current rules regarding auditor independence. The final rules advance our important policy goal of protecting the millions of people who invest their savings in our securities markets in reliance on financial statements that are prepared by public companies and other issuers and that, as required by Congress, are audited by independent auditors. We believe the final rules strike a reasonable balance among commenters' differing views about the proposals while achieving our important public policy goals.

Independent auditors have an important public trust. Investors must be able to rely on issuers' financial statements. It is the auditor's opinion that furnishes investors with critical assurance that the financial statements have been subjected to a rigorous examination by an objective, impartial, and skilled professional, and that investors, therefore, can rely on them. If investors do not believe that an auditor is independent of a company, they will derive little confidence from the auditor's opinion and will be far less likely to invest in that public company's securities.

One of our missions is to protect the reliability and integrity of the financial statements of public companies. To do so, and to promote investor confidence, we must ensure that our auditor independence requirements remain relevant, effective, and fair in light of significant changes in the profession, structural reorganizations of accounting firms, and demographic changes in society. There have been important developments in each of these areas since we last amended our auditor independence requirements in 1983.

More and more individual investors participate in our markets, either directly or through mutual funds, pension plans, and retirement plans. Nearly half of all American households are invested in the stock market. As technology has advanced, investors increasingly have direct access to financial information, and they act decisively upon relatively small changes in an issuer's financial results. These and other market changes highlight the importance to the market and to investor confidence of financial information that has been audited by an auditor whose only master is the investing public.

As discussed in the Proposing Release and below, the accounting industry has been transformed by significant changes in the structure of the largest firms. Accounting firms have woven an increasingly complex web of business and financial relationships with their audit clients. The nature of the non-audit services that accounting firms provide to their audit clients has changed, and the revenues from these services have dramatically increased. In addition, there is more mobility of employees and an increase in dual-career families.

We proposed changes to our auditor independence requirements in response to these developments. As more fully discussed below, we are adopting rules, modified in response to almost 3,000 comment letters we received on our proposal, written and oral testimony from four days of public hearings (about 35 hours of testimony from almost 100 witnesses), academic studies, surveys and other professional literature.

<u>The Independence Standard</u>. Independence generally is understood to refer to a mental state of objectivity and lack of bias. The amendments retain this understanding of independence and provide a standard for ascertaining whether the auditor has the requisite state of mind. The first prong of the standard is direct evidence of the auditor's mental state: independence "in fact." The second prong recognizes that generally mental states can be assessed only through observation of external facts; it thus provides that an auditor is not independent if a reasonable investor, with knowledge of all relevant facts and circumstances, would conclude that the auditor is not capable of exercising objective and impartial judgment. The proposed amendments to Rule 2-01 included in the rule four principles for determining

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whether an accountant is independent of its audit client. While some commenters supported our inclusion of the four principles in the rule, others expressed concerns about the generality of these principles and raised questions concerning their application to particular circumstances. In response, we have included the four principles instead in a Preliminary Note to Rule 2-01 as factors that the Commission will consider, in the first instance, when making independence determinations in accordance with the general independence standard in Rule 2-01(b).

The amendments identify certain relationships that render an accountant not independent of an audit client under the standard in Rule 2-01(b). The relationships addressed include, among others, financial, employment, and business relationships between auditors and audit clients, and relationships between auditors and audit clients where the auditors provide certain non-audit services to their audit clients.

Financial and Employment Relationships. Current requirements attribute to an auditor ownership of shares held by every partner in the auditor's firm, certain managerial employees, and their families. We believe that independence will be protected and the rules will be more workable by focusing on those persons who can influence the audit, instead of all partners in an accounting firm. Accordingly, we proposed to narrow significantly the application of these rules. Commenters generally supported our efforts to modernize the current rules because they restrict investment and employment opportunities available to firm personnel and their families in ways that may no longer be relevant or necessary for safeguarding auditor independence and investor confidence. Not all commenters agreed with all aspects of the proposals. We have modified the proposal in some respects, but the final rule, like the proposal, shrinks significantly the circle of firm personnel whose investments are imputed to the auditor. The rule also shrinks the circle of family members of auditors and former firm personnel whose employment with an audit client impairs the auditor's independence.

Non-Audit Services. As we discuss below, there has been growing concern on the part of the Commission and users of financial statements about the effects on independence when auditors provide both audit and non-audit services to their audit clients. Dramatic changes in the accounting profession and the types of services that auditors are providing to their audit clients, as well as increases in the absolute and relative size of the fees charged for non-audit services, have exacerbated these concerns. As the Panel on Audit Effectiveness (the “O'Malley Panel”) recently recognized, “The potential effect of non-audit services on auditor objectivity has long been an area of concern. That concern has been compounded in recent years by significant increases in the amounts of non-audit services provided by audit firms.”

We considered a full range of alternatives to address these concerns. Our proposed amendments identified certain non-audit services that, when rendered to an audit client, impair auditor independence. The proposed restrictions on non-audit services generated more comments than any other aspect of the proposals. Some commenters agreed with our proposals. Others believed that the proposals were not restrictive enough and recommended a total ban on all non-audit services provided by auditors to their audit clients. Still other commenters opposed any Commission rule on non-audit services. After careful consideration of the arguments on all sides, and for the reasons discussed below, we have determined not to adopt a total ban on non-audit services, despite the recommendations of some, and instead to identify certain non-audit services that, if provided to an audit client, render the auditor not independent of the audit client.

In response to public comments, in several instances we have conformed the restrictions to the formulations set forth in the professional literature or otherwise modified the final rule to better describe, and in some cases narrow, the types of services restricted. For example, the final rule does not ban all valuation and appraisal services; its restrictions apply only where it is reasonably likely that the results of any valuation or appraisal, individually or in the aggregate, would be material to the financial statements, or where the results will be audited by the accountant. The rule also provides several exceptions from the restrictions, such as when the valuation is performed in the context of certain tax services, or the valuation is for non-financial purposes and the results of the valuation do not affect the financial statements. These changes are consistent with our approach to adopt only those regulations

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that we believe are necessary to preserve investor confidence in the independence of auditors and the financial statements they audit.

We recognize that not all non-audit services pose the same risk to independence. Accordingly, under the final rule, accountants will continue to be able to provide a wide variety of non-audit services to their audit clients. In addition, they of course will be able to provide any non-audit service to non-audit clients.

Quality Controls. The quality controls of accounting firms play a significant role in helping to detect and prevent auditor independence problems. The final rule recognizes this role by providing accounting firms a limited exception from being deemed not independent for certain independence impairments that are cured promptly after discovery, provided that the firm has certain quality controls in place.

Disclosure of Non-Audit Services. Finally, we continue to believe that disclosures that shed light on the independence of public companies' auditors assist investors in making investment and voting decisions. Accordingly, we proposed and are adopting requirements for disclosures that we believe will be useful to investors. In response to commenters' concerns about the breadth of the proposed disclosure requirements, however, we have modified them in the final rule.

II. Background

Our Proposing Release generated significant comment and broad debate. We received nearly 3,000 comment letters. In addition to soliciting comments in the Proposing Release, we held four days of public hearings, including one day in New York City, so that we could engage in a public dialogue with interested parties. At the hearings, we heard from almost 100 witnesses, representing investors, investment professionals, large and small public companies, the Big Five accounting firms, smaller accounting firms, the AICPA, banking regulators, consumer advocates, state accounting board officials, members of the Independence Standards Board (“ISB”), academics, and others. In addition, the Subcommittee on Securities of the Senate Committee on Banking, Housing, and Urban Affairs held a hearing about our proposal.

We received thoughtful and constructive input from a broad spectrum of interested parties. That input helped us to understand better the sincere and strongly-held views on all sides and to shape final rule amendments that incorporate these views to the extent consistent with our public policy goals. As discussed specifically below, the final rule amendments, particularly those related to non-audit services, have been modified from the proposals.

Nevertheless, some commenters expressed concern that we have “rushed to regulate,” and they asked that we take more time before addressing auditor independence issues generally, and especially the issues regarding the provision of non-audit services to audit clients. As many commenters noted, however, the issues presented by this rulemaking are not new, and recent and accelerating changes in the accounting profession and in society have made resolution of these issues more pressing. For many years the profession has been discussing modernization of the financial and employment relationship rules, and the scope of services issue has been on the horizon even longer. Many previous Commissions have studied these issues. Against this backdrop, in light of the comments that our proposals generated, and informed by our experience and expertise in these matters, we believe that it is appropriate to act now.

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http://www.ascs.org/flash17s.html

Letter from Arthur Levitt to Members of the Audit Committee

December 27, 2000

Dear Members of the Audit Committee:

Almost a year ago, the Commission, our major markets and standard setters - building on the work of the Blue Ribbon Committee on Audit Committee Effectiveness - adopted rules that strengthen the audit committee's independence, and give its members the tools and the wherewithal to fulfill their duty to the investing public. In addition, the rules improve communications, through greater disclosure, among the board, outside auditors and management.

When auditors and the board engage in frank and meaningful discussions about the significant, but sometimes gray areas of accounting, both the company' s and its shareholders' interests are served. In this way, the board, including the audit committee, management, and outside auditors form a "three-legged stool" of responsible disclosure and active oversight.

In recent months, the Commission and the accounting profession have been engaged in a discussion on the vital issue of auditor independence. Among other reasons, increased economic pressures on the profession, coupled with greater competition and consolidation, mandated that we modernize and further clarify independence requirements. This discussion has led to a combination of rules and disclosures that establish clear guidelines on the non-audit services an auditor may provide to an audit client, as well as the meaningful involvement of the audit committee in consideration of consulting services that may impair independence. More specifically, the Commission's rules require companies to state in their proxy statement whether the audit committee has considered whether the provision of the non-audit services is compatible with maintaining the auditor's independence.

In August, the Panel on Audit Effectiveness issued its final report recommending that, among other things, audit committees obtain annual reports from management assessing the company's internal controls, specify in their charters that the outside auditor is ultimately accountable to the board of directors and audit committee, inquire about time pressures on the auditor and pre-approve non-audit services provided by the auditor.

The Panel, more specifically, provided guidance an audit committee can use to determine the appropriateness of a service. This guidance includes:

1. Whether the service is being performed principally for the audit committee.
2. The effects of the service, if any, on audit effectiveness or on the quality and timeliness of the entity's financial reporting process.
3. Whether the service would be performed by specialists (e.g., technology specialists) who ordinarily also provide recurring audit support.
4. Whether the service would be performed by audit personnel, and if so, whether it will enhance their knowledge of the entity's business and operations.
5. Whether the role of those performing the service would be inconsistent with the auditors' role (e.g., a role where neutrality, impartiality and auditor skepticism are likely to be subverted).
6. Whether the audit firm personnel would be assuming a management role or creating a mutual or conflicting interest with management.
7. Whether the auditors, in effect, would be "auditing their own numbers."

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8. Whether the project must be started and completed very quickly.
9. Whether the audit firm has unique expertise in the service.
10. The size of the fee(s) for the non-audit service(s).

I encourage your audit committee to discuss the Panel's recommendations as well as these ten factors and consider them in relevant discussions with your auditor. The Panel's report can be found at www.pobauditpanel.org/. I also encourage you to read the Commission's rule release at www.sec.gov/rules/final/33-7919.htm.

During my almost eight years at the Commission, I have come to believe that one of the most reliable guardians of the public interest is a competent, committed, independent and tough-minded audit committee. The audit committee stands to protect and preserve the integrity of America's financial reporting process. I encourage your committee to take every step possible to ensure that the integrity of the financial statements, and by extension, the interest of shareholders, remains second to none.

Sincerely,

Arthur Levitt

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webmaster@ascs.org
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This letter was personalized and sent from Catherine Kinney, Group Executive Vice President, Competitive Position Group, at the New York Stock Exchange, to NYSE-listed company Chief Financial Officers, General Counsels and Corporate Secretaries

February 15, 2001

Dear Mr./Ms.

Last year, we mailed two communications to our listed companies regarding the Exchange's new audit committee rule that was adopted on December 14, 1999. As the 2001 shareholder meeting and proxy season gets underway, I want to remind listed companies of certain notification and transition obligations that must be met in 2001.

Audit Committees

- **Written Affirmation Required in 2001**– As was required in 2000, and as specified in Section 303.02(C) of the Listed Company Manual, all listed companies will again be required to submit a Written Affirmation in 2001 that attests to the independence, financial literacy, and financial management expertise of audit committee members. It must also certify completion of the mandatory annual review of the audit committee charter. In 2001, we are again requesting that the Written Affirmation be submitted shortly after the annual shareholders' meeting. We recommend that you submit it as soon as your Board appoints or reappoints the audit committee, but in any event, no later than one month subsequent to the shareholder meeting date. The Written Affirmation must be resubmitted each subsequent time that the composition of the audit committee changes. A standard form of Written Affirmation is provided under cover of this letter that is to be used to fulfill this requirement. Please do not modify the text of this Affirmation in any way. Do not retype it onto your corporate letterhead or eliminate any footnotes or headings. If you have any questions about application of the Affirmation to your company's circumstances, please call the Corporate Governance department. As in 2000, you must attach a current list of your audit committee members, along with their biographies and shareholdings.

- **Override Disclosure Required in 2001 Proxy** – As permitted by certain limited circumstances outlined in Section 303.02(D), one former officer of the corporation or its affiliates may be appointed to the audit committee if the Board of Directors determines in its business judgement that their membership is required by the best interests of the corporation and its shareholders. Disclosure in the next annual proxy statement is then required. This disclosure obligation is also specified in the Securities and Exchange Commission's Final Rule on Audit Committee Disclosure (Release No. 34-42266) for all proxy and information statements relating to votes of shareholders occurring after December 15, 2000. For most companies, the 2001 proxy season will be the first where this disclosure is required. If an override was used for any portion of the year 2000, even if the need expired prior to the end of the year, such disclosure will be expected in your 2001 proxy statement.

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- **<u>Minimum Three Members by June 14, 2001</u>** – The Exchange implemented a transition period to allow companies sufficient time to comply with certain requirements of the new rule. Companies with less than three members on their audit committees have eighteen months from the date of Commission approval of the rule (December 14, 1999) to recruit the requisite members. For those companies that currently have audit committees with fewer than three members, the Exchange will look to receive a completed Written Affirmation covering a committee of at least three qualified members no later than June 14, 2001.

- **<u>"Grandfathering" of Audit Committee Members</u>** – The Exchange's implementation period "grandfathered" all audit committee members who, at the time the rule was adopted on December 14, 1999, were fully qualified under the Exchange's former audit committee rule, but were not qualified under the new, current audit committee rule. This grace period extends to any such audit committee member only until they next stand for reelection to the Board of the Company after December 14, 1999. Since many companies have "staggered" Boards of Directors, you may need to consider the expiration of this "grandfathering" as you prepare your Board slate for your 2001 shareholder meeting. One of the issues you may need to consider is the current rule's requirement that all Audit Committee members become financially literate within a reasonable period of time after their appointment to the audit committee.

- **<u>One Member with Financial Management Expertise by June 14, 2001</u>** – At least one member of the audit committee must have accounting or related financial management expertise, as the Board of Directors interprets such qualification in its business judgement. This must be achieved no later than eighteen months after the rule was adopted, i.e., by June 14, 2001.

<u>Annual Reports and Proxy Statements</u>

The Exchange's new annual report filing requirements (Section 203) were adopted on March 24, 2000. Because 2001 will be the first full year they will be in effect, I would like to mention the filing timeframes.

- **<u>Annual Reports due 120 days after fiscal year</u>** – Section 203.01 requires listed companies to distribute annual reports no later than 120 days after fiscal year end and at least 15 days before the annual meeting of shareholders. When the annual report is mailed to shareholders, <u>two copies must be sent to the Exchange together with advice as to the date mailed to shareholders</u>. A company that is unable to timely file its Form 10-K (or equivalent) must notify the Exchange prior to the SEC filing deadline.

- **<u>Electronic Distribution</u>** – Distribution of the annual report by electronic means (which may include posting on your web site) is permitted only as to beneficial holders who have given prior written consent to receiving the report in that form. Such written consent may be in the form of electronic mail.

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- **Proxy Materials** - Companies are required to submit three copies of all preliminary proxy materials that are filed with the SEC. They should be clearly marked as preliminary or draft, with a designation as to whether they are confidential. Six copies of definitive proxy materials (including the proxy card) must be sent to the Exchange no later than the day after the material is distributed to shareholders.

- **Mailing Address for Annual Reports and Proxy Materials** – Annual Reports and proxy materials should be sent to:

    New York Stock Exchange
    Securities Operations Department
    Ms. Cecilia S. Cheung
    20 Broad Street, 17th Floor
    New York, New York 10005

Corporate Governance Seminar

The Exchange held its first Corporate Governance seminar on January 22nd, 2001. We received a large response from our companies and thank the attendees for their feedback. We are now planning to hold another Corporate Governance Seminar at the Exchange in May 2001 and will be communicating more information on this topic in the coming months.

If you have any questions regarding the above matters, please call your Corporate Governance representative or your Client Services representative.

We look forward to your continued support and feedback on our corporate governance initiatives in 2001.

Sincerely,

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Written Affirmation *

The company named below (the "Company") hereby confirms to the New York Stock Exchange the following:

In making all representations in this Affirmation, the Company has reviewed and utilized the definitions of "Officer", "Independence", "Immediate Family", "Affiliates" and "Business Relationships" as specified in Section 303 of the Exchange's Listed Company Manual (the "Listed Company Manual").

A. Audit Committee Membership

Attached is a list of those individuals who currently comprise the full membership of the Audit Committee of the Board of Directors.[1]

The Company understands that any Audit Committee members who were fully qualified pursuant to the Exchange's previous audit committee rule, but are not qualified pursuant to current Section 303 of the Listed Company Manual, are eligible to serve on the Audit Committee only until they are next subject to re-election to the Board of Directors after December 14, 1999. At that time, they must either be fully qualified pursuant to Section 303 of the Listed Company Manual or resign from the Audit Committee.

The Company acknowledges that Section 303 of the Listed Company Manual requires an Audit Committee consisting of at least three directors, all of whom must meet the requirements set forth therein. If the Company's Audit Committee currently has fewer than three members, the Company will be required to appoint the requisite number of qualified members no later than June 14, 2001.

B. Independence of Audit Committee Members

Subject to any matter noted pursuant to subparagraph (1) below, the Board of Directors of the Company has determined that all members of the Audit Committee have no relationship to the Company that may interfere with the exercise of their independence from management and the Company. In this regard, the Company is familiar with the restrictions stated in Section 303.01(B)(3) of the Listed Company Manual.

(1) If any member of the Audit Committee has been appointed pursuant to the "override" provision of Section 303.02(D) of the Manual, such member is identified with an asterisk next to his/her name on the attached list.[2] With respect to any such appointment,the Company's Board of Directors has determined in its business judgment that membership on the Audit Committee by such person is required by the best interests of the corporation and its shareholders.

---

[1] Briefly describe each member's current occupation and any relationship to the Company and/or its Affiliates. Designate which members are first time appointees and attach their biographies,and indicate their shareholdings in the Company. You may satisfy this requirement by attaching information from a proxy statement or other public filing if your current audit committee is accurately represented therein.

[2] Note that this "override" is available only to former officers and their immediate family members,and to just one member of the audit committee.

***WILL NOT ACCEPT IF RETYPED, MODIFIED OR IF ANY TEXT OR FOOTNOTES ARE DELETED. If you have questions regarding applicability to your company's circumstances, please call the Corporate Governance Department prior to submission.**

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C. Financial Literacy

The Board of Directors has determined that each Audit Committee member is financially literate, or will become so in a reasonable period of time, as such qualification is interpreted in the Board's business judgment.

D. Financial Management Expertise

The Board of Directors has determined that one or more members of the Audit Committee possess accounting or related financial management expertise, as such qualification is interpreted in the Board's business judgment (or if no member satisfies this requirement, one such qualifying member will be appointed by June 14,2001).

E. Audit Committee Charter

The Company's Board of Directors has adopted and approved a formal written charter for the Audit Committee. If applicable, the Audit Committee has completed its annual review and reassessment of the adequacy of the charter. In this regard,the Company and the Audit Committee are familiar with the requirements for the charter as provided in Sections 303.01(B)(1)(a), (b) and (c) of the Listed Company Manual.

This Affirmation is signed by a duly authorized officer of the Company.

Name of Company: ______________________________

By: ______________________________

Print Name: ______________________________

Title: ______________________________

Date: ______________________________

Please submit to:

Corporate Governance Department
New York Stock Exchange
20 Broad Street, 17th Floor
New York, NY 10005

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Guiding Principles for Audit Committee Best Practices

As we noted at the outset of this Report, the Committee believes that the proper functioning of an audit committee relies first on the entire board, and then specifically on the audit committee members' attitude toward their own role. If an audit committee is determined to be diligent in its oversight role, a sure sense of appropriate action will follow; credible diligence is not rocket science. In fact, the specifics of how any audit committee conducts its business should be self-determined. Since each company has its own unique circumstances – type of business, industry, competitive environment, stage in the business cycle and business risks – audit committee practices will vary naturally. By recognizing the need for this variance, and by capturing it in uniquely appropriate policies, audit committee members go a long way toward fulfilling their responsibilities. This process, in turn, is an excellent discipline for the audit committee.

Therefore, in lieu of specifying a litany of best practices to which every audit committee should adhere, the Committee outlines "Guiding Principles" for best practices – a catalog of common sense fundamentals that apply regardless of an individual company's situation. The Committee intends the following Principles to serve as building blocks for devising company-specific processes and practices, and ultimately for the committee's charter. Again, we encourage audit committee members to study the various more detailed recommendations contained in the publications referenced in Appendix C and the Bibliography to this Report.

Principle 1: The Audit Committee's Key Role in Monitoring the Other Component Parts of the Audit Process

In its oversight capacity, the audit committee is neither intended nor equipped to guarantee with certainty to the full board and shareholders the accuracy and quality of a company's financial statements and accounting practices. Proper financial reporting, accounting, and audit functions are collaborative efforts conducted by full-time professionals dedicated to these purposes. The audit committee, as the first among equals, oversees the work of the other actors in the financial reporting process – management, including the internal auditor, and the outside auditors – to endorse the processes and safeguards employed by each. In particular, the audit committee should encourage procedures that promote accountability among these players, ensuring that management properly develops and adheres to a sound system of internal control, that the internal auditor objectively assesses management's accounting practices and internal controls, and that the outside auditors, through their own review, assess management and the internal auditor's practices.

The audit committee should seek to affirm the existence of these nexuses of accountability by learning the roles and responsibilities of each of these participants. These roles and responsibilities should be commonly understood and agreed to by each of the other participants in the process – preferably in writing.

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From this basic understanding of the relevant roles and responsibilities of each participant in the process, the audit committee will be in a position to devise appropriate questions as to how each participant carries out its functions. These questions should not be merely a "checklist" of standard questions to be asked each year, but should be tailored to a company's particular circumstances. (See Principle 4 below.)

Principle 2: Independent Communication and Information Flow between the Audit Committee and the Internal Auditor.

The Committee recognizes that responsible financial reporting is derived in large part from an effective system of internal controls. While management is responsible for internal controls, the internal auditor is in a position to evaluate and report on the adequacy and effectiveness of those controls.

The internal auditor occupies a unique position – he or she is "employed" by management, but is also expected to review the conduct of management. This can create significant tension since the internal auditor's "independence" from management is necessary for the auditor to objectively assess management's actions, but the auditor's "dependence" on management for employment is clear. Recognizing this tension, the Committee believes that it is essential to have formal mechanisms in place to facilitate confidential exchanges between the internal auditor and the audit committee. These mechanisms may take the form of regular meetings independent of management, or regular confidential memos or reports circulated only to the audit committee. If such meetings or correspondence are regularly scheduled regardless of the identification of irregularities or problems, independent dialogue between the audit committee and the internal auditor should lose its "taboo" nature and no longer imply treason against management.

The audit committee must establish and support a culture that promotes open disclosure on the part of the internal auditor and a recognition that if the internal auditor identifies a problem and cannot obtain the support of management, that he or she has a duty to the audit committee, the full board, and shareholders to disclose the relevant information to the audit committee. Management should more than acquiesce in this duty to disclose; management should encourage and support such disclosure by word and deed.

Principle 3: Independent Communication and Information Flow between the Audit Committee and the Outside Auditors

If the audit committee is to effectively accomplish its task of overseeing the financial reporting process, it must rely, in part, on the work, guidance and judgment of the outside auditor. Integral to this reliance is the requirement that the

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outside auditors perform their service without being affected by economic or other interests that would call into question their objectivity and, accordingly, the reliability of their attestation. Consistent with Recommendation 7 of this Report (which suggests that the listing rules require listed companies to formally disclose information about audit committee and outside auditor communications regarding auditor independence), the Committee believes that every audit committee should adopt additional voluntary measures to ensure outside auditors' objectivity.

As with the internal auditor, the audit committee should develop regularly scheduled meetings and/or reports with the outside auditors independent of management. Only through open, regular, frank, and confidential dialogue will the audit committee be in a position to utilize the knowledge of the outside auditors in assessing internal controls, management, the internal auditor, and the impact of each on the quality and reliability of the financial statements. In addition, the committee should promote a culture that values objective and critical analysis of management and the internal auditor. In this regard, the audit committee should ensure that the outside auditors have provided the committee with the information that would be required to be disclosed by GAAS, including the topics covered by SAS 54, 60, 61, and 82. The Committee should ask searching questions regarding this information, not simply accept a "report." (See Principle 4 below.)

Principle 4: Candid Discussions With Management, the Internal Auditor, and Outside Auditors Regarding Issues Implicating Judgment and Impacting Quality

Since the audit committee is largely dependent on the information provided to it by management, the internal auditor, and the outside auditors, it is imperative that the committee cultivate frank dialogue with each as outlined in Principles 2 and 3 above. As Harvard Business School Professor Joseph Hinsey stated at an open hearing held by this Committee, this dialogue should provide the audit committee with insights into the "whats and whys" behind the numbers and the process.

Given management's lead role, the committee will normally work closely with and rely upon the senior executives of the company, especially those executives representing financial management – the chief financial officer, the treasurer, and the controller. Management typically will apprise the committee of the overall business environment and risks, and its system for internal controls, and provide an explanation of the company's financial statements. In particular, management should provide the audit committee with:

- timely, periodic reviews of the financial statements and related disclosure documents prior to filing with the SEC;
- presentations concerning: any changes in accounting principles or financial reporting policies from a prior year; the accounting treatment accorded

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significant transactions; and any significant variations between budgeted and actual numbers in a particular account;
- information regarding any "second" opinions sought by management from an outside auditor with respect to the accounting treatment of a particular event or transaction; and
- management's response to the assessments provided by the internal and outside auditor.

Once this basic financial knowledge has been imparted, the committee then should look to the internal auditor and the outside auditors to verify management's compliance with process and procedures and seek additional input on any significant judgments made. The audit committee should engage the internal auditor and the outside auditors in a dialogue and set up other mechanisms to ensure that the committee has received all the necessary and pertinent information. For instance, when circumstances dictate, management should help the audit committee retain independent legal counsel and/or financial advisors. Additional mechanisms to support the audit committee may include a checklist of questions to review with management, the internal auditor, and the outside auditors. Such questions may cover:

- the accounting implications of new, significant transactions;
- changes in, or the continued propriety of, elective accounting principles;
- the methods of application of such principles and their aggressiveness or conservatism;
- the use of reserves and accruals;
- significant estimates and judgments used in the preparation of the financial statements;
- internal and outside auditors' methods for risk assessments and the results of those assessments;
- changes in the scope of the audit as a result of such risk assessments;
- the emergence or elimination of high risk areas;
- the effect of any external environmental factors (economic, industrial or otherwise) on financial reporting and the audit process; and/or
- any other questions addressing topics that the audit committee believes may influence the quality of the financial statements, including any other issues the outside auditor must address under GAAS. (See Recommendations 8 and 9 and Principle 3 above.)

Audit committees, however, are cautioned against using such a checklist of recommended questions as a substitute for conducting their own investigation and analysis.

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Principle 5: Diligent and Knowledgeable Audit Committee Membership

Consistent with Recommendations 2 and 3 of this Report, which urge qualification requirements regarding independence and financial literacy for all audit committee members, the Committee expects that audit committees will carefully consider further qualifications for those who serve on the committee. Importantly, the board of directors should have mechanisms that encourage selection and retention of diligent and knowledgeable members who are dedicated to and interested in the job and willing to devote a substantial commitment of time and energy to the responsibilities of the audit committee in addition to board responsibilities.

Such mechanisms might include distributing to nominees to the committee a written description of qualifications, diligence, and time commitment the board expects of members, as well as a clear statement of the expectation that audit committee members will recognize the seriousness of the committee's purpose and will fulfill their duties accordingly. In recognition of the additional time commitment necessary, the full board may decide that audit committee service merits higher compensation than service on other board committees.

The audit committee should also consider training and education programs to ensure that its membership has the proper background and knowledge base and stays current as to relevant developments in accounting and finance. To determine their educational needs, members must analyze their weaknesses and may ask management, the internal auditor and the outside auditors their views on members' gaps in knowledge or "know-how." Training may be conducted by professionals within the company, but the committee should also have the ability to engage outside advisors for educational programs.

Finally, in recognition of the time burden associated with audit committee service, the committee may wish to consider limiting the term of audit committee service, by automatic rotation or by other means.

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Draft 2/28/01

AUDIT COMMITTEE CHARTER

I. PURPOSE AND AUTHORITY

The Audit Committee is appointed by the Board to assist the Board in monitoring (i) the integrity of the Company's financial reporting process, (ii) the Company's internal controls and (iii) the independence and performance of the Company's auditors.

II. COMPOSITION OF COMMITTEE

The Audit Committee shall have at least the number of members required by the New York Stock Exchange. Each member of the Audit Committee shall meet the independence and experience requirements of the New York Stock Exchange. The members of the Audit Committee shall be appointed by the Board on the recommendation of the Chairman of the Company in consultation with the Nominating Committee.

III. RESPONSIBILITIES AND POWERS

The Audit Committee shall:

1. Submit this charter to the Board for approval; review and reassess the adequacy of this charter annually.
2. Review with management and the independent auditor the annual audited financial statements, including major issues regarding accounting principles and practices, and the adequacy of internal controls that could significantly affect the Company's financial statements; inquire as to such financial statements' completeness, accuracy and conformity with generally accepted accounting principles.
3. Review an analysis prepared by management and the independent auditor of the significant financial reporting issues and judgments made in connection with the preparation of the Company's financial statements.
4. Review with the independent auditor, internal auditors and management, major changes to the Company's accounting principles and practices resulting from rules promulgated by the Securities and Exchange Commission or the Financial Accounting Standards Board.
5. Recommend to the Board the appointment of the independent auditor, which firm is ultimately accountable to the Audit Committee and the Board.
6. Review the fees to be paid to the independent auditor.
7. Receive periodic reports from the independent auditor and management regarding the auditor's independence, discuss such reports with the auditor and management and, if so determined by the Audit Committee, recommend that the Board take appropriate action to ensure the independence of the auditor. Such reports shall include a statement as to the amount of the fees billed for each of the following categories of services rendered by the auditor: (i) the audit of the Company's annual financial statements for the most recent fiscal year and the reviews of the financial statements included in the Company's Quarterly Reports on Form 10-Q for that fiscal year; (ii) information technology consulting services for the most recent fiscal year, in the aggregate and by each service (and separately identifying fees for such services relating to financial information systems design and implementation); and (iii) all other services rendered by the auditor for the most recent fiscal year in the aggregate and by each service. The Audit Committee shall, if applicable, consider whether the independent auditor's provision of (a) information technology consulting services relating to financial information systems design and implementation and (b) other non-audit services to the Company is compatible with maintaining the independence of the auditor.
8. Evaluate the performance of the independent auditor and, if so determined by the Audit Committee, recommend that the Board replace the independent auditor.
9. Provide oversight to the internal audit function, including review of the organization, plans and results of such activity.

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10. Meet at least annually with the senior internal audit executive and the independent auditor in separate executive sessions.
11. Meet with the independent auditor (a) prior to the commencement of the audit to review the planning and scope of the audit and (b) after the completion of the audit to review the results of the audit.
12. Discuss with the independent auditor the matters required to be discussed by: (a) Statement on Auditing Standards No. 61, as it may be amended, relating to the conduct of the audit, and (b) Statement on Auditing Standards No. 71, as it may be amended, relating to the conduct of a review of interim financial information.
13. Review with the independent auditor any problems or difficulties the auditor may have encountered and any management letter provided by the auditor and the Company's response to that letter.
14. Prepare the report required by the rules of the Securities and Exchange Commission to be included in the Company's annual proxy statement.
15. Review with the Company's General Counsel legal matters that may have a material impact on the financial statements, the Company's compliance policies and any material reports or inquiries received from regulators or governmental agencies.
16. Make regular reports to the Board of Directors.
17. Take such other actions deemed appropriate by the members of the Committee to carry out the purpose set forth in Article I.

The Audit Committee shall have the authority to retain special accounting, legal, or other consultants to advise the Committee. The Audit Committee may request any officer or employee of the Company or the Company's outside counsel or independent auditor to attend a meeting of the Committee or to meet with any members of, or consultants to, the Committee. The Audit Committee shall keep minutes of all of its meetings.

While the Audit Committee has the responsibilities and powers set forth in this charter, it is not the duty of the Audit Committee to plan or conduct audits or to determine that the Company's financial statements are complete and accurate and are in accordance with generally accepted accounting principles. This is the responsibility of management and the independent auditor. Nor is it the duty of the Audit Committee to conduct investigations, to resolve disagreements, if any, between management and the independent auditor or to assure compliance with laws and regulations and the Company's Business Conduct Policy.

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Audit Committee Report

To the Stockholders of The New York Times Company:

Effective January 31, 2000, the Securities and Exchange Commission adopted new rules and amendments to current rules relating to the disclosure of information about companies' audit committees. The new rules require that, for all votes of shareholders occurring after December 15, 2000, the proxy statement must contain a report of the audit committee addressing several issues identified in the rules. In addition, the SEC recommends that audit committees adopt written charters. Any such charter must be included as an attachment to the proxy statement at least once every three years. Our Audit Committee has adopted a charter, a copy of which is included in this proxy statement as Appendix II.

Our Audit Committee is comprised of four directors, who are not officers of the Company. They are all considered "independent" under the listing standards of the New York Stock Exchange.

Under our Audit Committee's charter, management has the primary responsibility for the financial statements and the financial reporting process, including the system of internal controls. The Company's independent auditors, Deloitte & Touche LLP, are responsible for performing an independent audit of the Company's consolidated financial statements in accordance with auditing standards generally accepted in the United States of America and for issuing a report thereon. Our Audit Committee is responsible for monitoring, on behalf of our Board of Directors, (i) the Company's financial reporting process, (ii) the Company's internal controls and (iii) the independence and performance of the Company's auditors.

In this context, during 2000 the Committee met three times and held discussions with management and Deloitte & Touche LLP. The Committee's Chairman, as representative of the Committee, also discussed the Company's interim financial information contained in each quarterly earnings announcement with the Company's Chief Financial Officer or Controller and Deloitte & Touche LLP prior to public release.

Management has represented to the Committee that the Company's annual consolidated financial statements were prepared in accordance with accounting principles generally accepted in the United States of America, and the Committee has reviewed and discussed the annual consolidated financial statements with management and Deloitte & Touche LLP. The Committee has discussed with Deloitte & Touche LLP matters required to be discussed by Statement on Auditing Standards No. 61 (Communication with Audit Committees), which includes, among other items, matters related to the conduct of the audit of the Company's annual consolidated financial statements.

In addition, the Committee has discussed with Deloitte & Touche LLP, their independence from the Company and its management, including (i) the matters in the written disclosures and letter required by the Independence Standards Board Standard No. 1 and provided to the Committee by Deloitte & Touche LLP (Independence Discussions with Audit

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Committees) and (ii) the written confirmations from Company management with respect to information technology consulting services relating to financial information systems design and implementation services provided by Deloitte & Touche LLP. The Committee has considered whether the provision of information technology consulting services relating to financial information systems design and implementation and other non-audit services by Deloitte & Touche LLP is compatible with maintaining the auditors independence and has discussed with Deloitte & Touche LLP their independence as auditors.

The Committee has discussed with the Company's internal auditors and Deloitte & Touche LLP the overall scope and plans for their respective audits. The Committee meets with the internal auditors and Deloitte & Touche LLP, with and without management present, to discuss the results of their respective audits, the evaluations of the Company's internal controls, and the overall quality of the Company's financial reporting.

In reliance on the reviews and discussions referred to above, the Committee recommended to the Board of Directors, and the Board has approved, that the audited consolidated financial statements be included in the Company's Annual Report on Form 10-K for the year ended December 31, 2000, for filing with the SEC. The Committee and the Board also have recommended, subject to shareholder approval, the selection of Deloitte & Touche LLP as the Company's independent auditors for the fiscal year ending December 30, 2001.

Ellen R. Marram, *Chairman*
Raul E. Cesan
David E. Liddle
Charles H. Price II

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MAJOR ISSUES AND CURRENT DEVELOPMENTS IN EXECUTIVE COMPENSATION

by Bart Schwartz.[1]

I. Internal Revenue Code Section 162(m)

Overview

Section 162(m) of the Internal Revenue Code, adopted in the Revenue Reconciliation Act of 1993, limits the deductibility of compensation paid or accrued by a public company to not more than $1 million per individual per year. Section 162(m) applies to corporations required to register their stock with the SEC if the stock is listed on a national exchange or if the entities each have at least $5 million in assets and 500 shareholders. The deduction limit applies to the CEO and the four other highest paid officers for whom compensation must be reported under SEC rules. The SEC requires the Compensation Committee Report in the annual proxy statement to disclose, among other things, the company's position with respect to compliance with 162(m).

Although Section 162(m) covers all otherwise deductible remuneration, "performance based compensation" is an exception to the deduction limit.

Performance Based Compensation

Qualified performance based compensation must meet the following requirements:

- It is paid solely as remuneration for attaining one or more pre-established, objective performance goals.
- Performance goals are established by the compensation committee — a committee of two or more outside directors of a publicly held entity with the authority to establish and administer performance goals and to certify that such goals were attained.

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[1] Senior Vice President and General Counsel, The MONY Group Inc. ©2001. The author gratefully acknowledges the assistance in the preparation of this outline of Paul Wessel, a partner at Dewey Ballantine LLP, and Lea Miller, a summer associate at Dewey Ballantine LLP.

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- The material terms of the performance goal under which the compensation is to be paid are disclosed to and approved by the corporation's shareholders by vote before the payment is made.

- Prior to payment, the compensation committee certifies that all aspects of the performance goals were satisfied.

Preestablished Goals

A performance goal is pre-established if it is established in writing by the compensation committee not later than 90 days after the commencement of the services to which it relates and while the outcome is substantially uncertain (and in no event after 25 percent or more of the performance period has elapsed). The goals can be based on business criteria that apply to the individual, a business unit, or the corporation as a whole. Examples of valid criteria are return on equity, sales, earnings per share, stock price, or market share. A performance goal does not have to be a positive result or increase; it could include maintaining the status quo or limiting economic losses (although there are obvious ocular, if not legal, problems with this approach).

Objective Formula or Standard

The performance goal must be stated in terms of an objective formula or standard. A formula or standard is objective if a third party having knowledge of the relevant performance results could calculate the amount to be paid to the employee. The performance goal must also specify the individual or class of employees eligible to receive compensation.

It is impermissible for a compensation committee to have discretion to increase compensation payable on achievement of the performance goal but it may have discretion to decrease compensation payable on attainment of that goal. However, this "negative discretion" cannot be exercised to decrease the amount payable to one employee if there would be a resulting increase in the amount payable to another employee.

Stock Options

Certain special rules apply with respect to stock options and stock appreciation rights ("SARs"). Under these special rules, compensation in the form of stock options or SARs will automatically comply with the performance goal requirements exception as long as the following requirements are met:

- The grant or award is made by the compensation committee.

- The plan under which the options or SARs are granted states the maximum number of shares with respect to which options or SARs may be granted to any employee during a stated period.

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- The exercise price of the option at least equals the fair market value of the underlying stock at the time of the grant, and the value of the SAR is based solely on the increase in value of the underlying stock.

Shareholder Approval

The material terms of the performance goal under which the compensation is to be paid must be disclosed to, and approved by, the corporation's shareholders. The disclosure and approval must occur before the compensation is paid. Material terms include the following:

- A general description of the class of eligible employees.
- A description of the business criteria on which the performance goal is based (although the specific numerical targets that must be satisfied need not be disclosed).
- Either the maximum amount of compensation to be paid to any employee or the formula used to calculate the compensation to be paid.

The shareholder approval requirement would not be satisfied if the compensation would be paid regardless of whether the material terms are approved by shareholders. Information the compensation committee determines to be confidential and the disclosure of which would adversely affect the corporation does not have to be disclosed to shareholders.

Generally, a performance goal need not be re-disclosed to and re-approved by the shareholders until there is a change in the material terms of the performance goal. If the compensation committee retains discretion to change the targets under a performance goal, however, the material terms of the performance goal must be re-approved by shareholders at least once every five years.

The compensation committee must certify that the performance goals and other material terms have been satisfied before the compensation is paid. This certification is not necessary for compensation paid on the sole basis of an increase in the corporation's stock price (for example, compensation payable under stock options or SARs).

Outside Directors

The performance goals must be established by a compensation committee made up solely of at least two "outside directors." An outside director:

- Is not a current employee of the publicly held corporation.
- Is not a former employee of the publicly held corporation who receives compensation for prior services (other than benefits under a qualified retirement plan) during the tax year.

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- Is not a former officer of the publicly held corporation.

- Does not receive remuneration (including any payment in exchange for goods or services) from the publicly held corporation, either directly or indirectly, in any capacity other than as a director.

The rules concerning the definition of direct or indirect remuneration are detailed and complex. In general, however, with regard to personal payments, payments from the company to an entity in which the director owns more than 50 percent automatically disqualify the director from serving on the compensation committee. The rules would also typically preclude lawyers, accountants, and consultants from serving as outside directors for client companies if their firm's fees exceed $60,000.

In some situations, a company may deem it important for a director disqualified under Section 162(m) to continue to serve on the compensation committee of the board. One way to achieve this result and still preserve the company's compensation deductions is to create a special Section 162(m) compensation committee that does not include the disqualified director and administers only the performance-based plans. It may be possible for this compensation committee to function as a subcommittee of the full compensation committee, even if the disqualified director continues to serve on the full committee. Assuming that there are at least two directors who are not disqualified under the outside director rules, a special Section 162(m) committee made up solely of those directors may allow the company to insulate the performance-based plan without requiring changes in the full compensation committee of the board.

Private Companies Going Public

For a corporation that is not publicly held for the entire tax year, the Section 162(m) limit on deductibility will not apply to any compensation plan or agreement that existed during the period in which the corporation was not publicly held. If the corporation becomes publicly held in connection with an initial public offering, this relief applies only to the extent that the prospectus accompanying the initial public offering disclosed information concerning those plans or agreements that satisfied all applicable securities laws then in effect. This private-to-public exception is available until the earliest of the following.:

- The expiration of the plan or agreement.

- The material modification of the plan or agreement.

- The issuance of all employer stock and other compensation that has been allocated under the plan.

- The first meeting of shareholders at which directors are to be elected that occurs after the close of the third calendar year following the calendar year in which the initial public offering occurs.

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Special transition rules also apply for companies that become public companies as a spinoff from an existing public company.

II. New York Stock Exchange Proposal

The NYSE requires shareholder approval of stock option plans authorizing grants to officers and directors as a prerequisite to listing the underlying stock.. Broadly-based stock option plans are exempted from this shareholder approval requirement. A plan is considered to be "broadly-based" if (i) at least a majority of the company's full-time employees in the U.S. are eligible to receive grants of stock options and (ii) at least a majority of the shares underlying options granted under the plan are awarded to employees who are not officers or directors of the company.

Some institutional investors and shareholder activists have criticized this exemption. They believe all stock option plans should be submitted for shareholder approval to avoid inappropriate dilution of outstanding shares. The NYSE has developed a proposal which would replace the existing policy with stricter standards. The NYSE proposal has been submitted to NASDAQ for its review. The new rule would:

- require shareholder approval of all stock option plans in which officers and directors participate; and
- replace the current shareholder approval exemption for broadly-based plans with a new dilution standard.

The new dilution standard would limit the number of shares available for grant under all non-shareholder approved plans covering employees other than officers and directors to 10 percent of the aggregate number of shares currently available in all shareholder approved stock option plans. In order to calculate the 10 percent limit, companies would review their shareholder approved plans and count the number of shares underlying outstanding stock options plus the number of shares available for future grants of stock options under those plans.

III. Proposed SEC Amendments

The SEC has proposed a new requirement that public companies disclose on an annual basis information about the total number of securities authorized for issuance under all their equity compensation plans in effect at the end of the fiscal year. The new disclosures would be in a table that would appear in the proxy statement if shareholders are being asked to vote to approve a compensation plan and in the Form 10-K in other years. The new table would include the following information for each equity compensation plan:

- the total number of securities authorized for issuance thereunder by the Board of Directors;

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- the number of securities covered by awards or options granted during the last fiscal year;
- the number of securities covered by all outstanding options at fiscal year end; and
- the number of securities remaining available for future grants under the plan.

Information of this scope currently is disclosed by public companies only in the footnotes to the annual audited financial statements appearing in the Form 10-K and the annual report to shareholders.

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December 20, 2000

To: Corporate Secretaries of Listed Companies

Re: Stock Option Plans

In addition to its established reputation as the highest quality trading market, the New York Stock Exchange has long served as a forum for public debate on key corporate governance matters. Issues such as proxy voting standards and shareholder voting rights were initially developed and debated at the Exchange. The Exchange was also a pioneer in requiring that companies have independent audit committees and independent directors. Another important issue, the role of shareholders in the authorization of stock option plans, is now at the forefront of the corporate governance agenda. Speaking favorably of work the Exchange has done in this area, SEC Chairman Arthur Levitt is encouraging a new, coordinated approach to marketplace requirements for stockholder approval of listed company stock option plans.

In 1999, the Exchange sponsored a special Task Force that developed a proposal on this issue. Last Fall, the Board of the Exchange endorsed one of the Task Force's recommendations – that there be more complete disclosure in the proxy statement regarding potential equity dilution from stock options – and forwarded that recommendation to the SEC. Based on that recommendation, the SEC is actively working on appropriate changes to their disclosure rules.

Significant changes to the marketplace stockholder approval requirements have also been and continue to be studied and discussed, but I want to emphasize that no such proposal has yet been adopted by the Exchange's Board of Directors. In fact, the Board has specifically determined that significant changes in this area should be proposed only on a uniform basis with the other U.S. listing markets, and only after all our listed companies have had a chance to study and comment on those proposals.

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The Exchange's rules requiring stockholder approval of option plans covering officers and directors, and the exception in those rules for plans that are "broadly based", have been under study for several years. Following a rule filing in 1997 to clarify the meaning of the term “broadly based”, questions were raised by the institutional investor community about that definition. To thoroughly explore the issue, the Exchange circulated a "White Paper" in 1998 to some 4500 interested persons, including, of course, all our listed companies. We received 166 comments in response. We then created a Task Force of experts to address the comments and study the issue. The Task Force was drawn from our listed companies, investor representatives, and the law firms that represent them.

The Task Force made some interim recommendations regarding fine tuning of the definition of “broadly based”. These changes were adopted by the Exchange and approved on a “pilot” or temporary basis by the SEC in mid-1999, pending further work by the Task Force. The final recommendation from the Task Force was made in a report delivered in October 1999. The Task Force recommended that we move away from the "broadly based" plan exception, and instead require stockholder approval of all stock option plans covering officers and directors, with a dilution based standard for all other stock option plans. This was a response to concerns among the institutional investor community over dilution from option plans that were not subject to shareholder approval. The Task Force cautioned, however, that the Exchange should not adopt a new standard unless a similar change is made by all listing markets.

We realize that this is an important issue for both issuers and investors. Given the SEC’s interest, we want to be sure that our listed companies are focused on the issue, and that we have the benefit of your views. Accordingly we have put the Task Force report on our websites, both our listed company website at nysenet.com, and on our public website at nyse.com. We welcome any input you may have with respect to the subject generally, or with respect to the discussion and recommendations found in the Task Force report. You may direct any questions or comments to me, or to Steve Walsh, Managing Director (swalsh@nyse.com), who has been coordinating this project since its inception.

Regardless of whether you choose to comment at this point, be assured that you will have a full chance to consider and comment upon any uniform rule proposal that does result from this deliberative process.

Sincerely,

Catherine R. Kinney

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Report of the New York Stock Exchange Special Task Force on Stockholder Approval Policy

I. Introduction

As part of its corporate responsibility provisions, the New York Stock Exchange, Inc. (the "Exchange") has long required, as a prerequisite to listing, shareholder approval of stock option or purchase plans or any other arrangements pursuant to which officers or directors may acquire stock, subject to certain exceptions including a long-standing exception for "broadly-based plans." The other major securities markets have similar standards. The tremendous growth in equity compensation arrangements coupled with increased institutional investor interest in such arrangements has focused attention on the Exchange's shareholder approval requirements. In 1997, in response to requests, the Exchange proposed amendments to its standards which codified previous staff interpretations of the term "broadly-based." The proposed change was published for public comment in 1997. No comments were received, and the Securities and Exchange Commission (the "SEC") approved the amendments in 1998. These amendments proved to be controversial after adoption, however, as investor groups focused on the issues of option grants and shareholder approval standards. As a result, the Exchange issued a white paper, which was broadly disseminated, requesting public comment on the amended "broadly-based plan" standard and appointed a Stockholder Approval Policy Task Force (the "Task Force"), composed of members of all the Exchange's relevant constituencies, to make recommendations concerning possible changes in these requirements. After reviewing more than 160 comments and holding a number of meetings, the Task Force recommended changes in the requirements, which the NYSE proposed in October 1998, and the SEC approved, on a pilot basis, in June 1999. The changes

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tightened the "broadly-based plan" definition and made the test exclusive. The Task Force also recommended consideration of an overall dilution maximum for non-tax qualified plans.

After extensive deliberations, including consultation with academics, compensation and tax experts and others, the Task Force now unanimously recommends a strict shareholder approval policy for all plans in which officers and directors may participate, except for tax-qualified plans, grants made as material inducements of new employees, options issued to new employees to effect a merger or acquisition transaction, and warrants or rights issued to shareholders generally. In addition, the Task Force proposes a new standard that, in effect, will permit issuers, without obtaining shareholder approval, to adopt plans, or increase available equity grants under plans, by no more than 10% the level of potential dilution authorized under shareholder approved stock option or purchase plans, subject only to exceptions relating to tax-qualified plans and generally granted rights and warrants. The Task Force believes that this approach is superior, in terms of both good corporate governance and investor protection, to any of the several different dilution standards it considered.

II. History of the Issue

The Exchange's listing requirements have long exempted "broadly-based" plans from its shareholder approval requirements. This exemption was originally adopted because the Exchange believed that any potential concerns regarding preferential treatment of officers or directors would be mitigated if the plan was broadly available to the company's employees. In light of changes to legal requirements governing shareholder approval of plans and at the urging of listed companies, in 1996, the Exchange began a review of its policy requiring shareholder approval of certain plans. In December 1997, the Exchange filed a proposed rule change with the SEC to amend its shareholder approval policy with respect to stock option and similar plans, which was approved by the SEC on April 8, 1998

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(the "1998 Rule").[1] The 1998 Rule codified, among other things, existing Exchange interpretations regarding "broadly-based" plans. While no comments were received on the proposal, after its adoption members of the institutional investor community began to raise concerns about the definition of "broadly-based." In response, in June 1998, the Exchange issued a Request for Comment and "White Paper" regarding the definition of "broadly-based plan" and received 166 comments.

The Exchange established the Task Force to review the comments and make recommendations. The Task Force was composed of representatives of the Exchange's Legal Advisory Committee, Individual Investors Committee, Pension Managers Advisory Committee, Listed Company Advisory Committee, and members of other Exchange constituencies, including the Council of Institutional Investors. (The names of the original Task Force members and their affiliations are set forth in Attachment A.) The Task Force recommended a two stage approach. First, it recommended that certain changes be made in the definition of a "broadly-based" plan. This "Interim Rule" is discussed in further detail below in Section III. Second, the Task Force recommended that the Exchange commence a study and determine whether it was feasible to set an overall dilution maximum for all non-tax qualified plans that would otherwise be exempt from shareholder approval and recommended that the study be completed in time for the year 2000 proxy season. The Exchange responded to this recommendation by expanding the Task Force and asking it to consider a possible listing standard that would include a

[1] Release No. 34 - 39839 (April 15, 1998). The proposing release was Release No. 34-39659 (February 12, 1998).

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dilution test. (The names of the current Task Force members and their affiliations are set forth in Attachment B.) This report is the result of that further study.

III. The Interim Rule

As discussed above, the focus of the Interim Rule is the exemption from the requirement of shareholder approval for "broadly-based" plans. The 1998 Rule had defined "broadly-based" in the exemption itself, which exempted "a broadly-based plan that includes other employees (e.g., ESOPs)", and in subparagraph (g) in Para. 312.04. This new subparagraph provided that whether a plan would qualify as broadly-based would depend on a variety of factors, "including, but not limited to the number of officers, directors and other employees covered by the plan and whether there are separate compensation arrangements for salaried employees." The new subparagraph also provided a "non-exclusive safe harbor" for a plan "if at least 20 percent of the company's employees are eligible to receive stock or options under the plan and at least half of those eligible are neither officers nor directors (the '20 percent test')".

As recommended by the Task Force, the tighter Interim Rule deleted the references to other employees and ESOPs in the exemption itself and substituted a new subparagraph (h) for subparagraph (g) of Para. 312.04. Subparagraph (h) redefined "broadly-based" by eliminating the "variety of factors" aspect of the definition, the 20 percent test, and the definitional structure of a non-exclusive safe harbor. Instead, the subparagraph provides a definite and exclusive standard for a "broadly-based" plan. The standard has two conjunctive requirements:

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(1) at least a majority of the company's full-time employees in the United States, who are "exempt employees," as defined under Fair Labor Standards Act of 1938, must be "eligible to receive stock or options under the plan" and

(2) at least a majority of the shares of stock or shares of stock underlying options awarded under the plan, during the shorter of the three-year period commencing on the date the plan is adopted by the company or the term of the plan, must be awarded to employees who are not officers or directors of the company.

The first requirement of the definition prescribes a numerical test against which the qualification of a plan as "broadly-based" is to be measured. The employee base against which the numerical test is to be applied excludes part-time employees, employees located outside the United States and employees subject to the Fair Labor Standards Act of 1938. These exclusions were based on the view that the test should be applied to the employee base in which stock options and similar grants are more normally a part of employee compensation. Part-time employees and employees located outside the United States often have different compensation regimens, and employees subject to the Fair Labor Standards Act are often subject to compensation determined by collective bargaining arrangements and not involving stock options or similar grants. The second requirement of the definition seeks to ensure that stock options and similar grants will be broadly dispersed within the broadly-based plan, as measured during the first three years of the plan or, if shorter, the life of the plan. The employee base against which this requirement is to be measured includes employees subject to the Fair Labor Standards Act, as such inclusion was thought to be not inconsistent with the notion of "broadly-based". In addition to these amendments, as also recommended by the Task Force, the Interim Rule provides a definition of the term "officer" that incorporates the definition of that term under Section 16 of the Securities Exchange Act of 1934.

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The Interim Rule amendments to the Listed Company Manual were filed by the Exchange with the SEC on October 13, 1998. The SEC published its notice of the filing for comment on November 13, 1998,[2] and, on December 26, 1998, extended the period for comments until January 25, 1999. The Exchange submitted amendments to the filing on November 27, 1998 and March 12, 1999. The SEC issued an order on June 4, 1999 approving the Interim Rule on a pilot basis until September 30, 2000,[3] after having received 19 comment letters.[4] The SEC's order approving the Interim Rule stated that the rule was an improvement to the previous formulation. Moreover, the order referred to the study of a dilution standard by the Task Force and the Exchange being conducted on a definite time schedule, and included a request that any proposal to adopt a dilution standard (or a status report on the matter) be submitted to the SEC by October 15, 1999. In addition, the order stated that any filing seeking to change the Interim Rule or to extend its effectiveness beyond the initial pilot period must be submitted no later than May 18, 2000.[5]

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[2] Release No. 34-40679 (November 13, 1998).

[3] Release No. 34-41479 (June 4, 1999).

[4] The comment letters are available in the SEC Public Reference Room. File No. SR-NYSE-98-32.

[5] Any such request would have to be accompanied by a monitoring report including information on the types and number of employees who are eligible to participate under plans, as well as information concerning actual awards being made under plans.

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IV. The Deliberative Process of the Task Force

The Task Force met in person to consider the possible development of a dilution standard and to work out the terms of the Proposed Rule six times between July 1998 and July 1999, and held several teleconferences. Members of the Task Force participated actively in the discussions and in the development and drafting of the terms of the Proposed Rule. In the earlier meetings, there was extensive discussion of the varying views of Task Force members concerning the principles of equity dilution measurement in general and how those principles, once agreed upon, should be applied to form a shareholder approval policy. In order to assist the Task Force in identifying and applying such principles, the Exchange retained Jennifer N. Carpenter and David L. Yermack, professors at the Leonard N. Stern School of Business of New York University, as academic consultants to the Task Force. Ms. Carpenter and Mr. Stern prepared a paper for the Task Force, dated January 26, 1999, entitled "Measuring Dilution from Stock-Based Compensation" (the "Academic Study"), and met with the Task Force on several occasions.[6]

The Academic Study noted that there has been almost no scholarly research on how to measure dilution or identify appropriate levels or "flow rates" of potential dilution caused by stock option and similar equity compensation plans. The Study focused on the measurement of dilution to the holdings of existing shareholders and not on the measurement of the value to existing shareholders of the services that might be received in exchange for such dilution.

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[6] The study is available from Stephen G. Walsh, Managing Director, New York Stock Exchange, at 212-656-6240.

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The Task Force spent several meetings considering various of the issues presented in the Academic Study, including:

(1) by what units should dilution be measured: voting rights, rights to distributions of dividends and assets, or the portion of the value of the enterprise being transferred to plan beneficiaries;

(2) whether dilution should be measured on (a) an historical basis to the present, based on actual share issuances under plans, or (b) on a future basis, either by measuring "overhang" (for example, by measuring options issued and not exercised or expired plus options available for future grants under existing and currently proposed plans) or by measuring "run-rate" (for example, by measuring the annual rate at which options are authorized to be granted in future years);

(3) whether plans that do not involve the issuance of shares, such as phantom stock and stock appreciation rights plans, should be included in dilution measurements;

(4) how the repricing of options should be treated;

(5) whether dilution measurements should include repurchases of shares by companies as an offset to dilution as a general matter and, more specifically, whether the shareholder approval policy should apply to plans funded by treasury shares held by companies; [7]

(6) whether adjustments should be made for dilution measurement purposes to the total number of outstanding shares when that number increases as a result of issuances of shares for cash or to make acquisitions of other companies, or changes as a result of mergers or consolidations; and

(7) whether a dilution standard should include all plans of a company or only those plans that have not been approved by shareholders.

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[7] The shareholder approval requirements of the Exchange by their terms have been applied only as a "prerequisite to listing" the shares available for issuance under Plans. Since treasury shares are already listed shares, the requirements have not applied to Plans funded by treasury shares. For further discussion of this issue, see page 12.

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The Task Force concluded that it was not possible to come up with a simple dilution standard that would work for all companies and that did not create incentives in favor of short-term grants or premature option exercises contrary to good compensation policy.

In addition to the dilution standard approach, the Task Force considered a so-called "private ordering" approach. Under this approach, companies could submit to shareholders proposals for equity compensation under plans that would cover the ensuing three to five years. The proposals would not have to include the actual plans to be adopted but rather an outline of their provisions sufficient to enable shareholders to make estimates of maximum dilution. The subsequent adoption of plans would not require shareholder approval if consistent with the shareholder-approved "private ordering" proposals.

After extended discussion and debate, both in its formal meetings and in informal discussions among Task Force members and support staff, the Task Force unanimously agreed upon a strict approach to shareholder approval in which every plan, with very limited exceptions, in which directors and officers participate ("Officer Plans") would require shareholder approval. This decision was based, in part, on the consensus of the Task Force that issuers, as a matter of good corporate governance, should seek shareholder approval of Officer Plans and that a requirement that issuers do so would not impose undue costs or burdens on them. The decision was strengthened by the observation of many Task Force members, including company representatives, that public companies, as a matter of good corporate governance or for tax-related reasons, increasingly obtain shareholder approval of Officer Plans even if not required by listing standards. Further, the Exchange has no reliable or comprehensive information on the extent to which issuers actually rely on the exemption for "broadly-based" plans. Thus, the Task Force decided that this exemption no longer rested on sound public policy

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or corporate practice. Even as to plans in which directors and officers do not participate ("Employee Plans"), the Task Force concluded that shareholder approval of most plans should be required, subject to a ten percent of Potential Dilution "basket" within which companies would have the flexibility to adopt plans and make grants to persons who are not officers (as defined) and directors. The policy behind this approach is that most potential plan dilution -- 90 percent -- should be subject to stockholder approval and that officer and director grants should generally be subject to such approval. The specifics of the Proposed Rule recommended by the Task Force ("Proposed Rule") are described in the next section.

V. The Proposed Rule and How It Works

The Task Force recommends to the Board of Directors of the Exchange the Proposed Rule, which is based on a different premise and somewhat different structure than the Interim Rule.[8] The main part of the Proposed Rule provides that shareholder approval is required for the adoption of all "plans under which officers and directors may receive grants" --Officer Plans. The term "Plan" is defined to include all arrangements pursuant to which employees or others may acquire stock, subject to the limited exclusions described below. The Proposed Rule further requires shareholder approval for the adoption of all Plans (subject to the exceptions in the definition of the term Plan), except Plans that fall within a ten percent "basket" for grants not subject to shareholder approval. A Plan that falls within the ten percent basket is

[8] The Proposed Rule revises Para. 312.03(a) of the Listed Company Manual, deletes Para. 312.04(h) of the Interim Rule with respect to the definition of "broadly-based" Plans, and replaces it with an interpretation regarding treasury shares. See Attachment C.

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one pursuant to which "the maximum aggregate number of shares of stock that could be issued would not exceed, together with the then Potential Dilution of all other Plans that have not been approved by shareholders and outstanding Inducement Options and Acquisition Options, ten percent of the Potential Dilution of all Plans." The Proposed Rule defines the term "Potential Dilution" as "the maximum aggregate number of shares of stock currently authorized for issuance including both the number of shares available for grants and the number of shares underlying outstanding grants (i.e., unexercised and unexpired)". Illustrations of how the Proposed Rule would work in practice are set forth in Attachment C.

Under the Proposed Rule, the following types of Plans would be excluded from the definition of "Plan" and thus not require shareholder approval prior to issuance:

(1) any Plan intended to meet the requirements of Section 401(a) or 423 of the Internal Revenue Code (such as Employee Stock Ownership Plans);

(2) any arrangement whereby 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 employment with the company; ("Inducement Options");

(3) any arrangement for the issuance of warrants or rights issued generally to security holders of the company; and

(4) options issued to new employees (or assumed) to effect an acquisition or merger transaction ("Acquisition Options").

The first three of these exclusions from the definition of "Plan" continue historical exceptions from the Exchange's shareholder approval requirements. The fourth exception for Acquisition Options is closely related to the second exception for Inducement Options. In the case of the first and third exclusion, there is no opportunity for officers and directors to be disproportionately benefited, due to legal and structural restrictions. In the case of Inducement Options and Acquisition

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Options, the benefits provided by these options are the result of arm's-length transactions involving persons who are not officers, directors or employees of the issuing company at that time. In addition, Inducement Options and Acquisition Options are likely to involve time-sensitive situations, and their exclusion from the definition of "Plan" gives listed companies critically needed flexibility in terms of timing, as acquisitions are made or new executives recruited. However, importantly, after their grant, Inducement Options and Acquisition Options are both included in the numerator of the computation of Potential Dilution for purposes of the ten percent basket, and thus reduce the size of the basket, unless they have been or subsequently are approved by shareholders of either the acquiring or acquired company.

Finally, the Proposed Rule modifies the historical exclusions for Plans funded by treasury shares instead of newly issued shares. Historically, such Plans were completely excluded from the Exchange's shareholder approval requirements because the requirements were stated as "a prerequisite to listing", and the Exchange traditionally viewed shares reacquired by issuers and held as treasury shares as still listed as long as fees continued to be paid on the shares. The Task Force does not believe that such a distinction continues to make sense for a shareholder approval policy relating to Plans. Accordingly, the Proposed Rule modifies the historical approach by specifying that repurchased shares are subject to the shareholder approval standard, for purposes of the Proposed Rule. The rule contains an exception, however, for shares that have been repurchased by a company and, within two years after repurchase, are treated as outstanding for purposes of receiving dividends and entitlement to vote (if voting shares). In cases in which repurchased shares are to be used, (1) a majority of independent directors (or a majority of a committee consisting only of independent directors) must approve all Plans, prior to awarding any grants pursuant to such Plans, under which grants will be

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satisfied, in whole or in part, by repurchased shares and (2) the company must obtain shareholder, during the first two years of each Plan[9] or, if earlier, prior to the termination of such Plan, approval of the terms and conditions of such Plan and the fact that repurchased shares my be used. With respect to the latter, once the approval is obtained, it is valid for the life of the Plan up to a maximum of five years. For Plans with a term greater than five years, the company must obtain reapproval during the first two years of each succeeding five-year period the Plan remains in effect. Finally, disapproval of a Plan by shareholders will have no effect upon the stock options or stock awards duly granted, or upon the use of the shares repurchased under the Plan, prior to such vote by shareholders.

Throughout its deliberations, the Task Force considered the appropriateness of an exclusion from the shareholder approval requirements for any arrangement pursuant to which de minimus numbers of options or shares were issued to employees on the basis of universally applicable occurrences such as years of service, corporate anniversaries, overall corporate performance, or other standards which do not discriminate in favor of officers or directors. The Task Force ultimately decided not to include such an exclusion from the Proposed Rule, because it believed that the permissible ten percent non-approval "basket" would accommodate this type of arrangement, to the extent such grants are not made to officers (as defined) and directors.

[9] Another proposal advocated by some members of the Task Force is that the shareholders be entitled to vote at the first shareholder meeting following the adoption of the Plan.

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VI. Other Matters

A. Disclosure Enhancements

In connection with its consideration of a possible dilution standard for determining when shareholder approval of a plan is necessary, the Task Force learned, from the academic studies conducted for it and from consultants with investor advisory organizations, that it currently is quite difficult to make accurate calculations. The requisite information is not consistently available in any one place or format in corporate disclosure documents and is not all currently mandated by SEC disclosure requirements. To address this concern, the Task Force designated a special drafting group, which developed proposed changes in SEC disclosure standards to remedy the dilution information gap. The Task Force now recommends that the Exchange formally propose to the SEC that the disclosure requirements relating to equity compensation contained in SEC Regulation S-K be amended as described below. The Task Force believes that the recommended changes will not substantially increase disclosure costs or burdens on issuers. The changes the Task Force is recommending will, for the first time, give shareholders and analysts, in one place, all of the information necessary to make their own dilution calculations with a high degree of accuracy. These changes will facilitate both analysis and application of institutional dilution guidelines in voting decisions. The Task Force believes that these disclosure changes may well have a beneficial impact on shareholder education and effective corporate governance as important as the proposed changes in listing standards. In addition to providing needed information to evaluate dilution calculations, the proposed changes will permit investors to determine which plans have previously been approved by shareholders and enable them to review most equity

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compensation plans, in order to determine the precise nature of the awards that may be granted under such plans. Illustrations of the disclosure, which would be provided under the recommended changes, are set forth in Attachment D.

First, the Task Force is recommending that the existing table in Item 402(c)(1) of Regulation S-K be amended to require the inclusion of:

(1) the total number of options and stock appreciation rights ("SARs") granted to employees and all other persons during the last completed fiscal year and the weighted-average exercise price[10] of such options;

(2) the total number of outstanding options and SARS that were granted but unexercised that are held by employees and all other persons as of the end of the last completed fiscal year and the weighted-average exercise price for such options;

(3) the total number of options and SARs available for grant to employees and all other persons at the end of the last completed fiscal year; and

(4) the total number of shares of the issuer issued and outstanding as of the end of the last completed fiscal year.[11]

Second, the Task Force is recommending that the existing table in Item 402(e)(1) be amended to require the inclusion of:

(1) the total number of restricted stock, unrestricted stock and other similar awards granted to employees and all other persons during the last completed fiscal year;

---

[10] The weighted-average exercise price will be different than that required by FAS 123 and contained in Form 10-K because of the inclusion of awards to persons other than employees in the tables.

[11] The total number of options and SARs available for grant at the end of the last fiscal year need not be included to the extent shares are reserved that may also be awarded as restricted stock or unrestricted stock and included in Item 402(e)(1).

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(2) the total number of shares of outstanding restricted stock, unrestricted stock and other similar awards available for grant to employees and all other persons at the end of the last completed fiscal year; and

(3) the total number of shares of the issuer issued and outstanding at the end of the last completed fiscal year.[12]

Third, the Task Force is recommending that Item 10 of Schedule 14A be amended to require that information be provided with respect to all plans maintained by an issuer with respect to grants of options, restricted stock or similar equity awards. This information would include the name of each plan and whether securities available for award under such plan were approved by security holders, the aggregate amount of awards issued or outstanding under each plan and whether the plan permits repricing of awards and the circumstances regarding such repricing.

Finally, the Task Force is recommending that Item 601 of Regulation S-K be amended to provide that any compensatory plan providing for compensation to any officer or director or that is reasonably expected to exceed $100,000 to any employee to whom options, restricted stock or similar equity awards may be awarded, be filed with the SEC. This will ensure that the terms of the plan will be available for review by investors and analysts. Members of the Task Force have discussed these proposals with the SEC staff informally in connection with the staff's current review of the SEC's existing executive compensation disclosure requirements.

[12] Information is not required to the extent it is provided pursuant to Item 402(c)(2).

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B. Broker Votes

During the deliberations of the Task Force, some members suggested that the Exchange should also review Para. 402.08 of the Listed Company Manual as it relates to the shareholder approval listing standard. That Paragraph provides essentially that Exchange member organizations may vote shares they hold for customers, if the customers do not vote the shares within a stated period after having been solicited to do so and if the items to be voted on do not include certain specified significant, contested or controversial matters. Subparagraph (B)(12) provides that brokers may not vote, without customer instructions, on any matter that would authorize "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."

Changes to the broker voting rules are not within the Task Force's mandate from the Board of the Exchange or the direction from the SEC to the Exchange. They should not be considered without broader consultation with the Exchange's member firms and consideration of timing and other practical concerns in the shareholder voting process. Thus, the Task Force notes but takes no position on this issue.

VII. Conclusion

The Task Force has carefully considered the appropriate requirements for shareholder approval of stock option and related plans and submits recommendations which it believes advance the principles of good corporate governance and serve the interests of issuers and investors alike.

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The Task Force recommends that the Board of the Exchange advise the SEC of the recommendations of the Task Force, and also advise the NASDAQ/Amex Stock Markets of such recommendations. The Task Force recommends that the proposed rule changes should take effect in coordination with, and at the same time as, a substantially similar rule, or another standard which similarly protects investor interests, is approved for the NASDAQ/Amex Stock Markets. The Task Force believes that this coordination of standards is important because, with regard to corporate governance, the leading securities markets should seek to harmonize their rules in the best interests of investors, not to compete on the basis of disparities in their rules which may tend to compromise those interests or undermine the public's confidence and trust in those markets.

The Task Force also recommends that the Board of the Exchange authorize the Exchange staff to forward to the SEC the Task Force's recommendations for enhancement of SEC disclosure requirements.

* * * *

This Report is hereby respectfully submitted, on the 28th day of October 1999, for consideration by the Board of the Exchange.

Respectfully submitted,

The Task Force on
Stockholder Approval Policy

John F. Olson, Esq.
Chairman

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ATTACHMENTS

A	Original Task Force Members
B	Current Task Force Members
C	Proposed Rule and Illustrations
D	Illustrations of Proposed Disclosure Enhancements

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Attachment A

SHAREHOLDER APPROVAL POLICY TASK FORCE

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College Retirement Equities Fund

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Stockholder Approval Policy Task Force (Cont'd) **Page 2**

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Affiliations reflect positions held at the time of service on the Task Force.

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Attachment B

SHAREHOLDER APPROVAL POLICY TASK FORCE

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Stockholder Approval Policy Task Force (Cont'd) **Page 2**

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Attachment C (AMENDED 10/28/99)
Proposed Changes to Listed Company Manual

Listed Company Manual

SECTION 3
Corporate Responsibility

*   *   *

[Remove current 312.03(a) in its entirety]

312.03 Shareholder approval is required as a prerequisite to listing in four situations:

(a)(1) For purposes of this sub-section (a), the following terms shall be defined as indicated below:

> (i) Plan: a stock option or purchase plan, or any other arrangement pursuant to which officers, directors, employees or consultants may acquire stock, excluding (A) any plan intended to meet the requirements of Section 401(a) or 423 of the Internal Revenue Code, as amended (e.g., ESOPs), (B) any arrangement whereby 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 employment with the company ("Inducement Options"), (C) any arrangement for the issuance of warrants or rights issued generally to security holders of the company, and (D) options issued to new employees (or assumed) pursuant to one or more agreements entered into to effect an acquisition or merger transaction ("Acquisition Options").
>
> (ii) Authorized Dilution: the maximum aggregate number of shares of stock presently authorized for issuance under Plans, Inducement Options and Acquisition Options, approved in each case by shareholders, including both the number of shares available for grants and the number of shares underlying outstanding grants (i.e., unexercised and unexpired).
>
> (iii) Unapproved Shares: shares presently authorized for issuance under any Plan that has not been approved by shareholders and shares underlying outstanding Inducement Options or Acquisition Options not approved by shareholders.

(a)(2) Shareholder approval is required as a prerequisite to listing (and, in the circumstances specified in Para. 312.04 if repurchased shares are to be used) with respect to the adoption of any Plan (or an amendment thereto which would increase the

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number of shares authorized for issuance thereunder) pursuant to which:

(i) officers or directors may acquire stock; or

(ii) the number of shares of stock to be listed under the Plan, together with all other Unapproved Shares, would exceed ten percent of the Authorized Dilution. In applying this provision, a company's maximum ratio of Unapproved Shares to total Authorized Dilution may not exceed 1 to 10.

(a)(3) Companies that adopt Plans, Inducement Options or Acquisition Options without shareholder approval as permitted under sub-paragraph (a)(2)(ii) may subsequently obtain shareholder approval and thereby decrease the total Unapproved Shares. With respect to Acquisition Options, if a pre-existing Plan of the acquired company has been approved by such company's shareholders prior to the acquisition, approval by shareholders of an the acquired company prior to the acquisition shall constitute the requisite shareholder approval and shall not be considered in making the calculation pursuant to sub-paragraph (a)(2)(ii).

* * *

312.04 For the purpose
of Para. 312.03:

(a) Treasury shares: In determining the applicability of subparagraph (a) to a particular transaction, provided the two conditions listed below are satisfied, repurchased shares that, within two years of repurchase, are outstanding shares for the purposes of receiving the same dividend and voting rights as all other shares in the class, are excluded. All other repurchased shares are treated as though they are being newly listed.

The exclusion of repurchased shares pursuant to the preceding paragraph is subject to the following conditions: First, the company must obtain approval of each Plan under which grants will be satisfied in whole or in part by repurchased shares, as well as the maximum number of repurchased shares that may be used to satisfy grants made thereunder, from a majority of its independent directors (or a majority of a committee consisting only of independent directors). This approval must be received prior to awarding any grants pursuant to such Plan. Second, the company must obtain from shareholders during the first two years of each Plan or, if earlier, prior to the termination of such Plan, approval of the terms and conditions of such Plan and the fact that repurchased shares may be used. Once such shareholder approval is obtained, it is then valid for the life of the Plan up to a maximum of five years. For Plans with a term greater than five years, the Company must obtain the requisite shareholder approval [within the first two years]* of each succeeding five-year period the Plan remains in effect. Disapproval of a Plan by shareholders has no effect upon the use of shares repurchased or stock options or stock awards duly granted under the Plan prior to such vote by shareholders.

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* an alternative proposal advocated by some members of the Task Force is that the shareholder vote be required at the first shareholder meeting following the adoption of the Plan

(b) For guidance in analyzing transactions pursuant to subparagraph 312.03 (a), the following examples are illustrative of those provisions:

Ex. 1

1,000 shares issuable pursuant to all Plans, Inducement Options, and Acquisition Options, each of which has previously been approved by shareholders ("Authorized Dilution")
Adopt new Plan A – 60 shares
no shareholder approval required (additional shares = 6%)
Company seeks to adopt new Plan B – 60 shares
shareholder approval required because the ratio of Unapproved Shares to total Authorized Dilution would exceed 1 to 10

$$\frac{\text{120 (current Plan + other non-shareholder approved Plan A)}}{\text{1,000 (Authorized Dilution)}} = 12.00\ \%$$

Ex. 2

Authorized Dilution – 1,000 shares
Adopt new Plan A – 50 shares
no shareholder approval required (additional shares = 5%)
Company makes all 50 grants authorized under Plan A, of which 30 are exercised
Adopt new Plan B – 70 shares
no shareholder approval required because total Unapproved Shares is 90(70 Plan B + 20 Plan A), and thus the dilution factor = 9%
Company seeks to adopt new Plan C – 50 shares
shareholder approval required because ratio of Unapproved Shares to total Authorized Dilution exceeds 1 to 10

$$\frac{\text{140 (current Plan + non-approved Plan B + 20 shares from Plan A)}}{\text{1,000 (Authorized Dilution)}} = 14.00\ \%$$

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Ex.3

Authorized Dilution – 1,000 shares
Adopt new Plan A – 70 shares
no shareholder approval required (additional shares = 7%)
Adopt new Plan B – 20 shares
no shareholder approval required (additional shares of Plans A +B = 9.00%)
Company obtains approval for Plan B
Company seeks to adopt new Plan C – 60 shares
shareholder approval required because ratio of Unapproved Shares to total Authorized Dilution would exceed 1 to 10

130 (current Plan + other non-shareholder approved Plan A) = 12.75%
1,020 (Authorized Dilution -- includes Plan B)

Company seeks to adopt new Plan D – 30 shares
no shareholder approval required because Plan C, which has been approved by shareholders, is not included in the numerator, is included in the denominator, and thus the ratio of Unapproved Shares to total Authorized Dilution will not exceed 1 to 10

100 (current Plan + other non-shareholder approved Plan A) = 9.26 %
1,180 (Authorized Dilution of all other Plans includes Plans B and C)

Ex. 4 – Acquisition Options

Authorized Dilution – 1,000 shares
Issue Acquisition Options in connection with a merger – 300 shares
No shareholder approval required because issuance is not within the scope of the definition of “Plan” under 312.03(a)(1)(I)
Company seeks to adopt new Plan A – 50 shares
shareholder approval required

a. Assume no shareholders approved the Acquisition Options, then shareholder approval required because the because ratio of Unapproved Shares to total Authorized Dilution would exceed 1 to 10:

350 (current Plan + Acquisition Options issued in merger) = 35%
1,000 (Authorized Dilution – does not include Acquisition Options)

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b. Assume prior to the acquisition, the shareholders of the acquired company approved the Acquisition Options, then no shareholder approval required because the because ratio of Unapproved Shares to total Authorized Dilution would not exceed 1 to 10:

50 (current Plan + Acquisition Options issued in merger) = 5.00%

1,000 (Authorized Dilution – does not include Acquisition Options)

c. Assume shareholders of the Company approved the entire transaction, then no shareholder approval required because the because the Acquisition Options would be considered approved and the ratio of Unapproved Shares to total Authorized Dilution would not exceed 1 to 10:

50 (current Plan + Acquisition Options issued in merger) = 3.85%

1,300 (Authorized Dilution)

Ex. 5 – Inducement Options

Authorized Dilution – 1,000 shares
Company seeks to offer an Inducement Option of 200 shares
No shareholder approval required because issuance is not within the scope of the definition of "Plan" under 312.03(a)(1)(I)
Adopt new Plan A – 100 shares
shareholder approval required because ratio of Unapproved Shares to Authorized Dilution would exceed 1 to 10

300 (current Plan + Inducement Options) = 30%

1,000 (Authorized Dilution -- does not include the Inducement Options)

Company seeks and obtains approval for Inducement Options
Company seeks to adopt new Plan B – 100 shares
No shareholder approval required because Inducement Options, which have been approved by shareholders, are not included in the numerator, are included in the denominator, and thus the ratio of Unapproved Shares to total Authorized Dilution will not exceed 1 to 10

100 (current Plan) = 7.69%

1,300 (Authorized Dilution -- includes the initial 1,000 shares, Plan A and the Inducement Options)

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Ex. 6 – Repurchased Shares

- Authorized Dilution -- 10,000 shares
- Company's buy back program is as follows:

Year	1	2	3	4	5
Repurchased Shares	1,000	1,000	0	0	0
Shares receive dividends and voting attributes	500	500	500		

- At the end of year 5, Company seeks to adopt a new Plan through the use of repurchased shares
- Maximum number shares available to Company is 1,500 because the remaining balance of 500 repurchased shares did not receive dividend and voting attributes within 2 years of repurchase.
- Company obtains approval from Independent Directors to proceed with this Plan under the terms and conditions proposed and to use repurchased shares for the shares underlying the Plan
- Company begins to issue grants under the Plan in year 6, for a total of 1000 shares.
- In year 7 (no grants have been exercised) the Company seeks shareholder approval as required for the Plan's use of repurchased shares and is denied approval.
- Remainder of Plan cannot be satisfied through repurchased shares.
- Since there was no shareholder approval, the Company's "10% basket" is decreased by 500 shares (if the shareholders had approved the Plan, the 10% basket will not be decreased).

The total available to the company without shareholder approval for the next Plan is 600:

11,000 (Authorized Dilution + repurchased shares already granted) x 10%=1,100
1,100 - 500 (non-approved use for the current Plan) = 600

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Attachment D

MEMORANDUM

To: Members and Advisors of the Options Listing Standard Task Force

From: Scott P. Spector

Date: August 15, 1999

Re: NYSE Stockholder Approval Policy Task Force--Suggested Changes Relating to Equity Compensation Disclosure

---

Over the past several months, we have been asked to review and examine the disclosure rules relating to equity compensation presently contained in Regulation S-K promulgated by the Securities and Exchange Commission under the Securities Exchange Act of 1934. These provisions were adopted by the SEC pursuant to SEC Release Nos. 33-6962; 34-31327; and IC-9032; on October 16, 1992.

It is our view that this disclosure can be improved in a manner that does not substantially increase the burden on issuers. To this end, we believe that the recommended increased disclosure would enhance the ability of investors to review the equity compensation arrangements that are maintained by the issuer for purposes of compensating employees. In formulating this proposal, we take account of the stated goals of Regulation S-K to simplify but expand the disclosure in existence prior to 1992 without putting undue burden on issuers. We believe that our suggestions are consistent with these objectives.

1. We propose that the existing table in Item 402(c)(1) should be amended to require the inclusion of (i) the total number of options and SARs granted to employees and all other persons during the last fiscal year and the weighted-average exercise price for such options; (ii) the total number of outstanding options and SARs that were granted but unexercised that are held by employees and all other persons as of the end of the last fiscal year and the weighted-average exercise price for such options; (iii) the total number of options and SARs available for grant to employees and all other persons at the end of the last fiscal year; and (iv) the total number of shares of the issuer issued and outstanding as of the end of the last completed fiscal year.

Proposed revisions to the table have been included.

The total number of options and SARs available for grant at the end of the last fiscal year need not be included to the extent shares are reserved that may also be awarded as restricted stock or unrestricted stock and included in Item 402(e)(2).

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Note that the weighted-average exercise price will be different than that required by FAS 123 and contained in Form 10-K because of the inclusion of awards to persons other than employees in the tables.

2. We propose that the existing table in Item 402(e)(1) should be amended to require the inclusion of (i) the total number of shares of restricted stock, unrestricted stock and other similar awards granted to employees and all other persons during the last fiscal year; (ii) the total number of shares of outstanding restricted stock, unrestricted stock and other similar awards available for grant to employees and all other persons at the end of the last fiscal year; and (iii) the total number of shares of the issuer issued and outstanding as of the end of the last completed fiscal year.

Proposed revisions to the table have been included.

Information is not required to the extent such information is provided pursuant to Item 402(c)(2).

3. We propose that Item 10 of Schedule 14A be amended to require that information be provided with respect to all plans maintained by registrant with respect to grants of options, restricted stock or similar equity awards. This information would include the name of each plan and whether securities available for award under such plan were approved by security holders, the aggregate amount of awards issued or outstanding under each plan and whether the plans permit repricing of awards (and the circumstances regarding such repricing).

4. We propose that Item 601 be amended to provide that any compensatory plan providing compensation to any officer or director or that is reasonably expected to exceed $100,000 to any employee pursuant to which options, restricted stock or similar equity awards may be awarded, whether or not any executive officer of the registrant is a participant, be filed by the issuer.

The proposed changes are designed to provide disclosure to investors which is not readily available or which may be available only in the Form 10-K. The latter two proposed changes are designed to permit investors to determine which plans have been previously approved by shareholders and to enable investors to review all equity compensation plans, in order to determine the precise nature of the awards that may be granted under such plans.

Again, we believe that the foregoing described disclosures may be accomplished easily by issuers and will provide significant additional disclosure to investors without being unduly burdensome to issuers. We believe that these proposals should be considered by the Task Force for possible transmittal to the Securities and Exchange Commission for consideration as part of their continuing review of Regulation S-K.

Scott P. Spector

Members of the Drafting Committee:

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1. <u>Amended Proposed Item 402(c)</u> **[<u>Proposed Changes in Bold</u>]**

(c) *Option/SAR Grants Table.*

(1) The information specified in paragraph (c)(2) of this item, concerning individual grants of stock options (whether or not in tandem with SARs), and freestanding SARs made during the last completed fiscal year to each of the named executive officers shall be provided in the tabular format specified below:

OPTION/SAR GRANTS MADE IN LAST FISCAL YEAR
AND SHARES AVAILABLE FOR GRANT

Individual Grants					Potential Realizable Value At Assumed Annual Rates Of Stock Price Appreciation For Option Term		Alternative To (f) And (g): Grant Date Value
Name (a)	Number of Securities Underlying Options/ SARs Granted (#) (b)	Percent of Total Options/ SARs Granted To Employees In Fiscal Year (c)	Exercise Of Base Price ($/Sh) (d)	Expiration Date (e)	5% ($) (f)	10% ($) (g)	Grant Date Present Value $ (h)
CEO							
A							
B							
C							
D							
Total number of securities underlying options and SARs granted to employees and all other persons during the last completed fiscal year and the weighted-average exercise price of such options and SARs.							
Total number of securities underlying options and SARs granted but unexercised that are held by employees and all other persons at the end of the last completed fiscal year and the weighted-average exercise price of such options and SARs.							
Total number of securities underlying options and SARs available for grant to employees and all other persons at the end of the last completed fiscal year (including any shares that are held as repurchased shares and available for grant).						[13]	
Total number of shares of the Company issued and outstanding as of the end of the last completed fiscal year.							

(2) The table shall include, with respect to each grant:

[13] These shares also available for grant as restricted stock, unrestricted stock and other similar awards.

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(i) The name of the executive officer (column (a));

(ii) The number of securities underlying options and SARs granted (column (b));

(iii) The percent the grant represents of total options and SARs granted to employees during the fiscal year (column (c));

(iv) The per-share exercise or base price of the options or SARs granted (column (d)). If such exercise or base price is less than the market price of the underlying security on the date of grant, a separate, adjoining column shall be added showing market price on the date of grant;

(v) The expiration date of the options or SARs (column (e)); and

(vi) Either: (A) the potential realizable value of each grant of options or freestanding SARs, or (B) the present value of each grant, as follows:

(A) The potential realizable value of each grant of options or freestanding SARs, assuming that the market price of the underlying security appreciates in value from the date of grant to the end of the option or SAR term, at the following annualized rates:

(1) 5% (column (f));

(2) 10% (column (g)); and

(3) If the exercise or base price was below the market price of the underlying security at the date of grant, provide an additional column labeled 0%, to show the value at grant-date market price; or

(B) The present value of the grant at the date of grant, under any option pricing model (alternative column (f)).

(vii) **The table shall include:**

(A) the total number of securities underlying options and SARs granted to employees and all other persons during the last completed fiscal year and the weighted-average exercise price for such options and SARs.

(B) the total number of securities underlying options and SARs granted but unexercised that are held by employees and all other persons at the end of the last completed fiscal year and the weighted-average exercise price for such options and SARs.

(C) the total number of options and SARs available for grant to employees and all other persons at the end of the last completed fiscal year (including any shares that are held as repurchased shares and available for grant).

(D) the total number of shares of the issuer issued and outstanding as of the end of the last completed fiscal year.

The total number of options and SARs available for grant to employees and all others at the end of the last completed fiscal year need not be included to the extent shares are reserved that may also be awarded as restricted stock or unrestricted stock and is included in Item 402(e)(2).

2. Amended Proposed Item 402(e) **[Proposed changes in bold]**

(e) *Long-Term Incentive Plan ("LTIP") Awards Table.*

(1) The information specified in paragraph (e)(2) of this item, regarding each award made to a named executive officer in the last completed fiscal year under any LTIP, shall be provided in the tabular format specified below:

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RESTRICTED STOCK AND LONG-TERM INCENTIVE PLANS—AWARDS IN LAST FISCAL YEAR

Name (a)	Number Of Shares, Units Or Other Rights (#) (b)	Performance Or Other Period Until Maturation Or Payout (c)	Estimated Future Payouts Under Non-Stock Price-Based Plans		
			Threshold ($ Or #) (d)	Target ($ Or #) (e)	Maximum ($ Or #) (f)
CEO					
A					
B					
C					
D					
Total number of shares of restricted stock, unrestricted stock and other similar awards granted to employees and all other persons during the last completed fiscal year whether or not performance - based or included in Item 402(b)(2)(iv).					
Total number of shares of restricted stock, unrestricted stock and other similar awards available for grant to employees and all other persons at the end of the last completed fiscal year (including any shares that are held as repurchased shares and available for grant).					
Total number of shares of the Company issued and outstanding as of the end of the last completed fiscal year.					

(2) The table shall include:

(i) The name of the executive officer (column (a));

(ii) The number of shares, units or other rights awarded under any LTIP, and, if applicable, the number of shares underlying any such unit or right (column (bb);

(iii) The performance or other time period until payout or maturation of the award (column (c));

(iv) For plans not based on stock price, the dollar value of the estimated payout, the number of shares to be awarded as the payout or a range of estimated payouts denominated in dollars or number of shares under the award (threshold, target and maximum amount) (columns (d) through (f));

(v) **The total number of shares of restricted stock, unrestricted stock and other similar awards granted to employees and all other persons during the last completed fiscal year whether or not performance - based or included in Item 402(b)(2)(iv);**

(vi) **The total number of shares of restricted stock, unrestricted stock and other similar awards available for grant to employees and all other persons at the end of the last completed fiscal year (including any shares that are held as repurchased shares and available for grant). Where applicable indicate whether these are included in Item 402(c)(2); and**

(vii) **The total number of shares of the issuer issued and outstanding as of the end of the last completed fiscal year.**

3. New Proposed Item 10(c) **[All new]**

(c) Other Plans Not Subject to Security Holder Acts. Provide the following information for any plans maintained by a registrant other than plans described in subsections (a) or (b) above for which action is being taken by security holders to adopt or amend such plan pursuant to which grants of restricted stock, unrestricted stock, options to purchase stock or similar equity awards may be made under the plan.

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(1) The name of the plan and the type and amount of securities available for such awards under each plan and whether securities available for awards under such plan are approved by security holders;

(2) The aggregate amount of all awards issued or outstanding under each plan; and

(3) Whether the plan permits the repricing of awards and whether the registrant has repriced any similar awards during the last 5 years and, if so, the circumstances of such repricing.

4. Amended Proposed Item 601(B)(10)(iii)(A) **[Proposed changes in bold]**

(iii) Any management contract or any compensatory plan, contract or arrangement, including but not limited to plans relating to options, warrants or rights, pension, retirement or deferred compensation or bonus, incentive or profit sharing (or if not set forth in any formal document, a written description thereof) in which any director or any of the named executive officers of the registrant, as defined by Item 402(a)(3), participates **and any compensatory plan providing compensation to any officer or director or that is reasonably expected to exceed $100,000 to any employee pursuant to which grants of restricted stock, unrestricted stock, options to purchase stock or similar equity awards may be awarded whether or not any executive officers of the registrant participate**, shall be deemed material and shall be filed;

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OPTION/SAR GRANTS MADE IN LAST FISCAL YEAR AND SHARES AVAILABLE FOR GRANT

Individual Grants					Potential Realizable Value At Assumed Annual Rates Of Stock Price Appreciation For Option Term		Alternative To (f) And (g): Grant Date Value
Name (a)	Number of Securities Underlying Options/ SARs Granted (#) (b)	Percent of Total Options/ SARs Granted To Employees In Fiscal Year (c)	Exercise Of Base Price ($/Sh) (d)	Expiration Date (e)	5% ($) (f)	10% ($) (g)	Grant Date Present Value $ (h)
CEO	300,000	1.71	105.63	8/26/2008	19,929,041.83	50,504,104.82	-
A	130,000	0.74	105.63	8/26/2008	8,635,918.13	21,885,112.09	-
B	120,000	0.68	105.63	8/26/2008	7,971,616.73	20,201,641.93	-
C	90,000	0.51	105.63	8/26/2008	5,978,712.55	15,151,231.45	-
D	75,000	0.43	105.63	8/26/2008	4,982,260.46	12,626,026.20	-
Total number of securities underlying options and SARs granted to employees and all other persons during the last completed fiscal year and the weighted-average exercise price of such options and SARs.						17,620,000	$105.63
Total number of securities underlying options and SARs granted but unexercised that are held by employees and all other persons at the end of the last completed fiscal year and the weighted-average exercise price of such options and SARs.						83,204,000	$45.96
Total number of securities underlying options and SARs available for grant to employees and all other persons at the end of the last completed fiscal year.						4,247,000[14]	-
Total number of shares of the Company issued and outstanding as of the end of the last completed fiscal year.						?	?

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[14] These shares are also available for grant as restricted stock, unrestricted stock and other similar awards.

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RESTRICTED STOCK AND LONG-TERM INCENTIVE PLANS—AWARDS IN LAST FISCAL YEAR

Name (a)	Number Of Shares, Units Or Other Rights (1) (#) (b)	Performance Or Other Period Until Maturation Or Payout (c)	Estimated Future Payouts Under Non-Stock Price-Based Plans		
			Threshold (#) (d)	Target (#) (e)	Maximum (#) (f)
CEO	-	1/1/99-12/31/03	10,000	60,000	100,000
A	-	1/1/99-12/31/03	4,700	28,200	47,000
B	-	1/1/99-12/31/03	4,200	25,200	42,000
C	-	1/1/99-12/31/03	3,000	18,000	30,000
D	-	1/1/99-12/31/03	2,500	15,000	25,000
Total number of shares of restricted stock, unrestricted stock and other similar awards granted to employees and all other persons during the last completed fiscal year whether or not performance - based or included in Item 402(b)(2)(iv).					1,400
Total number of shares of restricted stock, unrestricted stock and other similar awards available for grant to employees and all other persons at the end of the last completed fiscal year (2)					4,247,000
Total number of shares of the Company issued and outstanding as of the end of the last completed fiscal year.					—

(1) The actual number of Performance-Contingent Shares that will be paid out at the end of the applicable period, if any, cannot be determined because the shares earned by the Named Executive Officers will be based upon our future performance compared to the future performance of the industry Peer Group.

(2) The same total number of shares of restricted stock, unrestricted stock and other similar awards available for grant to employees and all other persons is also available for grant as options and SARs at the end of the last completed fiscal year.

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Proposed Rule: Disclosure of Equity Compensation Plan Information

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 228, 229, 240 and 249

[Release Nos. 33-7944, 34-43892; File No. S7-04-01]

RIN: 3235-AI01

DISCLOSURE OF EQUITY COMPENSATION PLAN INFORMATION

AGENCY: Securities and Exchange Commission

ACTION: Proposed rules

SUMMARY: We are publishing for comment proposed amendments to the disclosure requirements applicable to proxy statements and periodic reports under the Securities Exchange Act of 1934. We seek to enhance disclosure of the number of securities authorized for issuance under, and received by or allocated to participants pursuant to, equity compensation plans.

DATES: Comments should be submitted on or before [insert date 60 days after publication in the Federal Register].

ADDRESSES: You should submit three copies of your comments to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549-0609. You also may submit your comments electronically to the following electronic mail address: rule-comments@sec.gov. All comment letters should refer to File Number S7-04-01; please include this file number in the subject line if you use electronic mail. Comment letters will be available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, N.W., Washington, D.C. 20549. We will post electronically submitted comment letters on our Internet web site http://www.sec.gov.[1]

FOR FURTHER INFORMATION CONTACT: Raymond A. Be, Office of Rulemaking, Division of Corporation Finance, at (202) 942-2886.

SUPPLEMENTARY INFORMATION: Today, we are publishing for comment proposed amendments to Item 201[2] of Regulation S-B,[3] Item 201[4] of Regulation S-K[5] and Form 10-K,[6] Form 10-KSB[7] and Schedule 14A[8] under the Securities Exchange Act of 1934.[9] Schedule 14C[10] under the Exchange Act also would be

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affected by the proposed amendments. These amendments would require disclosure in a registrant's proxy statement or annual report on Form 10-K or 10-KSB of the following information:

- the number of securities authorized for issuance under each equity compensation plan of the registrant in effect as of the end of the most recently completed fiscal year;
- the number of securities issued pursuant to equity awards made during the last completed fiscal year, plus the number of securities to be issued upon the exercise of options, warrants or rights granted during the last completed fiscal year, under each plan;
- the number of securities to be issued upon the exercise of outstanding options, warrants or rights under each plan; and
- other than securities to be issued upon the exercise of outstanding options, warrants or rights, the number of securities remaining available for future issuance under each plan.

We also are making a non-substantive change to Exchange Act Rule 14a-3[11] to make clear that this disclosure is not required in an annual report to security holders.

I. DISCUSSION OF PROPOSALS

A. Background

Today, the use of equity compensation, particularly in the form of stock options, appears to be growing.[12] As the use of equity incentives has grown, so too have concerns about their impact.[13] These concerns involve

- the absence of full disclosure to security holders about equity compensation plans;
- the potential dilutive effect of equity compensation plans; and
- the adoption of many plans without the approval of security holders.

Our current rules do not require disclosure of the total number of securities that a registrant has authorized for issuance under its entire equity compensation program. Although our rules require disclosure in a registrant's proxy statement of the material features of a compensation plan when submitting the plan for security holder action,[14] including, in the case of a plan containing options, warrants or rights, the title and amount of securities underlying such options, warrants or rights,[15] that disclosure need address only the plan upon which action is being taken.[16] Accordingly, we have been urged to consider greater transparency of all equity compensation plans, whether or not the plans have received security holder approval.[17] This information is important if investors are to assess the effect that equity compensation plans have on their ownership or to compare the equity compensation plans of a registrant with those of its competitors. Disclosure of the overall number of securities of a registrant authorized for issuance under employee stock option plans then in effect is sometimes available indirectly through the registrant's financial statements included in its annual report to security holders.[18] This disclosure is not necessarily effective, however, since it is not consistently available in any one location or format, may not include non-derivative securities awarded to employees and may not include stock options granted to non-employees.[19]

In addition, significant concern has arisen as to the level of potential dilution

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that equity compensation plans now represent. This concern relates to dilutive potential from the standpoint of both economic and voting power. Issuance of equity securities under these plans may result in a significant reallocation of ownership in the enterprise between existing security holders and management and employees.[20]

Finally, many equity compensation plans may not receive security holder approval. At the state level, approval by security holders is required in only a few jurisdictions.[21] At the federal level, approval by security holders is required only to qualify for favorable treatment under the federal income tax laws[22] or in the case of the issuance of options, warrants or rights by a business development company.[23] While the rules of self-regulatory organizations require publicly-traded companies to obtain security holder approval for some plans,[24] these rules contain exceptions that enable companies to implement many employee stock plans without security holder approval.[25] Accordingly, some market participants have expressed concern that a growing number of employee stock plans escape security holder scrutiny because they are not submitted for approval.[26]

We are proposing amendments that would require registrants to disclose, at least annually, information about the total number of securities that have been authorized for issuance under equity compensation plans in effect[27] as of the end of the last completed fiscal year, whether or not the plans have been approved by security holders. The purpose of the amendments is to promote investor understanding of a registrant's equity compensation policies and practices so that investors can make informed voting and investment decisions.

This disclosure would be set forth in a tabular format

- in the registrant's proxy statement[28] whenever the registrant is seeking security holder action regarding a compensation plan;[29] or
- in the registrant's annual report on Form 10-K[30] in years when the registrant is not seeking security holder action regarding a compensation plan.

B. Proposed Disclosure

The proposed amendments would require a registrant to provide a table identifying each equity compensation plan in effect as of the end of the last completed fiscal year and containing the following information with respect to each plan:

- the number of securities that have been authorized for issuance by the registrant's board of directors;
- the number of securities issued pursuant to equity awards made during the last completed fiscal year, plus the number of securities to be issued upon the exercise of options, warrants or rights granted during the last completed fiscal year;[31]
- the number of securities to be issued upon the exercise of outstanding options, warrants or rights;[32] and
- other than securities to be issued upon the exercise of outstanding options, warrants or rights, the number of securities remaining available for

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future issuance.

This information would be provided with respect to any equity compensation plan[33] that provides for the award of a registrant's securities or the grant of options, warrants or rights to purchase the registrant's securities[34] to officers, directors and employees of the registrant or its parent or subsidiary corporations, or to any other person.[35] Individual arrangements that contemplate the award of a registrant's securities or the grant of options, warrants or rights providing for the purchase of the registrant's securities may be aggregated and disclosed as a single item.[36]

This information would be provided without regard to whether the equity compensation plan was previously approved by a registrant's security holders. Registrants would be required to identify, either in the table or through a narrative statement, which of the equity compensation plans, if any, was adopted without security holder approval. They also would be required to provide a brief, narrative description of the material features of each plan adopted without security holder approval during the last completed fiscal year.[37] Finally, this information would be provided without regard to whether the securities to be issued under the equity compensation plan were authorized but unissued securities of the registrant or repurchased or "treasury" shares.

We request comment as to the appropriateness of the proposed disclosure. Would narrative disclosure be preferable to the proposed tabular format? Are there any additional categories of information (such as weighted average exercise price information) or different categories of information that should be included in the disclosure? Is it useful to disclose information about the number of securities awarded and the number of options, warrants or rights granted during the last completed fiscal year? Would disclosure of prior awards and grants over a different time period be more appropriate, and, if so, what period? Is it necessary, as proposed, for registrants to provide totals for the information set forth in each column of the tabular disclosure? When disclosure is being made in a registrant's proxy statement because the registrant is seeking security holder action regarding a compensation plan, should the tabular disclosure also cover the plan upon which action is being taken?

Is aggregated disclosure of individual arrangements appropriate? If not, what alternative approach would be preferable? Should aggregated disclosure be permitted in the case of certain equity compensation plans (such as plans that are assumed by the acquiring company in a merger, consolidation or other acquisition transaction)?

Should additional or different disclosure be required with respect to equity compensation plans that have been adopted without security holder approval (such as the information currently required under Item 10 of Schedule 14A)? Should disclosure be required if the plan was adopted in a year prior to the most recently completed fiscal year? Is it sufficient to require the disclosure of such plan's "material features," or should we identify the specific terms and conditions of the plan that must be disclosed (such as exercise price, vesting and expiration date information, or the existence of reload, stock swap, loan or option repricing features)? In lieu of, or in addition to, the disclosure required for an equity compensation plan that has been adopted without security holder approval, should a registrant be required to file any such plan as an exhibit to the registrant's annual report on Form 10-K for the fiscal year in which the plan was adopted?[38] Should specific disclosure about equity compensation plans that involve the use of repurchased or "treasury" shares be required?

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C. Location of Disclosure

1. Disclosure in Proxy Statement

We believe that an understanding of a registrant's equity compensation policies and practices is relevant to a security holder's decision regarding the adoption of a new compensation plan or the modification of an existing plan. Accordingly, if security holders are acting on a plan at a meeting, the proposed amendments would require that the disclosure be included in the registrant's proxy statement relating to the meeting at which security holders will be voting on the compensation plan.[39]

2. Disclosure in Annual Report on Form 10-K

Even in years when a registrant is not submitting a compensation plan for security holder action, we believe that it is important for security holders to know the extent to which the registrant has awarded securities or granted options, warrants or rights to participants under its existing equity compensation plans. The proposed amendments would require a registrant to disclose in its annual report on Form 10-K the information required by Proposed Item 201(d) of Regulation S-K.[40] This information would be included in Part III of Form 10-K. As such, the information could be incorporated by reference from a registrant's definitive proxy statement that involves the election of directors, if the definitive proxy statement is filed with the Commission not later than 120 days after the end of the fiscal year covered by the Form 10-K.[41]

We request comment as to the appropriateness of the location for the proposed disclosure. Should disclosure be required in the proxy statement whether or not a registrant is submitting a compensation plan for security holder action? If so, how would the disclosure requirements be made applicable to registrants that are subject to reporting under Section 15(d) of the Exchange Act?[42] Alternatively, is it necessary to provide disclosure in years when a registrant is not submitting a compensation plan for security holder action? Is similar information currently available to security holders,[43] and, if so, is this information adequate? Should the proposed disclosure be required in registration statements filed under the Securities Act of 1933?[44]

II. GENERAL REQUEST FOR COMMENTS

Any interested person wishing to address the rule changes that are the subject of this release, to suggest additional or different changes or to comment on other matters that may have an effect on the proposals contained in this release, is requested to submit comments. We request comment from the point of view of registrants, security holders and other users of information about the use of securities to compensate officers, directors, employees, consultants and advisors.

III. PAPERWORK REDUCTION ACT

Portions of the proposed amendments contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995,[45] or PRA. We are submitting the proposed amendments to the Office of Management and Budget, or OMB, for review in accordance with the PRA.[46] The titles for the collections of information are (1) "Regulation 14A (Commission Rules 14a-1

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through 14b-2 and Schedule 14A)," (2) "Regulation 14C (Commission Rules 14c-1 through 14c-7 and Schedule 14C)," (3) "Form 10-K," (4) "Form 10-KSB," (5) "Regulation S-B" and (6) "Regulation S-K." An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

Regulation 14A (OMB Control No. 3235-0059) was adopted pursuant to Section 14(a) of the Exchange Act[47] and prescribes information that a registrant must include in its proxy statement to ensure that security holders are provided information that is material to their voting decisions. Preparing and sending a proxy statement is a collection of information.

Regulation 14C (OMB Control No. 3235-0057) was adopted pursuant to Section 14(c) of the Exchange Act[48] and prescribes information that a registrant must include in an information statement when a security holder vote is to be held but proxies are not being solicited. Schedule 14C refers to Schedule 14A for the disclosure requirements related to compensation plans. Preparing and sending an information statement is a collection of information.

Form 10-K (OMB Control No. 3235-0063) was adopted pursuant to Sections 13[49] and 15(d) of the Exchange Act and prescribes information that a registrant must disclose annually to the market about its business. Preparing and filing an annual report on Form 10-K is a collection of information.

Form 10-KSB (OMB Control No. 3235-0420) was adopted pursuant to Sections 13 and 15(d) of the Exchange Act and prescribes information that a registrant that is a "small business issuer" as defined under our rules[50] must disclose annually to the market about its business. Preparing and filing an annual report on Form 10-KSB is a collection of information.

Regulation S-B (OMB Control No. 3235-0417) was adopted pursuant to the Securities Act and the Exchange Act and is the source of disclosure requirements for "small business issuer" filings under the Securities Act and the Exchange Act. Preparing this disclosure involves a collection of information.

Regulation S-K (OMB Control No. 3235-0071) was adopted pursuant to the Securities Act and the Exchange Act and sets forth the requirements applicable to the content of the non-financial statement portions of registration statements under the Securities Act and registration statements under Section 12,[51] annual and other reports under Sections 13 and 15(d), going-private transaction statements under Section 13, tender offer statements under Sections 13 and 14, annual reports to security holders and proxy and information statements under Section 14 and any other documents required to be filed under the Exchange Act. Preparing this disclosure involves a collection of information.

The proxy disclosure requirements of Section 14 of the Exchange Act, as well as the reporting requirements of Section 13 of the Exchange Act, apply to those entities that have securities registered under Section 12 of the Exchange Act. The reporting requirements of Section 15(d) of the Exchange Act apply to those entities with effective registration statements under the Securities Act that are not otherwise subject to the registration requirements of Section 12 of the Exchange Act. The likely respondents, therefore, include entities with more than 500 security holders and more than $10 million in assets (Section 12(g)),[52] entities with securities listed on a national exchange (Section 12(b))[53] and entities with an effective registration statement under the Securities Act (Section 15(d)).

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We estimate that approximately 9,892 respondents file proxy statements under Schedule 14A and annual reports on Form 10-K or 10-KSB, approximately 253 respondents file information statements under Schedule 14C and annual reports on Form 10-K or 10-KSB and approximately 1,939 respondents just file annual reports on Form 10-K or 10-KSB. We have based the number of entities that would complete and file each of the forms on the actual number of filers during the 2000 fiscal year.

We further estimate that approximately 60% of these respondents, or 7,250 respondents, have adopted equity compensation plans and, thus, will be subject to the enhanced disclosure contemplated by the proposed amendments. We estimate that approximately 50% of these respondents, or 3,625 respondents, adopt a new equity compensation plan or modify an existing plan each year. In addition, we estimate that approximately 25% of the respondents with equity compensation plans, or 1,813 respondents, have adopted non-security holder approved plans[54] and will be required to describe the material terms of these plans as part of their enhanced disclosure. We note that, while each respondent with an equity compensation plan will need to make the required disclosure, the disclosure will appear in only one filing each year -- either the proxy or information statement or the annual report on Form 10-K or 10-KSB.

Based on these assumptions, we estimate that 60% of the respondents that file proxy statements under Schedule 14A and annual reports on Form 10-K or 10-KSB, or 5,935 respondents, will need to prepare and provide the required tabular disclosure. We further estimate that 25% of these respondents, or 1,484 respondents, will need to prepare and provide descriptions of their non-security holder approved equity compensation plans. We estimate that one-half of the respondents will need to include this disclosure in their proxy statements and one-half in their annual reports on Form 10-K or 10-KSB,[55] as the case may be. Finally, we estimate that preparation of the required tabular disclosure will add two burden hours to each proxy or information statement or annual report on Form 10-K or 10-KSB and, where required, preparation of the required description of an equity compensation plan's material terms will also add two burden hours.[56] Thus, we estimate that the proposed amendments will require 7,419 burden hours to prepare the required disclosure [(one-half of 5,935 respondents x 2 hours) + (one half of 1,484 respondents x 2 hours)] and will add 3,710 hours[57] to the current Schedule 14A annual burden of 179,144 hours, resulting in a total Schedule 14A annual hour burden of 182,854 hours.

We estimate that 60% of the respondents that file information statements under Schedule 14C and annual reports on Form 10-K or 10-KSB, or 152 respondents, will need to prepare and provide the required tabular disclosure. We further estimate that 25% of these respondents, or 38 respondents, will need to prepare and provide descriptions of their non-security holder approved equity compensation plans. We estimate that one-half of this disclosure will be included in respondents' information statements and one-half in respondents' annual reports on Form 10-K or 10-KSB,[58] as the case may be. Thus, we estimate that the proposed amendments will require 190 burden hours to prepare the required disclosure [(one-half of 152 respondents x 2 hours) + (one-half of 38 respondents x 2 hours)] and will add 95 hours to the current Schedule 14C annual burden of 4,582 hours, resulting in a total Schedule 14C annual hour burden of 4,677 hours.

We estimate that 60% of the respondents that just file annual reports on Form 10-K or 10-KSB, or 1,163 respondents, will need to prepare and provide the

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required tabular disclosure. We further estimate that 25% of these respondents, or 291 respondents, will need to prepare and provide descriptions of their non-security holder approved equity compensation plans. We estimate that 20% of the respondents will include this disclosure in their annual report on Form 10-K and 80% in their annual report on Form 10-KSB. Thus, we estimate that the proposed amendments will require 6,668 burden hours to prepare the required disclosure [{(20% of 1,163 respondents x 2 hours) + (20% of 291 respondents x 2 hours)} + {(80%[59] of one-half of 5,935 respondents x 2 hours) + (80% of one-half of 1,484 respondents x 2 hours)}[60] + {(80% of one-half of 152 respondents x 2 hours) + (80% of one-half of 38 respondents x 2 hours)}[61]] and will add 3,334 hours to the current Form 10-K annual burden of 4,463,830 hours, resulting in a total Form 10-K annual hour burden of 4,467,194 hours. We also estimate that the proposed amendments will require 3,848 burden hours to prepare the required disclosure [{(80% of 1,163 respondents x 2 hours) + (80% of 291 respondents x 2 hours)} + {(20%[62] of one-half of 5,935 respondents x 2 hours) + (20% of one-half of 1,484 respondents x 2 hours)} + {(20 % of one-half of 152 respondents x 2 hours) + (20% of one-half of 38 respondents x 2 hours)}] and will add 1,924 hours to the current Form 10-KSB annual burden of 1,070,454 hours, resulting in a total Form 10-KSB annual hour burden of 1,072,378 hours.

In addition to the internal hours they will expend, we expect that respondents will retain outside counsel to assist in the preparation of the required disclosures. The total dollar cost of complying with Regulation 14A, revised to include the additional outside counsel costs expected from the proposed amendments, are estimated to be $93,263,250, an increase of $649,250 from the current annual burden. The total dollar cost of complying with Regulation 14C, revised to include the additional outside counsel costs expected from the proposed amendments, are estimated to be $2,385,625, an increase of $16,625 from the current annual burden. The total dollar cost of complying with Form 10-K, revised to include the additional outside counsel costs expected from the proposed amendments, are estimated to be $2,344,093,450, an increase of $583,450 from the current annual burden. The total dollar cost of complying with Form 10-KSB, revised to include the additional outside counsel costs expected from the proposed amendments, are estimated to be $562,324,700, an increase of $336,700 from the current annual burden.

We believe that the proposed amendments will enable investors to ascertain more readily the total number of securities that a registrant has authorized for issuance under its equity compensation plans. As discussed elsewhere in this release, there is growing concern about the level of potential dilution that equity compensation plans now represent. In addition, investors have expressed concern that many plans are implemented without the approval of security holders and that the current disclosure rules do not require comprehensive information about all of a company's plans. The proposed amendments will require registrants to present additional information in their proxy or information statements or their annual reports on Form 10-K or 10-KSB about their equity compensation plans. We believe that this information is important to an investor's decision to vote to approve a new compensation plan or the modification of an existing plan.

Compliance with the disclosure requirements will be mandatory for all registrants. There would be no mandatory retention period for the information disclosed, and responses to the disclosure requirements will not be kept confidential.

We request comment in order to (a) evaluate whether the proposed collections

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of information are necessary for the proper performance of the functions of the Commission, including whether the information will have practical utility, (b) evaluate the accuracy of our estimate of the burden of the proposed collections of information, (c) determine whether there are ways to enhance the quality, utility and clarity of the information to be collected and (d) evaluate whether there are ways to minimize the burden of the collections of information on those who respond, including through the use of automated collection techniques or other forms of information technology. [63]

Persons who desire to submit comments on the collection of information requirements should direct their comments to the OMB, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, D.C. 20503, and send a copy of the comments to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street N.W., Washington, D.C. 20549-0609, with reference to File No. S7-04-01. Requests for materials submitted to the OMB by the Commission with regard to this collection of information should be in writing, refer to File No. S7-04-01 and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services, 450 Fifth Street N.W., Washington, D.C. 20549-0609. Because the OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication, your comments are best assured of having their full effect if the OMB receives them within 30 days of publication.

IV. COST-BENEFIT ANALYSIS

We have identified certain costs and benefits of the proposed amendments. We request comment on all aspects of this cost-benefit analysis, including identification of any additional costs or benefits of, or suggested alternatives to, the proposals. Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

The proposed amendments to require certain information to be provided in the proxy or information statement when submitting a compensation plan for security holder action, or in the annual report on Form 10-K or 10-KSB in fiscal years when a registrant is not submitting a compensation plan for security holder action, will, if adopted, increase the amount of information available to investors about a registrant's equity compensation program, enabling investors to better understand the forms and amounts of equity compensation paid to officers, directors, employees, consultants and advisors. The proposed amendments are consistent with our existing disclosure requirements for executive compensation,[64] and further our objective of enabling investors to make better informed voting and investment decisions.

The potential benefit to investors would include greater insight into a registrant's equity compensation policies and practices. This information would benefit investors by providing additional information in a useful format about existing equity compensation plans when called upon to consider action on a new equity compensation plan or the modification of an existing plan. In addition, this information would be of use to investors in evaluating the performance of a registrant's management and board of directors.

We believe that the proposed amendments also would benefit investors by providing information, which is not always readily available, regarding the overall potential dilutive effect of a registrant's equity compensation program. This information also would lead to greater transparency concerning a registrant's

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capital structure and enable greater comparability of equity compensation programs between companies. Accordingly, this information may be factored into investment decisions, thereby leading to more accurate pricing for a registrant's securities. These benefits are difficult to quantify.

The proposed amendments may increase the costs to registrant in several ways. Specifically, the amendments will increase the costs associated with the preparation of information currently required to be furnished to security holders in proxy or information statements or reported in annual reports on Form 10-K or 10-KSB. Since this information is readily available to registrants, however, and portions must be disclosed in other filings,[65] we do not expect these additional costs to be significant. As discussed in Section III of this release for purposes of the PRA, we estimate the aggregate annual paperwork cost of compliance with the proposed amendments to be $3,172,050.

The proposed amendments may have indirect effects, as well. For example, the availability of additional information about a registrant's equity compensation policies and practices may have an impact on the market price of a registrant's securities where the number of securities reserved for issuance under the registrant's equity compensation plans is higher than expected. In addition, disclosure of further information about a registrant's equity compensation policies and practices may cause the registrant to scale back its equity compensation program if not received favorably by investors. This may make it difficult for some registrants, particularly small businesses, which rely heavily on equity compensation to recruit, motivate and retain key employees. These costs, to the extent they exist, are difficult to quantify. Therefore, we request information regarding these matters. Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

V. SUMMARY OF INITIAL REGULATORY FLEXIBILITY ANALYSIS

We have prepared an Initial Regulatory Flexibility Analysis, or IRFA, regarding the proposed amendments.[66] The following summarizes the IRFA:

As discussed in greater detail in the IRFA and in other sections of this release, the recent, increased use of equity compensation has raised concerns about the potential dilutive effect of equity compensation plans, the absence of the approval of security holders and the absence of full disclosure to security holders about a company's plans. These concerns may be especially acute in smaller companies, which often make liberal use of equity compensation in order to attract and retain key employees and to preserve scarce cash resources. In this regard, we are proposing amendments to our current requirements to increase the information provided to investors regarding equity compensation plans. This information will be included in proxy or information statements or in annual reports on Form 10-K or 10-KSB.

The IRFA sets forth the statutory authority for the proposed amendments. It also discusses "small entities" that would be subject to the proposals.[67] As described in the IRFA, we have estimated that there are approximately 2,500 Exchange Act reporting companies that currently satisfy the definition of "small business" under our rules. The IRFA indicates that the proposed amendments would affect all registrants. The IRFA states that the proposed amendments will increase costs for registrants, including some small businesses, because the proposal imposes new reporting and compliance requirements.

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The new disclosure requirements would apply to small businesses only if they are subject to Section 14 of the Exchange Act or have an effective registration statement under the Securities Act and if they adopt or maintain an equity compensation plan. We estimate the number of those entities to be approximately 1,500.[68] The proposed amendments relate to only one item of the proxy or information statement or annual report on Form 10-K or 10-KSB, and the information should be readily available to registrants because they already maintain records regarding their equity compensation plans. This information is needed for investors to better understand a registrant's equity compensation program. In addition, all registrants have various corporate law, financial reporting and other disclosure obligations that require maintenance of information regarding equity compensation plans similar to that covered by the proposed amendments. We believe that the proposed amendments will provide improved information for the investing public.

As explained in the IRFA, the Regulatory Flexibility Act directs us to consider alternatives that would accomplish the stated objective, while minimizing adverse impact on small entities. In that regard, we are considering the following alternatives: (a) differing compliance or reporting requirements that take into account the resources of small entities, (b) the clarification, consolidation or simplification of compliance and reporting requirements under the rule for small entities, (c) the use of performance rather than design standards and (d) an exemption from the coverage of the proposed amendments for small entities.

We encourage the submission of comments with respect to any aspect of the IRFA. In particular, we request comment on the number of small businesses that would be affected by the proposed amendments, the nature of the impact, how to quantify the number of small entities that would be affected and how to quantify the impact of the proposed amendments. Commenters are requested to describe the nature of any effect and provide empirical data and other factual support for their views to the extent possible. These comments will be considered in the preparation of the Final Regulatory Flexibility Analysis, if the proposed amendments are adopted, and will be placed in the same public file as comments on the proposed amendments. A copy of the IRFA may be obtained by contacting Raymond A. Be, Office of Rulemaking, Division of Corporation Finance, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549-0609.

VI. CONSIDERATION OF IMPACT ON THE ECONOMY, BURDEN ON COMPETITION AND PROMOTION OF EFFICIENCY, COMPETITION AND CAPITAL FORMATION

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or "SBREFA,"[69] we request information regarding the potential impact of the proposed amendments on the economy on an annual basis. Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

Section 23(a)(2) of the Exchange Act[70] requires us, when adopting rules under the Exchange Act, to consider the anti-competitive effects of any rule that we adopt. The proposed amendments are intended to improve the comparability of registrants' equity compensation policies and practices, which should promote

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competition. Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

In addition, Section 2(b) of the Securities Act and Section 3(f) of the Exchange Act[71] require us, when engaging in rulemaking that requires us to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition and capital formation. The proposed amendments enhance our disclosure requirements in light of trends in the use of equity compensation. The proposed amendments affect the information that registrants must provide to investors concerning their equity compensation plans. The purpose of the amendments is to promote investor understanding of a company's equity compensation policies and practices so that investors can make informed voting and investment decisions. Informed investor decisions generally promote market efficiency and capital formation. We request comment on whether the proposed amendments, if adopted, would promote efficiency and capital formation. Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

VII. STATUTORY AUTHORITY

The amendments contained in this release are being proposed under the authority set forth in Sections 3(b), 6, 7, 8, 10 and 19(a) of the Securities Act and Sections 12, 13, 14(a), 15(d) and 23(a) of the Exchange Act.

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

Reporting and recordkeeping requirements, Securities.

TEXT OF PROPOSED RULE AMENDMENTS

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

PART 228 - INTEGRATED DISCLOSURE SYSTEM FOR SMALL BUSINESS ISSUERS

1. The authority citation for Part 228 continues to read as follows:

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

2. By amending §228.201 to add paragraph (d) before the Instruction to read as follows:

§228.201 (Item 201) Market for Common Equity and Related Stockholder Matters.

* * * * *

(d) Securities authorized for issuance under equity compensation plans.

(1) In the tabular format set forth below, provide the information specified in paragraph (d)(2) of this Item as of the end of the most recently completed fiscal year with respect to each compensation plan of the registrant under which

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equity securities of the registrant are authorized for issuance.

Equity Compensation Plan Information

(a)	(b)	(c)	(d)	(e)
Name of plan	Number of securities authorized for issuance under the plan	Number of securities awarded plus number of securities to be issued upon exercise of options, warrants or rights granted during last fiscal year	Number of securities to be issued upon exercise of outstanding options, warrants or rights	Number of securities remaining available for future issuance
Plan #1				
Plan #2				
Plan #3				
Individual Arrangements (Aggregated)				
Total				

(2) The table shall include the following information as of the end of the most recently completed fiscal year:

(i) For each plan (other than individual arrangements):

(A) The name of the plan (column (a));

(B) The number of securities authorized for issuance under the plan (column (b));

(C) The number of securities issued pursuant to equity awards made under the plan during the most recently completed fiscal year, plus the number of securities to be issued upon the exercise of options, warrants or rights granted under the plan during the most recently completed fiscal year (column (c));

(D) The number of securities to be issued upon the exercise of options, warrants or rights outstanding under the plan (column (d)); and

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(E) Other than securities to be issued upon the exercise of outstanding options, warrants or rights, the number of securities remaining available for issuance under the plan (column (e)).

(ii) For individual arrangements:

(A) The number of individual arrangements being disclosed (column (a));

(B) The aggregate number of securities authorized for issuance under the individual arrangements (column (b));

(C) The aggregate number of securities to be issued upon the exercise of options, warrants or rights outstanding under the individual arrangements (column (d)); and

(D) Other than securities to be issued upon the exercise of outstanding options, warrants or rights, the aggregate number of securities remaining available for issuance under the individual arrangements, if any (column (e)).

(3) Identify each plan that was adopted without security holder approval and:

(i) If such plan was adopted during the most recently completed fiscal year, describe briefly, in narrative form, the material features of the plan; or

(ii) If such plan was adopted in a prior fiscal year, identify the filing containing such description.

(4) If any individual arrangement exceeds 25% of the aggregate number of securities disclosed pursuant to paragraph (d)(2)(ii)(B) of this Item, identify the relationship of the recipient to the registrant and describe briefly, in narrative form, the material features of the arrangement.

Instructions to Item 201(d).

1. For purposes of this paragraph, the term plan shall be defined in accordance with Item 402(a)(6)(ii) of Regulation S-B (§228.402(a)(6)(ii)).

2. No disclosure is required under this Item with respect to any plan, contract, authorization or arrangement, whether or not set forth in any formal documents, for the issuance of warrants or rights on substantially similar terms to all security holders of the registrant generally that does not discriminate in favor of officers or directors of the registrant. No disclosure is required under column (c) of Item 201(d)(1) with respect to individual arrangements involving equity awards and grants.

3. Except where it is part of a document that is incorporated by reference into a prospectus, the information required by this paragraph need not be provided in any registration statement filed under the Securities Act.

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

3. The general authority citation for Part 229 is revised to read as follows:

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

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80a-31(c), 80a-37, 80a-38(a), and 80b-11, unless otherwise noted.

* * * * *

4. The authority citation following §229.201 is removed.

5. By amending §229.201 to add paragraph (d) before Instructions to Item 201 to read as follows:

§229.201 (Item 201) Market price of and dividends on the registrant's common equity and related stockholder matters.

* * * * *

(d) Securities authorized for issuance under equity compensation plans.

(1) In the tabular format set forth below, provide the information specified in paragraph (d)(2) of this Item as of the end of the most recently completed fiscal year with respect to each compensation plan of the registrant under which equity securities of the registrant are authorized for issuance.

Equity Compensation Plan Information

(a)	(b)	(c)	(d)	(e)
Name of plan	**Number of securities authorized for issuance under the plan**	**Number of securities awarded plus number of securities to be issued upon exercise of options, warrants or rights granted during last fiscal year**	**Number of securities to be issued upon exercise of outstanding options, warrants or rights**	**Number of securities remaining available for future issuance**
Plan #1				
Plan #2				
Plan #3				
Individual Arrangements (Aggregated)				

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Total				

(2) The table shall include the following information as of the end of the most recently completed fiscal year:

(i) For each plan (other than individual arrangements):

(A) The name of the plan (column (a));

(B) The number of securities authorized for issuance under the plan (column (b));

(C) The number of securities issued pursuant to equity awards made under the plan during the most recently completed fiscal year, plus the number of securities to be issued upon the exercise of options, warrants or rights granted under the plan during the most recently completed fiscal year (column (c));

(D) The number of securities to be issued upon the exercise of options, warrants or rights outstanding under the plan (column (d)); and

(E) Other than securities to be issued upon the exercise of outstanding options, warrants or rights, the number of securities remaining available for issuance under the plan (column (e)).

(ii) For individual arrangements:

(A) The number of individual arrangements being disclosed (column (a));

(B) The aggregate number of securities authorized for issuance under the individual arrangements (column (b));

(C) The aggregate number of securities to be issued upon the exercise of options, warrants or rights outstanding under the individual arrangements (column (d)); and

(D) Other than securities to be issued upon the exercise of outstanding options, warrants or rights, the aggregate number of securities remaining available for issuance under the individual arrangements, if any (column (e)).

(3) Identify each plan that was adopted without security holder approval and:

(i) If such plan was adopted during the most recently completed fiscal year, describe briefly, in narrative form, the material features of the plan; or

(ii) If such plan was adopted in a prior fiscal year, identify the filing containing such description.

(4) If any individual arrangement exceeds 25% of the aggregate number of securities disclosed pursuant to paragraph (d)(2)(ii)(B) of this Item, identify the relationship of the recipient to the registrant and describe briefly, in narrative form, the material features of the arrangement.

Instructions to Item 201(d).

1. For purposes of this paragraph, the term plan shall be defined in accordance with Item 402(a)(7)(ii) of Regulation S-K (§229.402(a)(7)(ii)).

2. No disclosure is required under this Item with respect to any plan, contract,

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authorization or arrangement, whether or not set forth in any formal documents, for the issuance of warrants or rights on substantially similar terms to all security holders of the registrant generally that does not discriminate in favor of officers or directors of the registrant. No disclosure is required under column (c) of Item 201(d)(1) with respect to individual arrangements involving equity awards and grants.

3. Except where it is part of a document that is incorporated by reference into a prospectus, the information required by this paragraph need not be provided in any registration statement filed under the Securities Act.

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

6. The authority citation for Part 240 is revised to read in part as follows:

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

* * * * *

7. The authority citation following §240.14a-3 is removed.

8. By amending §240.14a-3 to revise paragraph (b)(9) to read as follows:

§240.14a-3 Information to be furnished to security holders.

* * * * *

(b) * * *

(9) The report shall contain the market price of and dividends on the registrant's common equity and related security holder matters required by Item 201(a), (b) and (c) of Regulation S-K (§229.201(a), (b) and (c) of this chapter).

* * * * *

9. By amending §240.14a-101, Item 10 of Schedule 14A by adding paragraph (c) before the undesignated heading Instructions and revising Item 14(d)(4) of Schedule 14A to read as follows:

§240.14a-101 Schedule 14A. Information required in proxy statement.

*** * * * ***

Item 10. Compensation Plans. * * *

(c) Information regarding plans and other arrangements not subject to security holder action. The information called for by Item 201(d) of Regulation S-K (§229.201(d) of this chapter) with respect to each equity compensation plan in effect as of the end of the last completed fiscal year (other than the plan or plans being acted upon as described in paragraph (a) of this Item), whether or not such plan has been approved by security holders.

* * * * *

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Item 14. Mergers, consolidations, acquisitions and similar matters. * * *

(d) Information about parties to the transaction: registered investment companies and business development companies. * * *

* * * * *

(4) Information required by Item 201(a), (b) and (c) of Regulation S-K (§229.201(a), (b) and (c) of this chapter), market price of and dividends on the registrant's common equity and related stockholder matters;

* * * * *

PART 249 - FORMS, SECURITIES EXCHANGE ACT OF 1934

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

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

* * * * *

11. By amending Form 10-K (referenced in §249.310) by revising Item 12 of Part III to read as follows:

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

Form 10-K

Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

* * * * *

Part III

* * * * *

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

Furnish the information required by Item 201(d) of Regulation S-K (§229.201(d) of this chapter) and by Item 403 of Regulation S-K (§229.403 of this chapter).

* * * * *

12. By amending Form 10-KSB (referenced in §249.310b) by revising Item 11 of Part III to read as follows:

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

Form 10-KSB

* * * * *

Part III

* * * * *

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Item 11. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.

Furnish the information required by Item 201(d) of Regulation S-B and by Item 403 of Regulation S-B.

* * * * *

By the Commission.

Jonathan G. Katz
Secretary

Dated: January 26, 2001

Footnotes

[1] We do not edit personal, identifying information, such as names or electronic mail addresses, from electronic submissions. Submit only information you wish to make publicly available.

[2] 17 CFR 228.201.

[3] 17 CFR 228.10, et seq.

[4] 17 CFR 229.201.

[5] 17 CFR 229.10, et seq.

[6] 17 CFR 249.310.

[7] 17 CFR 249.310b.

[8] 17 CFR 240.14a-101.

[9] 15 U.S.C. §78a, et seq.

[10] 17 CFR 240.14c-101.

[11] 17 CFR 240.14a-3(b)(9).

[12] The National Center for Employee Ownership, a non-profit research organization, estimates that nearly 10 million employees currently receive stock options, up from one million in 1992. See Pallavi Gogol, When Good Options Go Bad, Bus. Wk., Dec. 11, 2000, at EB 96. See also Broad-based Stock Options - 1999 Update, William J. Mercer, Inc. (1999) (survey of 350 major industrial and service corporations finding that 39.4% have broad-based (at least 50% of employees eligible to participate) stock option plans and 18% made grants under such plans; compared with 17% of companies offering broad-based stock option plans and 5.7% making grants in 1993).

[13] See Eric D. Roiter, The NYSE Wrestles with Shareholder Approval of Stock

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Option Plans, Corp. Gov. Adv., Vol. 8, No. 1 (Jan./Feb. 2000), at 1. See also, for example, Gretchen Morgenson, Hidden Costs of Stock Options May Soon Come Back to Haunt, N.Y. Times, June 13, 2000, at A1; Robert McGough, Tech Companies' Liberal Use of Stock Options Could Swamp Investors, Drain Firms' Resources, Wall St. J., July 28, 2000, at C1; Shawn Tully, The Party's Over, Fortune, June 26, 2000, at 156.

14 See Item 10(a)(1) of Schedule 14A [17 CFR 240.14a-101, Item 10(a)(1)].

15 See Item 10(b)(2)(i)(A) of Schedule 14A [17 CFR 240.14a-101, Item 10(b)(2)(i)(A)].

16 Similarly, while Item 402(c) of Regulation S-B [17 CFR 228.402(c)] and Item 402(c) of Regulation S-K [17 CFR 229.402(c)] require disclosure of the number of stock option grants during the last fiscal year, that disclosure need address only the named executive officers of the registrant (as defined in the item). See also Item 402(b)(2)(iv)(B) of Regulation S-B [17 CFR 228.402(b)(2)(iv)(B)] and Item 402(b)(2)(iv)(B) of Regulation S-K [17 CFR 229.402(b)(2)(iv)(B)].

17 See, for example, the letter dated September 1, 2000 from Keith Johnson, Chief Legal Counsel, State of Wisconsin Investment Board, the letter dated August 28, 2000 from James P. Hoffa, General President, International Brotherhood of Teamsters, the letter dated August 23, 2000 from Peter C. Clapman, Senior Vice President & Chief Counsel, Investments, Teachers Insurance and Annuity Association - College Retirement Equities Fund and the letter dated August 17, 2000 from Sarah A.B. Teslik, Executive Director, Council of Institutional Investors, each to the Commission responding to Self-Regulatory Organizations; New York Stock Exchange, Inc. ("NYSE"); Notice of Filing of Proposed Rule Change by the NYSE to Extend the Pilot Relating to Shareholder Approval of Stock Option Plans, Securities Exchange Act Release No. 43111 (Aug. 2, 2000) [65 FR 49046 (Aug. 10, 2000)]. These letters are available in our Public Reference Room at 450 Fifth Street, N.W., Washington, D.C. 20549-0609, in File No. SR-NYSE-00-32. See also Self-Regulatory Organizations; NYSE; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval of Amendments Nos. 1 and 2 Thereto Relating to Shareholder Approval of Stock Option Plans, Securities Exchange Act Release No. 41479 (June 4, 1999) [64 FR 31667 (June 11, 1999)].

18 See Exchange Act Rule 14a-3(b) [17 CFR 240.14a-3(b)]. Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation, (Oct. 1995), requires that an entity disclose in its financial statements the number of shares authorized for grants of options or other equity instruments (¶46), the number and weighted-average exercise prices of options outstanding at the beginning of the year, outstanding at the end of the year, exercisable at the end of the year and granted, exercised, forfeited or expired during the year for each year for which an income statement is presented (¶47(a)) and the number, weighted-average exercise price and weighted-average remaining contractual life of options outstanding and options currently exercisable at the date of the latest statement of financial position presented (¶48).

19 In a recent annual study on stock plan dilution, the Investor Responsibility Research Center, Inc. ("IRRC") found that about 20% of the companies surveyed did not disclose the number of shares available for future awards under their employee stock plans. See Potential Dilution - 1999, The Potential Dilution from Stock Plans at the S&P Super 1,500 Companies, IRRC (2000) ("IRRC Dilution

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Study").

[20] The amount of securities allocated for equity compensation plans has been increasing for several years. A recent study of the stock-based pay practices at the nation's 200 largest corporations indicates that these companies allocated 13.7% of outstanding shares (calculated on a fully diluted basis) for management and employee equity incentives in 1999, compared to only 6.9% in 1989. See 1999 Equity Stake, Study of Management Equity Participation in the Top 200 Corporations, Pearl Meyers & Partners, Inc. (1999). The percentage may be even higher in some industries, such as the high-technology sector. See Trends in Equity Compensation 1996 - 2000, iQuantic, Inc. (2000) (number of options outstanding as a percentage of the total number of common shares outstanding for 200 major high-technology companies was 15.8% in 1999 compared to 12.4% in 1997). This figure does not take into account securities available for future grant. See also IRRC Dilution Study (average potential dilution for 1,175 companies studied was 13.5% in 1999 compared to 11.6% in 1997; average potential dilution of 434 "S&P 600 SmallCap" companies studied was 16.3% in 1999 compared to 13.8% in 1997).

[21] See Herbert Kraus, Executive Stock Options and Stock Appreciation Rights, L.J. Press (2000), at 2.07. These states include Alaska (Alaska Stat. §10.06.343), Hawaii (Haw. Rev. Stat. §415-20), Maine (13A Me. Rev. Stat. Ann. §508[3]), New Mexico (N.M. Stat. Ann. §53-11-20), South Dakota (S.D. Comp. L. §47-3-48 (security holder approval required for issuance of shares to officers or employees)), Vermont (Vt. Stat. Ann. §6.24) and West Virginia (W. Va. Code Ann. §31-1-84). See also N.Y. Bus. Corp. Law §505(d). Prior to October 11, 2000, Section 505(d) of the Business Corporations Law of the State of New York required approval of any stock option plan by a majority of a corporation's shareholders. As amended by S. 6780 (Oct. 11, 2000), this provision now requires approval of a stock option plan by a majority of the shareholders only where the corporation's shares are not listed or authorized for trading on a stock exchange or automated quotation system.

[22] See 26 U.S.C. §§162(m) and 422 (1998).

[23] See Section 61(a)(3)(A)(iv) of the Investment Company Act of 1940, 15 U.S.C. §80a-61(a)(3)(A)(iv).

[24] See NYSE, NYSE Listed Company Manual, ¶312.03(a) (Foundation 1996); American Stock Exchange, LLC ("AMEX"), AMEX Company Guide, §711 (Foundation 1996); Nasdaq Stock Market Rule 4460(i)(1)(A), NASD Securities Dealer Manual (CCH) at 5512 (1996 Supp).

[25] Id. See also Randall S. Thomas and Kenneth J. Martin, The Determinants of Shareholder Voting on Stock Option Plans, 35 Wake Forest L. Rev. 31, 48 (2000).

[26] See n. 17 above.

[27] An equity compensation plan that provides for the grant of options, warrants or rights is considered to be in effect as long as securities remain available for future grant under the plan or options, warrants or rights previously granted under the plan remain outstanding.

[28] The discussion of proxy statements in this release also includes information statements.

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29 As discussed in Section I.B. below, the required disclosure would encompass each equity compensation plan of the registrant in effect as of the end of the last completed fiscal year other than the compensation plan or plans subject to security holder action. Those plans, of course, would be subject to the existing disclosure requirements of Item 10 of Schedule 14A.

30 The discussion of Form 10-K in this release also includes Form 10-KSB.

31 This disclosure would not apply to any plan, contract, authorization or arrangement for the issuance of warrants or rights on substantially similar terms to all security holders of the registrant generally that did not discriminate in favor of officers or directors of the registrant. See Proposed Item 201(d), Instruction 2, of Regulation S-B and Regulation S-K.

32 See n. 31 above.

33 This would include, without limitation, employee stock purchase plans that provide for the acquisition of authorized but unissued securities or repurchased or "treasury" shares, but would exclude so-called "open market" employee stock purchase plans.

34 Notwithstanding that an equity compensation plan may permit alternative types of awards (for example, restricted stock or stock options), the securities authorized for issuance under the plan and remaining available for future issuance under the plan are to be counted only once.

35 Thus, disclosure would be required with respect to all equity compensation plans, without regard to whether the plan participants are employees, directors, general partners, trustees, officers, consultants and advisors, vendors or independent contractors.

36 See Proposed Item 201(d) of Regulation S-B and Regulation S-K. Item 402(a)(6)(ii) of Regulation S-B [17 CFR 228.402(a)(6)(ii)] and Item 402(a)(7)(ii) of Regulation S-K [17 CFR 229.402(a)(7)(ii)] define the term "plan" to include any plan, contract, authorization or arrangement, whether or not set forth in any formal documents, that is applicable to one or more persons.

37 See Proposed Item 201(d)(3) of Regulation S-B and Regulation S-K. In 1992, we eliminated the requirement under Item 10 of Schedule 14A (and Item 1 of Schedule 14C) that a registrant provide extensive disclosure of all existing plans when seeking security holder approval of a compensation plan. See Executive Compensation Disclosure, Securities Exchange Act Release No. 31327, Section II.L (Oct. 16, 1992) [57 FR 48126 (Oct. 21, 1992)]. We are not proposing to reinstate that specific requirement. We seek to ensure that adequate information is available to security holders, however, about the number of securities authorized for issuance under a registrant's existing equity compensation plans, whether or not the plans have been approved by security holders.

Once disclosure of the material terms of an equity compensation plan that was adopted without security holder approval has been made, in subsequent years a registrant need only identify the filing containing the narrative description of the plan if the plan was still in effect as of the end of the last completed fiscal year.

38

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— Currently, Item 601(b)(10)(iii)(A) of Regulation S-K [17 CFR 229.601(b)(10)(iii)(A)] requires the filing of any compensatory plan, contract or arrangement in which any director or any of the named executive officers of the registrant, as defined by Item 402(a)(3) (17 CFR 229.402(a)(3)), participates, as well as any other compensatory plan, contract or arrangement in which any other executive officer of the registrant participates unless immaterial in amount or significance. See also Item 601(b)(10)(ii)(A) of Regulation S-B [17 CFR 228.601(b)(10)(ii)(A)].

[39] See Proposed Item 10(c) of Schedule 14A. This would include a vote to modify an existing compensation plan, such as a vote to increase the number of securities authorized for issuance under the plan.

[40] See Proposed Item 11 of Form 10-KSB and Proposed Item 12 of Form 10-K.

[41] See General Instruction E(3) to Form 10-KSB [17 CFR 249.310b] and General Instruction G(3) to Form 10-K [17 CFR 249.310].

[42] 15 U.S.C. §78o(d).

[43] See n. 18 above and the accompanying text.

[44] 15 U.S.C. §77a, et seq.

[45] 44 U.S.C. §3501, et seq.

[46] 44 U.S.C. §3507(d) and 5 CFR 1320.11.

[47] 15 U.S.C. §78n(a).

[48] 15 U.S.C. §78n(c).

[49] 15 U.S.C. §78m.

[50] Exchange Act Rule 12b-2 [17 CFR 240.12b-2].

[51] 15 U.S.C. §78l.

[52] 15 U.S.C. §78l(g).

[53] 15 U.S.C. §78l(b).

[54] See Trends in Equity Compensation 1996-2000, iQuantic, Inc. (2000) (estimated percentage of companies with non-security holder approved stock option plan was 27.3% in 1999 (161 survey respondents) compared to 3.2% before 1996).

[55] See n. 59 below and the accompanying text.

[56] These time estimates are based on the fact that the information needed to make the proposed disclosure should be readily available to respondents.

[57] We estimate that respondents will prepare 50% of the required disclosure and that outside counsel will prepare the remaining 50%. Accordingly, 50% of the total burden resulting from our equity compensation disclosure rules is

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reflected as burden hours and the remaining 50% is reflected in the total cost of complying with the information collection requirements. We used an estimated hourly rate of $175.00 to determine the estimated cost to the respondent of the disclosure prepared by outside counsel. We arrived at that hourly rate estimate after consulting with several private law firms.

[58] See n. 59 below and the accompanying text.

[59] We estimate that in years where respondents are not submitting new compensation plans or modifications of existing plans for the approval of security holders, 80% of the required disclosure will be included in respondents' annual report on Form 10-K and 20% in respondents' annual report on Form 10-KSB.

[60] See n. 55 above and the accompanying text.

[61] See n. 58 above and the accompanying text.

[62] See n. 59 above.

[63] Comments are requested pursuant to 44 U.S.C. §3506(c)(2)(B).

[64] See Item 402 of Regulation S-B [17 CFR 228.402] and Item 402 of Regulation S-K [17 CFR 229.402].

[65] See, for example, n. 18 above and the accompanying text.

[66] The analysis has been prepared in accordance with the Regulatory Flexibility Act, 5 U.S.C. §603.

[67] For purposes of this analysis, we have defined "small business" in Securities Act Rule 157 as any entity whose total assets on the last day of its most recent fiscal year were $5 million or less and is engaged, or proposes to engage, in small business financing. [17 CFR 230.157.] A registrant is considered to be engaged, or to propose to engage, in small business financing under this rule if it is conducting, or proposes to conduct, an offering of securities which does not exceed the dollar limitation prescribed by Section 3(b) of the Securities Act, 15 U.S.C. §77c(b).

[68] This figure is based on our estimate that 60% of registrants that file proxy or information statements under Section 14 of the Exchange Act or annual reports on Form 10-K or 10-KSB have adopted equity compensation plans.

[69] Pub. L. No. 104-121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C. and as a note to 5 U.S.C. §601).

[70] 15 U.S.C. §78w(a)(2).

[71] 15 U.S.C. §§77b(b) and 78c(f).

http://www.sec.gov/rules/proposed/33-7944.htm

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HellerEhrman
ATTORNEYS

Advising Audit Committees

Lori Lynn Phillips
Scott D. Wiener

Securities NPG Retreat
November 3, 2001

SOURCES OF KEY RULES

- SEC Disclosure Requirements
- NYSE and NASDAQ Listing Requmts
- "Blue Ribbon Panel" Report
- Statutes and Case Law (federal and state)

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SEC Perspective

- "Increasing sense of urgency surrounding the need for responsible financial reporting...."
- "Effective oversight of the financial reporting process is fundamental to preserving the integrity of our markets."

SEC Perspective

- "Audit Committees play a critical role in the financial reporting system by overseeing and monitoring management's and the independent auditor's participation in the financial reporting process."

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NYSE & NASDAQ Listing Rules

- Definition of independence
- Structure and membership
- Audit committee duties

Director Independence

- No relationships that would interfere with independent judgment

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Not Independent If:

- Employment by company or affiliate
  (NYSE & NASDAQ)
- Comp > $60,000 in prior year
  (excluding board and retirement benefits)
  (NASDAQ)

Not Independent If:

- Family relationship with officer or employee
  (NYSE & NASDAQ)
- Interlocking directorships
  (NYSE & NASDAQ)

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Not Independent If:

- Controls entity w/ material business relationship w/ company

(NYSE & NASDAQ)

Audit Committee Membership

- At least three members
- All must be independent
  - limited exception for one member — disclosure required
  - However, may be treated as insider for liability purposes
- All must be financially literate
- One must have financial or accounting experience

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Audit Committee Duties

- Review audited financials w/ mgmt
- "Ensure" outside auditor independence
- Discuss SAS 61 subjects with auditors
- Meet w/ auditors re quarterly financials
- Filing of Form 10-K
- Proxy Statement disclosure

"Ensure" Auditor Independence

- Receive independence disclosure annually (ISB Standard No. 1)
- Discuss independence with auditors

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SAS 61

- Auditor must discuss certain subjects with audit committee annually

SAS 61 Topics *MUST* Be Discussed Annually

- Internal controls
  (note auditor's limited responsibility)
- Significant accounting policies
- Accounting for unusual transactions
- Controversial or emerging areas

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SAS 61 Topics *MUST* Be Discussed Annually

- Sensitive accounting estimates
- Significant audit adjustments
- Passed or waived adjustments

"Differing Estimates or Errors?"

SAS 61 Topics *MUST* Be Discussed Annually

- ***Quality*** of company's accounting principles as applied
  - consistency
  - clarity
  - completeness
  - faithfulness
  - verifiability
  - neutrality

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SAS 61 Topics *MUST* Be Discussed Annually

- Disagreements with management
- Negotiations w/ management re retention
- Difficulties encountered
  - E.g., delays and difficulty getting information

SAS 71 Meetings Re Quarterly Financials

- Auditors must perform quarterly review
- Auditors must consider need for SAS 61 communication
- Must meet before filing 10-Q
- Should meet before earnings release

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Filing of Form 10-K

- Meet with auditors to discuss independence and SAS 61 matters
- Review and discuss audited financials with management
- Recommend to board whether audited financials should be included in 10-K

Proxy Statement

- Must include ***Audit Committee report*** stating whether committee:
  - discussed financials with management
  - discussed SAS 61 subjects with auditors
  - received ISB No.1 disclosures from auditors
  - recommended to board that audited financials be included in 10-K
- Audit committee members are thus "speakers" and open to greater liability

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Proxy Statement

- Must disclose audit committee charter
  - attach copy every three years

Lynn Turner's "Best Practices"

- Regularly scheduled meetings
- Regularly review management's relationship with auditors -- inside and outside
- Review all management letter comments from auditors

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Lynn Turner's "Best Practices"

- Pay reasonable audit fee
  - avoid "loss leader"
- Question quality of earnings releases
- Conduct annual self-assessment

Blue Ribbon Panel Recommendations

- Annual mgmt report re internal controls
  (include in annual report?)
- Annual review of auditors
  (internal and external)
- Auditors consult re personnel changes

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Blue Ribbon Panel Recommendations

- Proactively prevent negative factors (e.g., time or fee pressure)
- Pre-approve non-audit services above established threshold

New Exposures for Audit Committee Members?

- **SEC:**
  "It is not our intention to subject audit committee members to increased liability"
- **Reality:**
  Exposure significantly increased

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New Exposures for Audit Committee Members?

- ***New Duties = New Exposures***
- Audit Committee must speak publicly
- SEC focus on accounting
- SEC rejected "safe harbor" for shareholder litigation
- Courts may subject audit committee members to higher liability standard (e.g., control person, group publication)

Managing the Increased Risk

- Audit Committee Charter
- Formal Audit Committee Procedures

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Audit Committee Charters

- Full board must adopt charter
- Charter must be published in proxy statement every three years

Audit Committee Procedures

- Develop written procedures
- Keep formal minutes
- Note-taking not recommended
- Meet ***separately*** with auditors

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Audit Committee Procedures

- Educate committee members
- Consider independent consultant
- ***Independent judgment***

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