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CORPORATE GOVERNANCE IN LIGHT OF SARBANES-OXLEY AND THE NYSE RULES

The Sarbanes-Oxley Act of 2002 and the corporate governance rules adopted by the New York Stock Exchange* have raised the bar for corporate accountability. In the areas of corporate governance, auditing and accounting, executive officer and director responsibility, insider trading and financial disclosure, Congress and the NYSE have imposed wide-ranging new requirements of which all directors and officers, as well as all accountants, consultants, investment bankers and lawyers, should be aware. This memorandum is not a complete summary of the Sarbanes-Oxley Act or the NYSE rules. It is an overview of the new statutory and regulatory requirements applicable to NYSE-listed companies and a reminder of the procedures that should be followed in the current environment.

While there is no change in the fundamental legal principles applicable to the duties and responsibilities of boards of directors, there is a clear change in attitude by investors and the public at large that could manifest itself in adverse judicial decisions and further legislation. As a result, boards must be vigilant not only in monitoring compliance with the new laws and rules, but also in following appropriate procedures in performing their duties. It is incumbent upon every board to ensure that its procedures and the company's compliance are "state of the art."

The Board of Directors

Qualifications and Role of Independent Directors

- *Majority of Independent Directors.* The NYSE rule requires that a majority of directors be independent on all listed company boards except for those of "controlled companies," i.e., companies of which more than 50% of the voting power is held by an individual, a group, or another corporation. The deadline for compliance with this requirement is 24 months after the date the SEC approves the proposed rule; for companies newly listing on the NYSE, the deadline is 24 months after listing.
- *Definition of Independence.* "Independence" means:
    - The board must affirmatively determine that the director has no material relationship with the company (directly or as a partner, shareholder or officer of an organization that has a relationship with the company). If a family member of a director is an *officer* of the company, the director cannot be deemed independent.
    - There is a five-year cooling-off period for former employees of the company, or of its independent auditor; for former employees of any company whose compensation committee includes an executive officer of the listed company; and for immediate family members of the above.

* The NYSE proposed rules remain subject to SEC review.

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- Ownership of a significant amount of stock, or affiliation with a major shareholder, does not by itself preclude a board of directors from determining that an individual is independent. However, the Sarbanes-Oxley Act requires the SEC to issue rules by April 26, 2003 that will preclude any "affiliate" of the company from being a member of the audit committee.

- *General Standards.* The NYSE provides that a company may adopt and disclose categorical standards to assist it in determining director independence, and may make a general disclosure if a director meets these standards. Any determination for a director who does not meet the standards must be specifically explained.

- *Non-Management Directors.* The NYSE requires that the non-management directors of each listed company meet without management in regularly scheduled executive sessions. Each company must disclose either the name of the presiding director at each session or the process by which the presiding director is chosen, and a means for shareholders to communicate with the non-management directors. This requirement will be effective six months after the date the SEC approves the proposed rule.

- *No Requirement of a Lead Director.* There is no requirement in the NYSE rules or in the Sarbanes-Oxley Act that a company have a nonexecutive chairman of the board or a lead director.

Corporate Governance

Committee Structure and Responsibilities

- *Compensation and Nominating/Governance Committees.* The NYSE rules require that every listed company, other than controlled companies, have a compensation committee and a nominating/governance committee, or the equivalents. Companies must establish these committees within six months of the date the SEC approves the rules and have at least one independent director on each of these committees within 12 months of SEC approval. Companies must have wholly independent committees within 24 months of the date of SEC approval, or within 24 months of newly listing.

- *Committee Charters.* The nominating/governance and compensation committees must each have a published charter, which must address the committee's purpose, duties and responsibilities and provide for an annual performance evaluation of the committee. In addition, each charter should address committee member qualifications, committee member appointment and removal, committee structure and operations (including authority to delegate to subcommittees) and committee reporting to the board. All listed companies must have committee charters in place within six months of SEC approval of the NYSE rules.

- *Committee Authority.* The NYSE rule provides that the nominating/governance committee should have the sole authority to retain and terminate any search firm to be used to identify director candidates, including sole authority to approve the search firm's fees and other retention terms. The compensation committee should have the sole authority to retain and terminate a consulting firm to assist in the evaluation of director, CEO or senior executive compensation, including sole authority to approve the firm's fees and other retention terms. These powers should be set forth in the committee charters.

Corporate Governance Guidelines and Code of Ethics

- *Corporate Governance Guidelines.* The NYSE requires that each listed company adopt and disclose a set of corporate governance guidelines. These must address director qualification standards, director responsibilities, director access to management and independent advisors, director compensation, director orientation and continuing education, and management succession and provide for an annual performance evaluation of the board of directors. The corporate governance guidelines should set the tone for directors, officers and all employees of the company. Listed companies must have these guidelines in place within six months of SEC approval of this rule.
- *Code of Business Conduct and Ethics.* The NYSE requires that each listed company adopt and disclose a code of business conduct and ethics. The code should address conflicts of interest, corporate opportunities, confidentiality, fair dealing, protection and proper use of company assets, compliance with laws, rules and regulations (including insider trading laws) and the reporting of illegal or unethical behavior. The company must promptly disclose any waivers of the code for officers or directors. Listed companies must have this code in place within six months of SEC approval of this rule.
- *Financial Code of Ethics.* The Sarbanes-Oxley Act requires the SEC to adopt rules by January 26, 2003 requiring companies to disclose whether they have a code of ethics for senior financial officers (and if not, why not). The code must promote honest and ethical conduct, full, accurate and timely disclosure and compliance with law. The SEC rules will also require that any change in, or waiver of, the code of ethics will require prompt disclosure on Form 8-K.
- *Professional Responsibility.* The requirement under the Sarbanes-Oxley Act that each audit committee establish procedures for receiving complaints and anonymous tips from whistle-blowers ties into the requirements under the Sarbanes-Oxley Act and the NYSE rules that each company adopt a code of ethics. These requirements will be effective under SEC rules to be adopted no later than April 26, 2003 and should raise the level of professional responsibility across the board, from directors and executive officers to rank-and-file employees.
- *Chief Ethics Officer.* Some major companies have created the new position of Chief Ethics Officer with a view toward helping to meet their responsibilities under the Sarbanes-Oxley Act and the NYSE rules.

Internal Controls and Annual Reviews

- *Internal Control Report.* The Sarbanes-Oxley Act requires that each Form 10-K contain an internal control report, which will state the responsibility of management for maintaining an adequate control structure and financial reporting procedures, and assess the effectiveness of the internal controls. The auditor must attest to and report on management's assessment. These requirements will be effective upon adoption of implementing rules by the SEC, but no deadline was established in the Sarbanes-Oxley Act.
- *Internal Audit Function.* The NYSE requires each listed company to have an internal audit function. This requirement will be effective six months after SEC approval of the rule.

- *Annual Evaluations.* The NYSE requires that the performance of the board and each committee be reviewed annually to ensure that the board and all committees are functioning effectively.

Shareholder Approval of Stock Plans

- *Voting on Option Plans.* The NYSE rule requires that shareholders be given the opportunity to vote on *all* stock option plans, except employment-inducement options, option plans acquired through mergers and tax-qualified plans. This rule will be effective immediately upon SEC approval.
- *Broker-No-Vote.* The NYSE rule precludes brokers from voting on stock option plans without customer instructions. This rule will be effective immediately upon SEC approval.
- *Expensing of Options.* While the Sarbanes-Oxley Act and the NYSE did not address the issue of making FASB 123 applicable to the profit and loss statement rather than to footnote disclosure only, this issue is still very much alive and many major companies have announced voluntary adoption.

Enhanced Penalties and Enforcement

- *Criminal Liability.* The Sarbanes-Oxley Act creates new criminal offenses and raises penalties for some existing offenses. The Act imposes severe criminal penalties for securities fraud violations, false CEO/CFO certifications, mail and wire fraud violations and retaliation against whistleblowers.
- *Obstruction of Justice.* The Sarbanes-Oxley Act creates a new criminal offense, punishable by fine and/or imprisonment, of corruptly altering, destroying, mutilating or concealing a record, document or other object, or attempting to do so, with the intent of impairing the object's integrity or availability for use in an official proceeding. Under the same provision, it is a crime to obstruct, influence or impede any official proceeding, or to attempt to do so.
- *Ongoing Obligations.* The Sarbanes-Oxley Act requires that public accountants maintain their audit or review workpapers for five years after the end of the fiscal period in which the audit was concluded. The SEC is directed to issue rules to implement this provision by January 26, 2003. This obligation does not arise only in the context of a pending proceeding or official investigation, but applies at all times and is punishable by fine and/or imprisonment.
- *Equitable Relief.* The Sarbanes-Oxley Act provides that, in civil enforcement actions brought by the SEC, courts may grant any equitable relief that is appropriate for the protection of investors. This could result in broader and more intrusive court oversight of (and monetary remedies against) violators of the Act.
- *NYSE Reprimand Letter.* The NYSE has the power to issue a public reprimand letter to any listed company that violates the NYSE listing standards. This will be effective immediately upon SEC approval of the proposed rule.

Directors' Duties and Protections

The Sarbanes-Oxley Act and the NYSE rules have not changed the business judgment rule or the other fundamental tenets of corporation law applicable to boards of directors; nor have they weakened the structures insulating directors from personal liability that have been developed over the years in order to avoid discouraging competent people from serving as directors.

Directors' Duties, Compensation, Indemnification and Insurance

- *General Requirement.* The basic responsibility of directors is to exercise their business judgment to act in a manner they reasonably believe to be in the best interests of the company and its shareholders. In discharging this obligation, directors are entitled to rely on management and the advice of the company's outside advisors and auditors. In the current environment, directors should take extra care to establish that they have a reasonable basis for such reliance. For example, directors should establish that they have a strong foundation for trusting the integrity, honesty and undivided loyalty of the management team upon whom they are relying and the independence and expertise of the company's outside advisors and auditors.
- *Director Compensation.* Director compensation is one of the more difficult issues on the corporate governance agenda. The form and amount of director compensation should be determined by the compensation committee with appropriate benchmarking against peer companies. Perquisite programs and company charitable donations to any organizations with which a director is affiliated should also be carefully scrutinized to make sure that they do not jeopardize any director's independence or create any potential appearance of impropriety. Any payments to directors for consulting or other services beyond the regular directors' fees should be carefully considered and fully disclosed. Note that any such payments will disqualify a director from audit committee service.
- *Director Indemnification.* Directors may be indemnified by the company to the fullest extent permitted by law. Bylaws and indemnification agreements should be reviewed on a regular basis to ensure that they provide the fullest possible coverage. Directors can also continue to rely on statutory exculpation from personal liability for breaches of the duty of care under charter provisions put in place pursuant to Section 102(b)(7) of the Delaware corporation law and similar statutes in other states.
- *D&O Insurance.* D&O coverage provides a key protection to directors against the risk of personal liability. While such coverage has become substantially more expensive, it is still available in most instances, has not been limited or restricted by the Sarbanes-Oxley Act and remains highly useful. It is important to note that D&O policies are not strictly form documents and can be negotiated. Careful attention should be paid to retentions and exclusions, particularly those that seek to limit coverage based upon a lack of adequate insurance for other business matters, or based on assertions that a company's financial statements were inaccurate when the policy was issued. To avoid any ambiguity that might exist as to directors' and officers' rights to coverage and reimbursement of expenses in the case of a bankruptcy, many companies are purchasing separate supplemental insurance

policies covering only directors and officers and not the company (so-called "side-A" coverage) in addition to their normal policies covering both the company and the directors and officers individually.

Conduct of Board Meetings

- *Time Commitment and Scheduling.* The typical practice for a meeting of a board with a majority of out-of-town directors—to have morning committee meetings followed by a full board meeting that ends at lunchtime—is no longer a viable paradigm. Directors are being criticized for not adequately monitoring the corporations they serve; the legal community, including prominent judges, has stated that Enron's short meetings are evidence of failure by the directors to fulfill their fiduciary duties; and the NYSE and the Business Roundtable, as well as various organizations representing investors, have advocated more extensive agendas for boards and committees and more extensive discussion and review by directors. These agendas and duties make it difficult, if not impossible, to properly discharge the directors' obligations in the four-to-five hour timeframe that has become customary.

- *Time Commitment and Scheduling — A New Paradigm.* In order to provide the time necessary for board meetings in this environment, committees with extensive agendas, like the audit committee, should consider scheduling their meetings early in the afternoon of the day before the board meeting and, to the extent required, continuing them through a working dinner. This time frame could also be used for regular meetings of only the non-management directors. The board meeting itself could then start earlier in the morning and continue through a working lunch, with adjournment planned for mid-afternoon. This schedule should permit the consideration and discussion of all that is necessary today to satisfy current requirements.

- *Annual Retreat.* Boards should consider the desirability of an annual two-to-three-day board retreat with the senior executives at which there is a full review of the company's financial statements and disclosure policies, strategy and long-range plans, and current developments in corporate governance. Each retreat may be held at a location close to one of the company's operations so as to give the directors an opportunity to become acquainted with a number of the company's operations as the annual retreats are rotated among the company's various locations. During the retreat, meals and social activities can be arranged in a manner that encourages the directors on a one-to-one basis to get to know the senior executives.

- *Director Participation.* Directors are expected to attend on a regular basis board meetings and the meetings of the committees on which they serve and to spend the time that is needed to properly discharge their functions. Directors should make sure that they are receiving from management and from the company's auditors and outside advisors all of the information and data they deem relevant to understanding the issues before them and reaching sound business judgments with respect thereto. Perhaps the clearest lesson so far from the accounting and compliance crises making headlines today is that, too often, boards did not have clear information as to what was going on at the companies in question.

- *Orientation and Continuing Education.* Companies should provide comprehensive orientation for new directors (as strongly encouraged by the NYSE) so as to acquaint them with the company's strategy, long-range plans, financial statements, properties and operations, corporate governance guidelines and senior executives. An annual retreat could satisfy a major portion of such an orientation, as well as provide continuing education for current directors.

The Audit Committee and the Independent Auditor

Audit Committee Membership

- *Sarbanes-Oxley Independence.* The Sarbanes-Oxley Act requires every audit committee member to be "independent," meaning that no member may be an "affiliate" of the company or any of its subsidiaries, and no member may receive any consulting, advisory or other fees from the company other than director and committee fees. The SEC is required to direct the adoption of listing standards to implement these requirements no later than April 26, 2003.
- *NYSE Independence.* The NYSE rules require that each member of the audit committee be "independent" within the meaning of the NYSE rules; in addition, the NYSE, like the Sarbanes-Oxley Act, precludes an audit committee member from receiving compensation from the company other than director and committee fees. Companies must comply with the rules governing audit committee independence within 24 months of the date these rules are approved by the SEC. Existing NYSE rules governing audit committee independence continue to apply during this transition period.
- *Membership on Multiple Audit Committees.* Recognizing the time commitment necessary to being an effective audit committee member, the NYSE recommends that each prospective audit committee member carefully evaluate the existing demands on his or her time. If a company does not limit the number of audit committees on which its audit committee members serve, and if an audit committee member simultaneously serves on the audit committees of three or more public companies, then the board must affirmatively determine that such simultaneous service would not impair the ability of the director to serve effectively on the company's audit committee. The determination must be disclosed in the company's proxy statement. This requirement will be effective immediately upon SEC approval of the rule.
- *Financial Expert.* The Sarbanes-Oxley Act requires the SEC to adopt rules by January 26, 2003 requiring companies to disclose in their periodic reports whether at least one member of the audit committee is a "financial expert" and if not, why not. The SEC will define the term "financial expert" in its rules implementing this requirement, but the definition will include: an understanding of generally accepted accounting principles and financial statements; experience in the preparation or auditing of financial statements and the application of accounting principles in connection with the accounting for estimates, accruals and reserves; experience with internal accounting controls; and an understanding of audit committee functions. The Sarbanes-Oxley Act contemplates that this experience would be acquired through education and experience as a public accountant or auditor or a principal financial officer, comptroller or principal accounting officer of a public company, or the equivalent.
- *Financial Literacy.* The NYSE currently requires that each member of the audit committee be "financially literate," and that one member have "accounting or related financial management expertise," as those terms may be interpreted by the board of directors in its business judgment.

Other Audit Committee Requirements

- *Relationship with the Independent Auditor.* The Sarbanes-Oxley Act and the NYSE rules require that the audit committee directly oversee and compensate the independent auditors. This requirement will be effective under Sarbanes-Oxley no later than the end of April 2003 and under new NYSE rules six months after SEC approval. The audit committee must resolve any disagreements between the auditors and management.
- *Whistle-Blower Procedures.* The Sarbanes-Oxley Act requires the audit committee to establish procedures for receiving complaints and anonymous employee tips. This requirement will be effective no later than April 26, 2003.
- *Audit Committee Autonomy.* The Sarbanes-Oxley Act requires the audit committee to have the ability to engage its own advisors and to have its own funding for paying its advisors. This requirement will be effective no later than April 26, 2003.
- *Audit Committee Charter.* The NYSE requires that each audit committee have a published charter that addresses the committee's purpose and the duties and responsibilities of the audit committee. These include retaining and terminating the company's independent auditors; reviewing a report describing the auditor's quality controls and independence; discussing the annual and quarterly financial statements with management and the independent auditor; discussing earnings press releases and earnings guidance provided to analysts and ratings agencies; overseeing the company's policies with respect to risk assessment and risk management; periodically meeting separately with management, the internal auditors and the independent auditors; reviewing with the auditor any audit problems or difficulties and management's response; setting clear hiring policies for employees or former employees of the independent auditors; and reporting regularly to the board of directors. The charter must state that the committee has the ability to hire outside advisors as it deems appropriate. The charter must also provide for an annual performance evaluation of the committee. Every listed company must increase the authority and responsibility of the audit committee as provided in the NYSE rules and have the requisite charter in place within six months of SEC approval of the rules.

Auditor-Company Relationship

- *Public Company Accounting Oversight Board; Effective Dates.* The Sarbanes-Oxley Act creates the PCAOB to oversee the auditing of public companies. The PCAOB will be organized and effective no later than April 26, 2003, and each public accounting firm must register with the PCAOB within six months thereafter. The restrictions described below that apply to registered public accounting firms will become effective upon such registration. These restrictions are also subject to the adoption of rules by the SEC or the PCAOB.
- *Independence of Auditor.* The Sarbanes-Oxley Act prohibits a public accounting firm from auditing a company if, within the year preceding the start of the audit, the company's CEO, CFO, controller or chief accounting officer was associated with the auditor and participated in the company's audit.
- *Separate Executive Sessions.* The NYSE requires that the audit committee periodically meet separately with management, the independent auditors and the internal auditors. This requirement will be effective six months after SEC approval of the new rule.

- *Rotation of Audit Partners.* The Sarbanes-Oxley Act requires that for each client of a registered public accounting firm, the lead audit partner and the audit partner responsible for reviewing the audit must be rotated at least once every five years. There is no requirement that the audit firm be rotated, though the NYSE recommends that each audit committee consider whether, in the interest of assuring continuing auditor independence, there should be regular rotation of the audit firm. Under the Sarbanes-Oxley Act, the Comptroller General of the United States will conduct a study and review of the potential effects of requiring the mandatory rotation of accounting firms. A report will be issued within one year.
- *Auditor Reports.* The Sarbanes-Oxley Act requires each registered public accounting firm provide timely reports to the audit committee regarding all critical accounting policies, alternative GAAP methods discussed with management, the ramifications and the auditing firm's preferred alternative, and any other material written communication between the auditor and management.
- *Improper Influence.* Under the Sarbanes-Oxley Act, it is unlawful for any director or officer, or any person acting under their direction, to "fraudulently influence, coerce, manipulate or mislead" an accountant engaged in an audit to render the financial statements materially misleading. The SEC is granted exclusive authority to enforce this requirement, which will become effective upon adoption of SEC rules by April 26, 2003.

Limits on Non-Audit Services

- *Prohibited Activities.* Registered public accounting firms are prohibited from performing certain services to clients, including:
    - bookkeeping or other services related to the accounting records or financial statements of the audit client;
    - financial information systems design and implementation;
    - appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
    - actuarial services;
    - internal audit outsourcing services;
    - management functions or human resources;
    - broker or dealer, investment adviser, or investment banking services; and
    - legal services and expert services unrelated to the audit.
- *Expert Services.* The scope of the restriction on "expert services" is not defined and may include other types of consulting services. The PCAOB is authorized to adopt rules restricting additional non-audit services.
- *Audit Committee Approval.* The Sarbanes-Oxley Act provides that registered public accounting firms may provide non-audit services to their audit clients that are not specifically prohibited (including tax services), but such services must be approved in advance by the audit committee (subject to limited exceptions) and disclosed in the company's SEC filings. The audit committee must also approve all audit services in advance. The SEC is directed to adopt rules by January 26, 2003 to implement these requirements.

Responsibilities of Executive Officers and Directors

CEO and CFO Certifications

- *CEO and CFO Certification under Section 906.* There are two separate CEO/CFO certifications in the Sarbanes-Oxley Act. The certification under Section 906 is effective immediately and requires that the CEO and CFO certify, as to each 10-K and 10-Q, that the report complies with SEC regulations and fairly presents, in all material respects, the financial condition and results of operations of the company, *without qualification as to GAAP*. False certifications may result in significant criminal penalties.

- *CEO and CFO Certification under Section 302.* On August 29, 2002, the SEC adopted rules implementing Section 302 of the Sarbanes-Oxley Act, which also requires CEOs and CFOs to certify the contents of their companies' periodic reports. Under the new rules, a company's CEO and CFO are required to certify, with respect to each quarterly and annual report (and amendments), that (1) they have reviewed the report, (2) based on their knowledge, the report is not misleading, (3) based on their knowledge, the financial statements and other financial information included in the report "fairly present" in all material respects the financial condition, results of operations and cash flow of the issuer and (4) they are responsible for establishing and maintaining, and have performed certain specified tasks with respect to, the company's "internal controls" and "disclosure controls and procedures," including making disclosures to the issuer's auditors and audit committee regarding all significant deficiencies and material weaknesses in the company's internal controls and presenting in the periodic report their conclusions about the effectiveness of the disclosure controls and procedures.

  - *New "Fairly Presents" Standard.* The certification as to financial information covers not only financial statements but all financial information, including footnotes, selected financial data and MD&A. The release states that the standard of "fairly presents" with respect to the financial information is meant to be broader than GAAP requirements. The standard is meant to encompass the selection and proper application of accounting policies, the disclosure of financial information that is informative and reasonably reflects the underlying events and the inclusion of other information necessary to give investors a materially complete picture of the issuer's financial condition, results of operations and cash flows.

  - *Internal Controls and Procedures.* The new rules also require all issuers that file reports under Section 13(a) or Section 15(d) of the Exchange Act, including foreign private issuers, to establish and maintain an overall system of "disclosure controls and procedures" (a newly defined term under the Exchange Act) designed to ensure that issuers are able to timely record, process and report the information (financial and otherwise) required in their periodic and current reports and definitive proxy materials, and communicate this information to management. Issuers must evaluate these controls and procedures within the 90-day period preceding the filing date of each periodic report under the supervision and with the participation of the issuer's management, including the CEO and CFO. These rules are intended to complement existing requirements to establish and maintain "internal controls," a term that the Exchange Act defines in relation only to financial reporting and control of assets, as well as the new Section 302 certification requirements. The SEC is not requiring any particular procedures under these rules, but expects each issuer to develop a process that is consistent with its business, internal management and supervisory practice. The SEC recommends that issuers create committees (possibly including the controller, general counsel, head of risk management, head of investor relations and persons associated with business units) to consider the materiality of information and determine disclosure obligations on a timely basis and to report to senior management.

- *Application of Rules Regarding Certification.* The new certification rules apply to quarterly and annual reports filed after August 29, 2002 (although the certification requirements regarding controls become effective for reports covering periods *ending* after August 29, 2002) by any issuer under Section 13(a) or 15(d) of the Exchange Act, including foreign private issuers filing annual reports on Form 20-F or 40-F. The certification requirements do not apply to reports on Forms 8-K or 6-K. Certification requirements with respect to investment companies are treated separately under the new rules. The form of certification is contained in amended forms of the periodic reports that are part of the new rules, and no wording changes to the form of certification are permitted. Officers providing a false certification potentially could be subject to SEC enforcement action for violating Section 13(a) or 15(d) of the Exchange Act, and to both SEC and private actions for violating Section 10(b) and Rule 10b-5.

- *Separate Certification Requirements in Effect for Periodic Reports.* The Section 302 certification is in addition to, and does not supersede, the certification required under Section 906 of the Sarbanes-Oxley Act. The SEC's statement in the adopting release with respect to Section 302 certifications that reports on Forms 6-K and 8-K are "current reports . . . rather than periodic (quarterly and annual) reports" provides useful guidance that Section 906 certifications for "each periodic report containing financial statements" do not apply to reports on Forms 8-K or 6-K.

- *CEO Certification for NYSE.* The NYSE requires that each listed company CEO certify to the NYSE each year that he or she is not aware of any violation by the company of NYSE corporate governance listing standards. Every listed company must comply with this requirement within six months of SEC approval of the rule.

- *Due Diligence.* The effect of the CEO and CFO certifications under the Sarbanes-Oxley Act and the NYSE rules is that the due diligence burden will be shared by key executives who report to the certifying officers and, in larger companies, to even lower levels of executives. The CEO and CFO will require that their certifications be supported by sub-certifications. Companies will develop checklists and review procedures to assist in performing the due diligence and to create a record of what was done. This should increase both the effectiveness of internal controls and the quality of corporate responsibility at every level.

Other Requirements Applicable to Officers and Directors

- *Forfeiture of CEO and CFO Bonuses.* The Sarbanes-Oxley Act provides that if the company is required to restate its financial statements due to material noncompliance with the financial reporting requirements of the securities laws as a result of misconduct, the CEO and CFO must reimburse the company for any bonus or incentive- or equity-based compensation received during the year following the filing of the flawed report, as well as any profits on sales of company securities during that period. There is no requirement that the misconduct in question be that of the CEO or CFO.

- *Officer and Director Bar.* The Sarbanes-Oxley Act lowers the standard for a court to bar a person from being a director or officer of a company for securities law violations from "substantial unfitness" to "unfitness." In addition, the SEC may seek a bar in an administrative proceeding.
- *Bar on Personal Loans.* Effective July 30, 2002, the Sarbanes-Oxley Act prohibits companies from making personal loans to directors and executive officers; this requirement will essentially eliminate all personal loans to directors and executive officers, and, unless clarified, cashless exercise of stock options, split-dollar life insurance plans and numerous other extensions of credit. Existing loans may stay in place, but they may not be modified or renewed. Certain limited classes of loans are excepted if they are made in the ordinary course of a company's consumer credit business and made on the same terms as generally made to the public.
- *Freeze on Payments.* The Sarbanes-Oxley Act gives the SEC the authority to seek a temporary court order to freeze "extraordinary payments (whether compensation or otherwise)" to directors, officers, employees or agents of a company if there is an ongoing securities investigation of the company or those persons. The freeze will be effective for 45 days unless set aside by a court, and may be extended upon good cause for an additional 45 days or, if the individual is charged with any securities law violation during such period, until the conclusion of any related legal proceeding.

Insider Trading and Financial Disclosure Requirements

Insider Trades

- *Accelerated Disclosure of Insider Trades.* The Sarbanes-Oxley Act amended Section 16(a) of the Securities Exchange Act of 1934 to require earlier filing by corporate insiders of changes in beneficial ownership on Form 4. Under the Act, reports that previously were due on the tenth day of the month following the month in which the transaction occurred will now be due on the second business day following the transaction. Aside from the accelerated deadline for Form 4 filings, the principal amendment was the expansion of the class of transactions reportable on Form 4 to include the grants, cancellations and re-pricings of stock options and the other transactions that are exempted from Section 16(b) "short swing profit" recovery by Rule 16b-3. Such transactions were previously required to be reported only annually on Form 5. Transactions previously reportable on Form 5, other than those referred to above, can still be reported on Form 5 annually. Transactions previously exempt from Section 16(a) reporting remain exempt under the new rules. The new two-business-day period begins running on the execution date of the transaction (generally, the trade date).
- *Securities Trading Bar.* The Sarbanes-Oxley Act precludes directors and executive officers from trading in company securities acquired as compensation during any employee plan

blackout period; the remedy is disgorgement of profits. This requirement will be effective January 26, 2003.

Securities Analysts

- *Conflict of Interest.* Conflict of interest rules in the Sarbanes-Oxley Act will restrict investment bankers' involvement with analysts; prohibit retaliation for adverse research reports; and define research blackout periods following offerings in which the firm has participated as underwriter or dealer. These rules will be implemented by SEC or stock exchange rules no later than July 30, 2003.
- *Conflict Disclosure.* Conflict disclosure rules in the Sarbanes-Oxley Act will require disclosure of an analyst's holdings of company securities and any compensation or client relationship between an analyst and a company (including any compensation paid to an analyst based on investment banking fees). These rules will be implemented by SEC or stock exchange rules no later than July 30, 2003.

Financial Disclosure

- *Financial Reports.* Effective July 30, 2002, the Sarbanes-Oxley Act requires that financial reports reflect "all material correcting adjustments" identified by outside auditors. The Act also requires the SEC to review companies' filings at least every three years.
- *Off-Balance Sheet Transactions.* The Sarbanes-Oxley Act requires the SEC to adopt rules by January 26, 2003 that companies disclose all material off-balance sheet transactions, arrangements, obligations, contingencies and other relationships of the company with unconsolidated entities or other persons that may have a material current or future effect on overall financials or on "significant components" of revenue or expenses.
- *Pro Forma Information.* The Sarbanes-Oxley Act requires the SEC to adopt rules by January 26, 2003 that pro forma financial information included in SEC reports or press releases be presented so as to not be misleading. In addition, pro forma information must be reconciled with the financial condition and results of operations of the company under GAAP.
- *Current Reporting.* The Sarbanes-Oxley Act requires companies to disclose "on a rapid and current basis" such additional information in plain English concerning material changes in their financial condition or operations, which may include trend and qualitative information, as the SEC determines by rule is necessary or useful. No deadline is specified for SEC rulemaking. This requirement has major implications and may, depending on the SEC's rules implementing the new laws, push the U.S. system of disclosure toward the English disclosure model.
- *Principles-Based Accounting.* Under the Sarbanes-Oxley Act, the SEC is required to conduct a study by July 30, 2003 on the adoption by the U.S. financial reporting system of a principles-based accounting system. The study will examine the extent to which principles-based accounting and financial reporting exists in the United States, the length of time required and the methods that would be used to change from a rules-based to a principles-based system. The study will also undertake a thorough economic analysis of the implementation of a principles-based system.

- *Proposed Form 8-K Disclosure Rules.* Prior to the adoption of the Sarbanes-Oxley Act, the SEC proposed rules designed to enhance investor confidence by requiring companies to provide more current disclosure about specified significant corporate events. The proposed rules would add many new items to the list of events that require a company to file a current report on Form 8-K:

    - Execution, amendment or termination of a material agreement not made in the ordinary course of the company's business;
    - Termination or reduction of a business relationship with a customer that would result in a loss of 10% or more of the company's revenues;
    - Entry by the company or a third party into a transaction or agreement, or the occurrence of an event (including default or acceleration events), that would create or trigger a direct or contingent financial obligation that is material to the company;
    - Definitive commitment to take actions, including plans to exit an activity, under which material write-offs or restructuring charges will be incurred under GAAP;
    - Determination by the board (or officers where board approval is not required) that the company is required to record a material impairment charge under GAAP;
    - A change in the company's credit rating or outlook, the refusal to assign a credit rating after being requested by the company, or the issuance of a credit watch on the company by a rating agency to whom the company provides information;
    - Notice from a national securities exchange or association that the company or its securities do not satisfy its listing standards or have been delisted;
    - Notice from the company's current or previous independent accountants that the company should not rely on a previously issued audit report, or a board or audit committee conclusion that any previously issued audited financial statements should no longer be relied upon;
    - Any event (such as a lock-out period) that materially limits, restricts or prohibits participants in the company's broad-based employee benefit, retirement or stock ownership plans from acquiring or disposing of their plan assets, other than restrictions based on access to material non-public information;
    - Unregistered sales of equity securities and material modifications to rights of securityholders (these items were formerly included in other Exchange Act reports);
    - Departure of a director for any reason, or the election of a new director other than at an annual meeting;
    - Departure or appointment of a company's CEO, president, COO, CFO or chief accounting officer; and
    - Amendment to a company's certificate of incorporation or bylaws not disclosed in a proxy or information statement.

- *Disclosure of Non-Binding Agreements.* While agreements still under negotiation would not require Form 8-K disclosure, the proposed disclosure of the execution or amendment of material agreements would cover both definitive agreements, such as merger and other business combination agreements, as well as letters of intent and other non-binding agreements. Companies would be required to file a copy of the agreement or letter as an exhibit, together with a description of the material terms and any other material relationships between the parties.
- *More Rapid, Fuller Disclosure.* The proposed rules would create a uniform filing period of two business days for all mandated Form 8-K disclosure items, compared to the current range of five to fifteen days. Many of the proposed Form 8-K items would require companies to provide explanations, including management's analysis of the expected effect of the event on the company. The SEC expects such explanations to be as specific and quantitative as possible.

Foreign Private Issuers

The Sarbanes-Oxley Act

The Sarbanes-Oxley Act does not contain any exemption for foreign private issuers. In particular, the following two items may require foreign companies to make changes in their corporate governance structures.

- *CEO/CFO Certification.* The Act requires that each annual report on Form 20-F or Form 40-F that is filed with the SEC include a written certification by the CEO and CFO. This requirement will necessitate the creation and maintenance of adequate internal controls to enable the officers to provide their certifications.
- *Independent Audit Committees.* The Act requires that every public company create and maintain an audit committee that meets independence standards.

The NYSE Rules

The proposed NYSE rules generally do not apply to foreign private issuers, with the following exception:

- *Disclosure of Differences.* The NYSE rule requires that a foreign private issuer disclose, in English, in its annual report or on its website, any significant ways in which its corporate governance practices differ from those followed by domestic companies under NYSE listing standards. This may be a brief, general disclosure rather than a detailed analysis. Every foreign private issuer must comply with this requirement within six months of SEC approval of the rule.

The Integrity of the Securities Market

In addition to the studies mentioned above, the Sarbanes-Oxley Act calls for various additional studies to be undertaken, with reports to be produced within six months to one year of the Act's enactment. The studies described below are intended to examine, from different angles, the integrity of the securities market, the role of various actors in the recent crisis and solutions to rebuild investor confidence and ensure the quality of the market. They have the potential of resulting in further major changes.

- *GAO Study Regarding Consolidation of Public Accounting Firms.* The Comptroller General of the United States is required to conduct a study identifying the factors that have led to the consolidation of public accounting firms since 1989, and the present and future impact of that consolidation on capital formation and securities markets, both domestic and international. The study will focus on possible solutions to any negative effects on capital and markets, including ways to increase competition and the number of available public auditors. The study will also attempt to identify the problems faced by business organizations that have resulted from limited competition among public auditors, including higher costs, lower quality of services, impairment of auditor independence and lack of choice. The study will consider whether and to what extent federal or state regulations impede competition among accounting firms.

- *Commission Study of Credit Rating Agencies.* The SEC is required to conduct a study of the role and function of credit rating agencies in the operation of the securities market. The study will examine the role of rating agencies in the evaluation of issuers, the importance of that role to investors and the functioning of the securities markets, any impediments to the accurate appraisal by rating agencies of the financial resources and risks of issuers, any barriers to entry into the business of acting as a rating agency and any measures needed to remove such barriers, any measures that might improve the dissemination of information concerning resources and risks of issuers when rating agencies announce ratings, and any conflicts of interest in the operation of rating agencies and any measures that should be taken to prevent or ameliorate the effects of such conflicts.

- *SEC Study of Securities Law Violators and Violations.* The SEC is required to conduct a study, based on the four-year period from January 1, 1998 to December 31, 2001, to determine the number of securities professionals (including accountants, accounting firms, investment bankers and investment advisors, brokers, dealers and attorneys) who have been found to have aided and abetted a violation of the federal securities laws without being sanctioned or penalized in any way, and the number of securities professionals who have been primary violators of the federal securities laws. In addition, the study will yield a description of the violations committed by these professionals, including the specific violations, the sanctions and penalties imposed upon them (if any), the occurrence of multiple violations by the same persons, and the amount of disgorgement, restitution or fines that the SEC has assessed and collected from the violators.

- *SEC Study of Enforcement Actions.* The SEC is required to study all enforcement actions over a five-year period involving securities reporting violations and financial restatements to identify areas that are most susceptible to fraud, manipulation or inappropriate earnings management.

- *GAO Study of Investment Banks.* The Comptroller General of the United States is required to conduct a study of whether investment banks and financial advisers assisted public companies in manipulating their earnings and obfuscating their true financial condition. The study will address the role of investment banks and financial advisers in the collapse of

Enron, in the failure of Global Crossing, and generally in creating and marketing transactions that may have been designed solely to enable companies to manipulate revenue streams, obtain loans or move liabilities off balance sheets without altering the economic or business risks faced by the companies.

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